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Catch the Wave in 2005

Timing Issues in Selling A Company

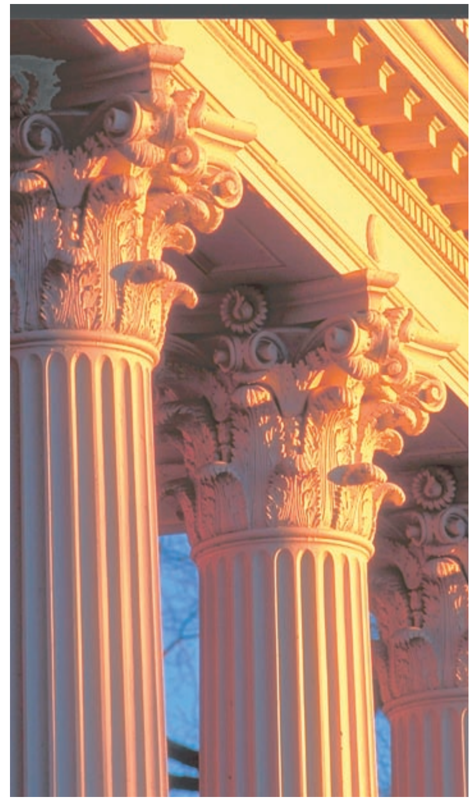
With the recession of 2000 behind us and the economy growing for the past several years, many private owners are asking about the condition of the market for selling their companies. Market conditions as we enter 2005 are extremely favorable for a seller and the next couple of years may prove to be a peak in pricing for mid market private companies. A review of the capital markets, business climate, and supply and demand for deals suggests that a private owner considering a sale should grasp the opportunity and strongly consider a sale of the business.

As advisors to private owners we consider a range of factors in evaluating the best timing for a sale. For the moment set aside the array of personal objectives that may guide an owner to sell and focus on the critical factors that drive valuations and pricing of transactions. We generally look at four areas when assessing timing:

1. The characteristics of the supply and demand for business acquisitions.
2. The supply and cost of capital to support those acquisitions.
3. The overall state of the economy from a macro economic perspective.
4. Specific company performance related variables.

In the discussion below we conclude that the current confluence of factors points to the current situation as a unique sellers market. This sellers market should hold its crest for 1-2 years before beginning to taper in the intermediate term.

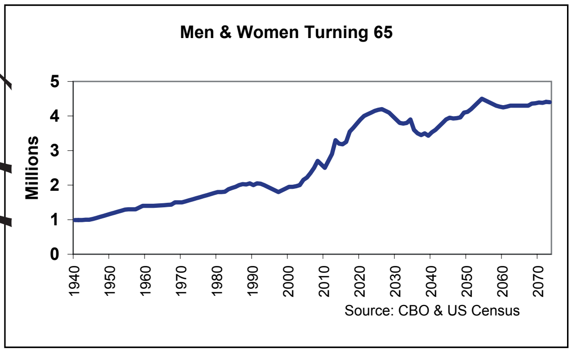
Demand is high, the capital markets are flush, the long term demographic and economic pressures are favorable.... Private owners planning a sale should grab their board and ride the exceptional wave over the next several years...



EVARTS CAPITAL
Private Investment Banking

Todd Peter is a partner of Evarts Capital, a Cleveland based investment bank serving lower mid market companies.

Supply



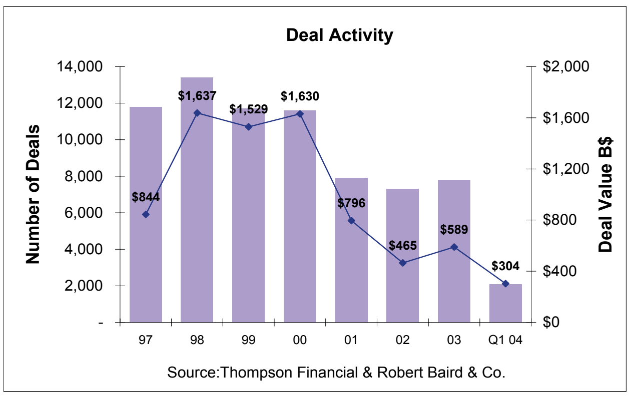
Most private businesses come to market as the owner approaches retirement. It is widely reported that private business only successfully transfer to a second generation in about 30% of cases. Additionally this group has faced a period where the business acquisition markets have been less than favorable and economic times have been weak, delaying the normal number of exits.

The population data graphs at left shows a simple extrapolation of the recent decades of census data that the "retiring population" (and presumably the retiring business owner population) will be increasing greatly.

During the period from 2001 to late 2003 the number of companies coming to market has diminished, and the M&A statistics for the period show a dramatic reduction in deals completed. Although supply has increased in late 2003 and 2004 the number of deals still lags and competition for purchases is high.

The market supply characteristics are very favorable to sellers, and while this continues in 2005 the trend over the next 5 years will be towards increased supply. This relative reversal will reduce seller negotiating power.

Over the next 5-10 years the number of private companies coming to market is expected to surge driven by pent up retirements and demographics.



Demand

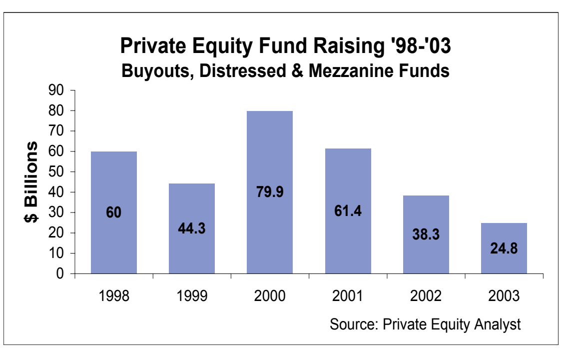
The demand for lower and mid market acquisitions is driven by three groups of buyers. First are strategic corporate buyers, the traditional best exit path for a private company. During the economic slowdown most corporate buyers reined in M&A spending to preserve cash and liquidity to weather the recession. Four years of cost cutting and consolidation have pretty much run the course and corporations are looking again for top line growth and have reentered the M&A playing field.

Second and most dramatic in appetite has been the growth of the private equity marketplace for mid market companies. The private equity industry has evolved over the last 2 decades from an initial focus on very large deals, and over time increasingly focused on the mid market. These funds raised enormous amounts of capital in the mid to late 1990's.

During the recession the funds spent several years dealing with restructuring their investments and reacting to the poor economy in 2001- 3. Now after a hiatus of low deal activity, investing interest and activity is high. Many funds with remaining un-invested capital are nearing the end of their investment cycles and are aggressively moving to commit capital to deals rather than having to return capital to limited partners. Deal prices have rebounded reflecting this cycle.

In the lower portion of the mid market, typically deals under $10 million, a key element of demand are the displaced senior executives from corporate life that are now out seeking to acquire an entrepreneurial business. These buyers, often supported by the smaller private equity groups or friends and colleagues, are hungry and ready buyers for smaller deals

Today, flush private equity firms, rebounding strategic buyers and a healthy crop of entrepreneurs provide a swelling demand for mid market acquisitions across the deal size spectrum



Over the next 2-5 years private equity funds will temper their pricing as more deals enter the market and the uninvested capital overhang is reduced.

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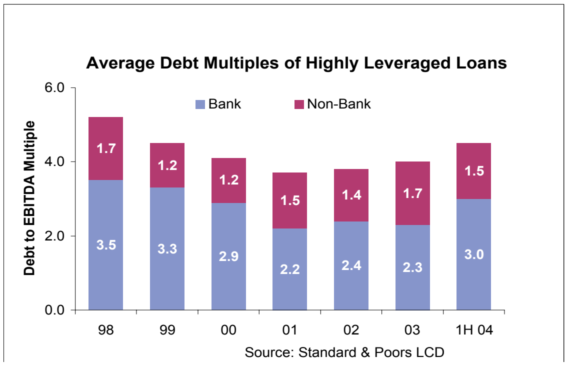
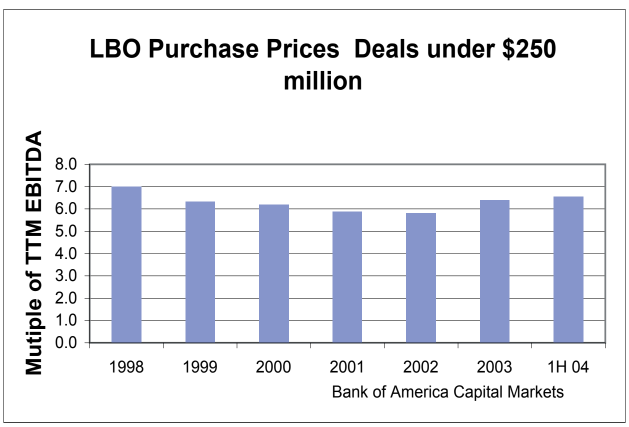
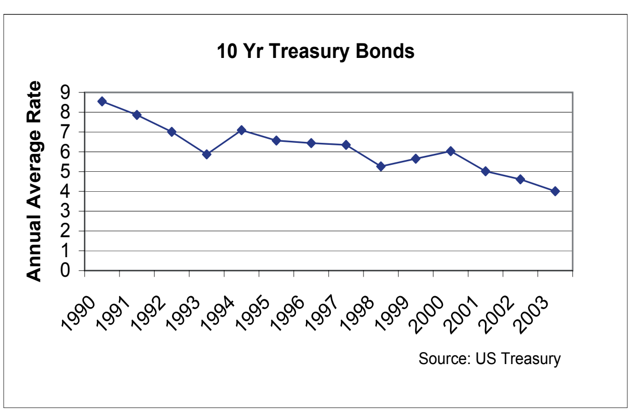
Capital Supply



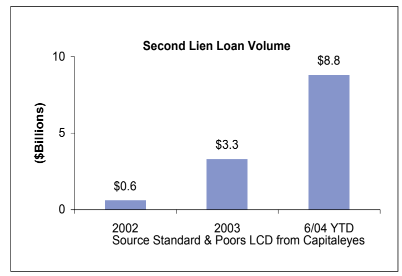
....secured debt, subordinate debt and equity capital are plentiful and supportive of strong valuations





The price a buyer is willing to pay for a company is driven by their cost of capital. The lower the cost of capital or expected return, the higher the price a buyer can pay. Lower cost of capital increase deal prices.

In 2004/5 the supply of capital is very favorable for acquisitions. The banking industry has rebounded from the pessimism and credit squeeze of 2001- 2002 and are anxious to again begin to grow invested capital and drive their own revenue line. Lending multiples of EBITDA have increased across the deal spectrum typically by .75 to 1 turns of EBITDA from the low point in 2001. With interest rates still extremely low by historic standards the senior lending markets are providing a good base of low cost capital that supports strong valuation multiples.



Additionally, the private capital markets have spawned a number of new non-bank lenders in the senior, senior subordinated, asset based arenas. Free of regulatory constraints, these sources are stretching lending levels at very reasonable premiums to traditional bank rates. A great deal of the supply of capital in this segment is coming from hedge funds in both cash flow and asset based type loans.

Large corporate buyers are often influenced by their stock price performance, and the improvement in stock valuations in early 2004 began an increase in large merger activity. This indirectly contributes to a real or perceived better priced currency to support acquisition efforts.

The private equity funds are motivated to put capital to work and are lowering their IRR expectations somewhat as reflected in higher multiples and higher equity capitalization of deals. The drop in expected returns is consistent with the apparent extreme efficiency of transactions in the middle markets where multiples being paid at times touch on public equity EBITDA multiples. Overall the cost of capital trends in private equity argue that equity pricing is at a low point and that now is an excellent time to go to market.

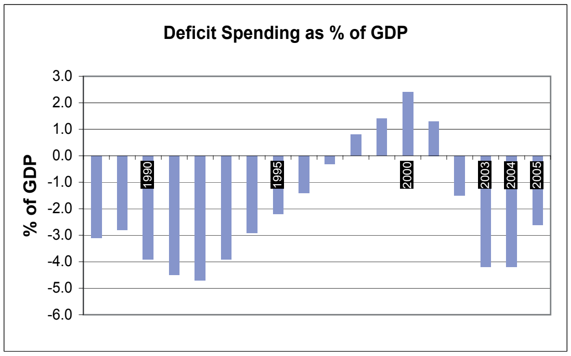
Capital supply is strong at all levels of the balance sheet.

Economy

The overall economic environment and uncertainty levels about future economic growth impact the ability to sell a company and hence the ultimate transaction value. The US macro economic environment is being buffeted with three fundamental trends - global competition, monetary policy, and government deficits.

Since 2000 the combined policy actions of the US government and Federal Reserve have been extremely supportive at a macro economic level to the economy. The combination of tax cuts, record low interest rates, and deficit spending provided substantial stimulus and growth in the economy.

The increase in fiscal deficits, the current account trade deficit and the longer term need to fund the baby boomers' Social Security expenditures argue for pressure over the next decade to flatten spending, or raise taxes. Much as with interest rates, fiscal policy over the next 5 years will likely be stable or less stimulative than at present.



The rise of China and India as emerging economic superpowers has already had an impact on the US economy and business valuations. Across the industrial heartland any business subjected to the pricing pressure of offshore production or outsourcing has declined in value. The enormous supply of educated labor and extraordinarily low cost of unskilled labor in the Far East will continue to suppress pricing and profitability of US firms without unique competitive advantages. The record levels of the current account deficit will add considerable uncertainlty to exchange rates and upward pressure on US interest rates in the next 3-5 years.

These growing economies will eventually emerge as acquisitive offshore buyers seeking strategic footholds in the US market as have European and Japanese buyers. While an encouraging long term factor for sellers, this new demand will likely take 3-5 or more years to fully develop.

The present macro economic conditions strongly argue that the present is a favorable time to sell.

Company

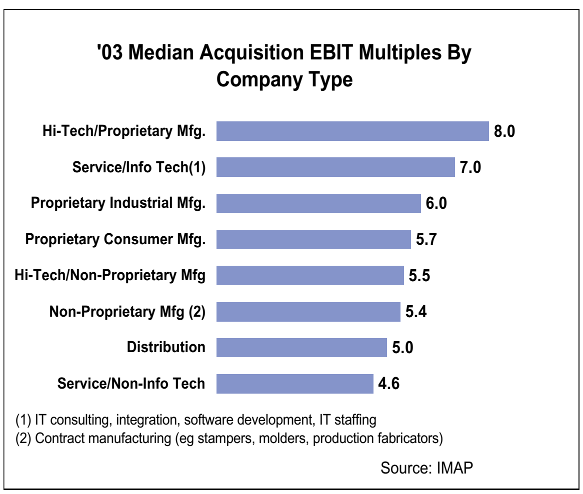
It would be an exceptional event when the external markets, or the macro economic environment overwhelm the underlying specfic company performance attributes that drive valuation, but they can be the icing on the cake.

A company's financial performance and industry factors drive the valuation level of a company. The normalized cash flow performance of the company will have the largest impact on company value. A company considering a sale should be able to demonstrate a track record of earnings. The longer the track record the higher the company will be valued by the market. Deviation from normal values that can be explained clearly, such as a recession and demonstrated recovery, or a failed new product and implemented corrective action, or an underperforming division and a completed divestiture of that division, can be overcome in the sale process. Demonstrated growth in earnings will argue for a boost in valuation multiples.

Industry characteristics and growth prospects will impact value. A company outperforming its industry growth rates will be able to attain superior valuations even when broader metrics may be less favorable.

A company may find that their industry sector is highly sought after. This may be due to general industry considerations or specific factors such as industry consolidations like those in industries from video rental to funeral homes to banking. These artificial and external factors can transform a bad time to sell into a perfect one!

The capital markets, economy, and seller/buyer supply will not overwhelm company performance in determining value but may swing the range of value by +/- 25% from peak to peak. The perfect time to sell couples strong company performance with exceptional external market factors.



Summary

The present number of buyers exceeds the sellers by a substantial margin across the spectrum of deal size. The number of sellers and supply of businesses should increase over the next 5 – 10 years. The cost and availability of debt and equity capital are favorable and unlikely to improve substantially over the 5 years. The current economic environment, while not perhaps the best of times, may prove to be relatively strong. The globalization of the world economy may pressure future valuations. ***A company considering a sale or liquidity transaction in the next few years would be wise to gather their advisors and evaluate setting the process in motion while the external environment is favorable on just about every front.***

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