White Paper

Positive Indicators Point to an Upbeat 2010 M&A Middle Market Forecast

FOCUS

Investment Banking

Seasoned, Systematic, Successful℠

Seasoned, Systematic, Successful℠

Table of Contents

Positive Indicators Point to an Upbeat 2010 M&A Middle Market Forecast

By Doug Rodgers, Chief Executive Officer and Managing Partner, FOCUS

Despite an unprecedented worldwide economic meltdown, FOCUS' middle market merger, acquisition, divestiture and corporate finance business remained active in 2009. On average, the firm served over 40 clients in any given month, and closed 12 transactions during the year.

At the beginning of a new year, it is useful to look back and assess what happened in 2009, and then to look forward to define the trends we believe will make a difference in the middle market M&A industry in the coming year.

Learning from the Challenges of the Past

The period from the third quarter of 2008 through the first quarter of 2009 was reminiscent of the late 1980s when the US experienced "unthinkable" business failures that surprised and, to some extent, frightened everyone:

- Major financial institutions failed: Continental Illinois Bank, Seattle First, and Drexel Burnham Lambert, along with many regional banks and large savings and loan banks.
- The entire US steel industry collapsed, creating the "rustbelt" economy as a whole.
- Oil and oilfield services industries cratered as oil fell from $32 to $6 in 18 months.

In a similar pattern, the period from late 2008 through 2009 produced a new phrase—"too big to fail"—along with a surge of "improbable" business failures and serious setbacks:

- Major financial institutions failed (or required government bailouts)—Bear Stearns, Lehman Bros, AIG, Wachovia, and National City Bank plus 137 local and regional banks, according to Bankrate.com.
- The entire US automotive industry was at risk—General Motors and Chrysler visited bankruptcy court, along with dozens of auto parts suppliers.

Generally, throughout 2009, there was a widespread loss of confidence in our economic system and its regulators. Unemployment kept rising with virtually no end in sight, and consumers, business owners, and business leaders exhibited a general inability to place any bets on the future due to fear, uncertainty, and doubt. In the media, pundits gained recognition by selling bad news and a long, slow recovery.

The Good News—Prosperity Usually Follows Pain

The late 1980's were both painful and scary. However, the time was followed by a long period of prosperity. Booms and economic blips generally are more fragile and fleeting than we perceive at the time, and recovery may be more likely and earlier than we expect. In my opinion, in 2010, the US economy and regulatory system will continue to recover from the events of 2008/9, recovering gradually, with a few speed bumps along the way, but faster than the pundits predict.

We do expect the coming economic expansion phase to be industry selective. Just as the recovery of the 1980s did not bring back lost jobs in the steel industry, this expansion will not bring back the lower skill jobs lost in our lower tech manufacturing sector. These jobs have been, and will continue to be going offshore, leaving a significant population of long term unemployed who may be destined for "under employment" unless they retrain for the world of the 20-teens.

Unemployment Rates by Educational Achievement

Education (25 years & older)	Dec-07	Nov-09	Change Dec-07 vs. Nov-09
Less Than High School	7.5%	15.0%	7.5%
High School Graduate	4.6%	10.4%	5.8%
Some College/Assoc. Degree	3.7%	9.0%	5.3%
College Graduate & Above	2.1%	4.9%	2.8%
Overall Unemployment Rate	4.9%	10.0%	5.1%

SOURCE: Tim Duy's Fed Watch based on U.S. Department of Labor data.

The graph above shows the unemployment rates based off of educational achievement (for those over 25 years and older) at December 2007 (the start of the current recession) and November 2009. The lower the educational achievement, the higher the unemployment rate and the greater the increase in unemployment rates since December.

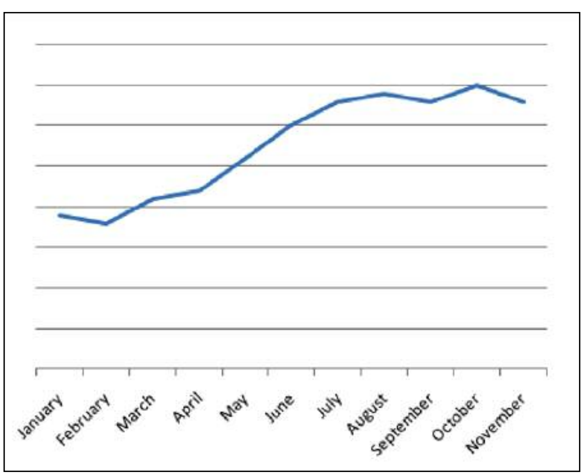
Looking Back to Move Forward

In early 2009, FOCUS published a summary of middle market M&A trends for the coming year, believing that the middle market would remain a steady generator of transactions. We concluded that:

- Foreign investment was down but not completely out—with all of its issues, the US is still a compelling place to invest.
- Availability of financing would be key, and as companies became more realistic about their price and value expectations, it would create opportunities.
- Deals were out there if you know where to look with offerings from sectors perceived as less risky presenting the most M&A opportunities, including information technology; government, aerospace and defense; and business services.
- Retiring baby boomers would be selling out—seven million US companies are owned by individuals 44 to 62 years of age.

For the most part, these trends held true, but a number of other things impacted the 2009 M&A climate. The lack of available debt drove many financial buyers out of the market. However, strategic buyers (especially public companies) remained cautiously active, and surprisingly still paid strong prices for solid companies, particularly for targets that filled a strategic void in their offerings.

FOCUS New Client Intake (trailing six months)



At FOCUS, each successive quarter of 2009 saw gradual improvement over the prior quarter, and new client intake returned to 2007 levels, as shown by graph below.

Signs of 2010 M&A Middle Market Improvement

After waiting on the sidelines since the summer of 2008, sellers are returning to the market, as they accept reality and get on with life and business, providing a "pent up supply" of sellers.

Continued pressure on the US dollar and exchange rate encourages activity in the US M&A sector from offshore buyers as demonstrated by FOCUS' recent engagement by European and Indian firms to source acquisitions in the US market.

Gradual improvement of debt markets will bring more buyers into the market in 2010. Financial buyers are beginning to return, but in smaller numbers. In addition, strategic buyers are becoming more active as the economic forecast continues to improve, according to a variety of objective sources:

Indicators point to improving economy: *The Leading Economic Index has been on an uptrend for more than half a year and it is now slightly higher than its latest peak in July 2007. Improving financial conditions, labor market indicators, and housing permits have helped the LEI continue its gains…The indicators point to improvement in the new year. The US LEI increased for the eighth consecutive month.*—December 17, 2009 | The Conference Board Leading Economic Index™

More robust funding and planning: *For the first time this year, a majority of executives expect consumer demand for their goods to rise in the near term. Respondents offer relatively positive views of the economy and say they can now make longer-term strategic plans. However, many expect investment decisions over the next two years to be affected by heightened exchange rate volatility.*—McKinsey Global Survey December 2009

Early forecasts of reduced DoD spending may have been exaggerated: *According to insidedefense.com, the White House will increase the defense budget (not including overseas operations) by as much as $14 billion more than was originally slated for the 2011 budget, up to $556 billion. Significant opportunities for contractors will be available—total defense funding requested will be above $700 billion for the first time in history.*

US Consumer Confidence Edges Higher in December 09: *Consumer confidence rose for the second straight month as more Americans expect the U.S. economy to improve in 2010, The Conference Board reported on December 29, 2009. The index climbed to 52.9 in December from a revised 50.6 in November. According to Lynn Franco, research director at The Conference Board, "A more optimistic outlook for business and labor market conditions was the driving force behind the increase in the expectations index."*

2010 Availability of Bank Credit for M&A Transactions

Currently, a limited number of banks are making loans for M&A. When available, senior debt is one to two times earnings before interest, taxes, depreciation, and amortization (EBITDA), and generally in the form of asset-based lending. Mezzanine debt providing total debt of two to three times EBITDA is generally available, and sometimes more available than senior debt. When debt is available, the due diligence process and the length of time required to get to closing may be very painful.

2010 Market Influence of Private Equity for M&A

During 2009, most private equity focused on resolving portfolio company issues. The M&A deals they did pursue tended to be add-ons to existing portfolio companies, and generally were done at bargain prices. In 2010, we expect private equity buyers to become more active as debt becomes more available, but at lower pricing multiples than the prior business cycle. Many private equity firms will develop new models that will work in the lower leverage market environment.

2010 M&A Business with Public Companies

In 2010, companies defined as "small cap" (valued from $300 million to $2 billion) will be sellers and "go private" candidates as the cost of being public continues to punish them. Many small caps may have problems with access to debt, from both public and private sources. However, perceived risk associated with their small size may keep their stock prices low, creating attractive targets for "mid-cap" ($2 to $10 billion) companies. Mid-cap companies will be least affected by the debt crunch, becoming more active M&A buyers, taking advantage of attractive pricing, and getting ready for the next expansion.

Best Business Sectors in 2010

Going forward in 2010, businesses with predictable and/or recurring revenues will be most active in M&A, including the following sectors:

- Energy: especially alternative energy, oil, gas, and related energy services
- Food and food service
- Government, aerospace, and defence
- Healthcare and life sciences
- Information technology
- Rail transportation and related products and services
- Security: physical and electronic
- Telecom and wireless

Looking Forward to a Robust 2010

As the economy continues to improve in 2010, we expect increased middle market merger, acquisition, and corporate sale activity, driven by acquirers utilizing M&A strategies both for growth and for strategic capability/customer acquisition. We also expect to see deals driven by lenders who are forcing borrowers to move their credit somewhere else or reduce the level of leverage on their balance sheets. In part, the continuing success of FOCUS reflects a special brand of client service that delivers a unique blend of investment banking and corporate development consulting services. We look forward to expanding opportunities and a prosperous new year.

Seasoned, Systematic, Successful℠

FOCUS Closed 12 Deals in 2009

Last year, FOCUS completed 12 M&A assignments. Of particular note are the following eight publicly-disclosed M&A transactions:

Information Technology Sector

Allin Corporation—Sell Side

Allin Corporation's Microsoft IT consulting and solutions segments were acquired by Dell. The sale involved Allin's business units located in Pittsburgh and Philadelphia, PA and San Jose and Walnut Creek, CA and focused on consulting services around Microsoft's core infrastructure as well as business management software and services.

Global Software—Sell Side

Global Software Corporation was acquired by Harris Computer systems, a division of Constellation Software, Inc. Global Software is a leading provider of law enforcement records management, computer aided dispatch and jail management software solutions to the public safety market. Harris Computer is a wholly owned subsidiary of Constellation Software, a leading provider of financial management and customer information systems software solutions.

Pepperweed Advisors—Sell Side

Pepperweed Advisors was acquired by Cognizant. Pepperweed Advisors is the information technology consulting service division of Pittsburgh-based Pepperweed Consulting, the largest Hewlett-Packard software partner in North America. Cognizant, headquartered in Teaneck, NJ, is a Forbes Global 2000 company and a member of the Fortune 1000. This acquisition allows Cognizant to expand its IT Infrastructure Services practice in two areas – IT Service Management and IT Asset Management.

Government, Aerospace & Defense Sector

Newtek International —Sell Side

Newtek International, Inc., an IT services firm, was acquired by Zantech IT Services, Inc. Newtek provides software engineering, IV&V and program management to civilian and federal defense customers, including Army, Labor, HUD, DHS, FEMA and others. Zantach IT services is excited about this acquisition which gives them a jump start toward their growth goals.

Nextek —Alternative Finance

Alabama-based, Nextek, Inc. has entered into a $6,419,000 senior term and working capital loan facility to replace its previous banking and subordinated debt arrangements. The banking services provided by Cole Taylor Bank will help Nextek continue to grow and will save a significant amount of operating expense by taking advantage of the favorable financing terms as compared with its prior financing arrangements.

Healthcare and Life Sciences Sector

Verify Solutions—Sell Side

Verify Solutions, a healthcare auditing company was acquired by HMS Holdings Corporation, the nation's leader in cost containment, program integrity and coordination of benefit solutions for government funded and commercial healthcare entities. The acquisition allows HMS to provide additional services that follow their mission to help control healthcare costs.

Education Sector

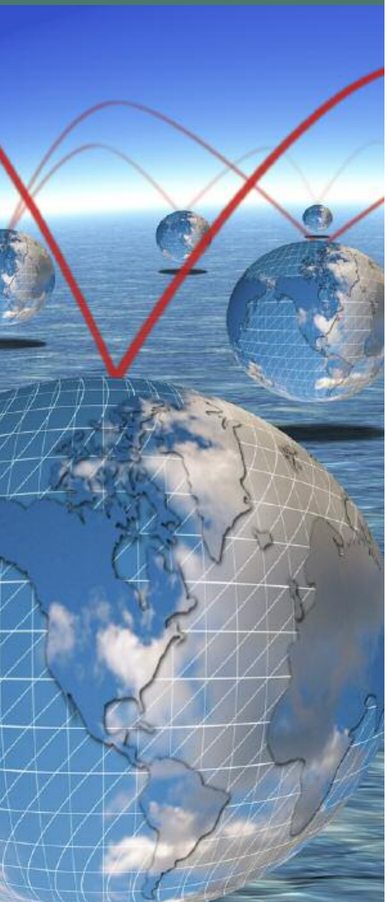
Performance Pathways—Sell Side

Performance Pathways, Inc., a leading provider of instructional management software for K-12 school districts, was acquired by SunGard Public Sector's K-12 Education Business Unit. Performance Pathways' products are a natural extension of SunGard Public Sector's PLUS Solutions integrated product suite offered to K-12 school districts.

Business Services/Call Center Sector

TouchStar—Sell Side

Assets from Denver-based TouchStar Software Corporation have been acquired by Noble Systems Corporation, based in Atlanta. The acquisition further improves Noble's small and medium business offering to complement its large enterprise offer and provides TouchStar users a way forward with the resources of an experienced contact center technology partner.



FOCUS Industry Practice Groups

Education & Human Capital | www.focusbankers.com/education

Energy | www.focusbankers.com/energy

General Middle Market Businesses

Government, Aerospace & Defense | www.focusbankers.com/gad

Healthcare & Life Sciences | www.focusbankers.com/health

Information Technology | www.focusbankers.com/technology

Internet & Digital Information Group | www.focusbankers.com/idi

Seasoned, Systematic, Successful℠

About FOCUS, LLC

Founded in 1982 in Washington, D.C., FOCUS, LLC provides a range of investment bank services tailored to the needs of middle market businesses and their executives. Today, we are a national firm serving clients from offices in major cities across the United States. FOCUS specializes in serving business units with revenue or transaction sizes between $5 and $300 million, serving entrepreneurs, corporate owners and various types of investors. FOCUS clients include large corporations and private equity firms that engage the firm for middle market transactions.

FOCUS has achieved a very high close rate on accepted buy side, sell side and corporate finance mandates because of the unique resources, process and perspective that we bring to middle market investment banking. FOCUS has developed a systematic, research driven, open and proven transaction process. It is the driving force of our firm and distinguishes us from other investment banks serving the middle market.

With extensive investment banking transaction experiences and a group of seasoned operating and financial executives, our firm provides a unique value proposition. We bring a strong operating perspective, a wealth of practical experience and a unique research and transaction process to our middle market clients. Our knowledgeable resources include seasoned partners managing directors, principals, research staff, internal databases of national and international contacts and deal experience in a range of industry sectors.

Securities transactions conducted by FOCUS Securities LLC, an affiliated company, registered Broker Dealer member FINRA/SIPC

FOCUS

Investment Banking

1133 20th Street, NW
Suite 200
Washington, DC 20036

202-785-9404
202-785-9413 fax
www.focusbankers.com