

Middle Market M&A Update, Spring 2011

Summary

It's an exciting time for middle market enterprises. After months of bleak financial performance, it appears that the market has flattened out and valuations are rising.

Merger and acquisition activity picked up dramatically towards the end of 2010, and continues to appear promising throughout 2011.

Chiefly, the environment for middle market M&A transactions has been bolstered by several significant factors driving consistent demand for acquisition candidates: increased credit availability, large amounts of available cash reserves, and favorable international currency valuations sparking interest from foreign buyers. Combined, these trends present an advantageous set of circumstances for U.S. owners considering an exit strategy.

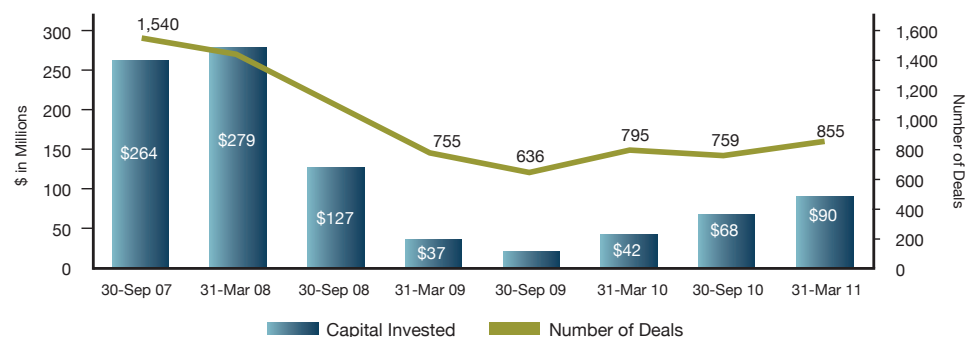
In addition, industry consolidation continues to be prevalent as a response to cost reduction pressures. Projected growth rates in specific industries are also feeding M&A activity. For corporations that experienced limited growth from existing operations during the recession, the climate has turned positive for faster expansion via acquisition.

M&A activity on the rise

Research data addressing the six-month period through March 31, 2011 demonstrates significant M&A activity, rebounding to pre-recession levels, as shown in Figure 1. A large part of this activity occurred during 4Q2010, some of which may have been prompted by the anticipated expiration of lower capital gains tax rates.

Figure 1

Rebounding M&A Activity



In 1Q2011, according to Mergermarket, the number of U.S. deals in the middle market was up nearly 54% for the quarter over 1Q2010, marking the busiest period since 1Q2007.

Interesting to note, nearly 80% of the M&A activity in 1Q2011 involved companies valued at less than \$250 million. The activity in this

segment of the middle market echoes The DAK Group's long-standing belief that these corporations are extremely attractive acquisition candidates. They are highly valued by buyers for the synergies they offer in niche areas of specialized technologies, service, customer access, or geography.

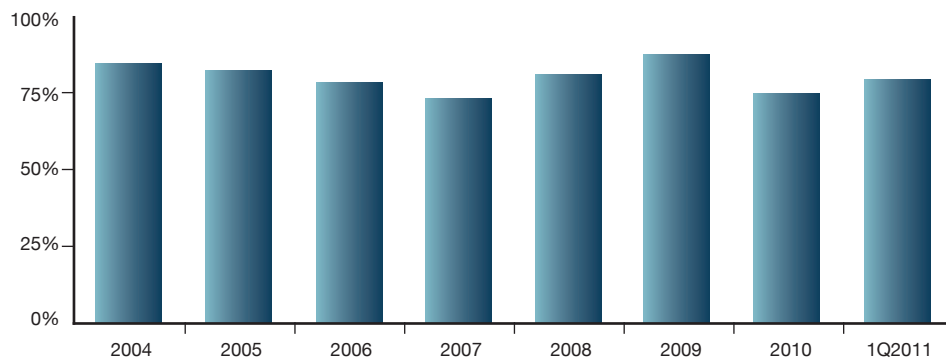


Figure 2
Percentage of Deal Volume Involving Middle Market Companies <\$250 million

Historical activity supports this view; despite the media attention given to billion dollar takeovers, transactions involving companies valued at \$50 - \$250 million continue to represent the majority of all acquisitions, as shown in Figure 2.

Borrowing a page from the strategic growth playbook, many private equity investors are initiating transactions as part of an add-on strategy; they increasingly combine new acquisitions with current holdings to gain much of the same synergy as strategic buyers. For the sixth straight year, private equity add-ons have increased as a percentage of total transactions, as seen in Figure 3.

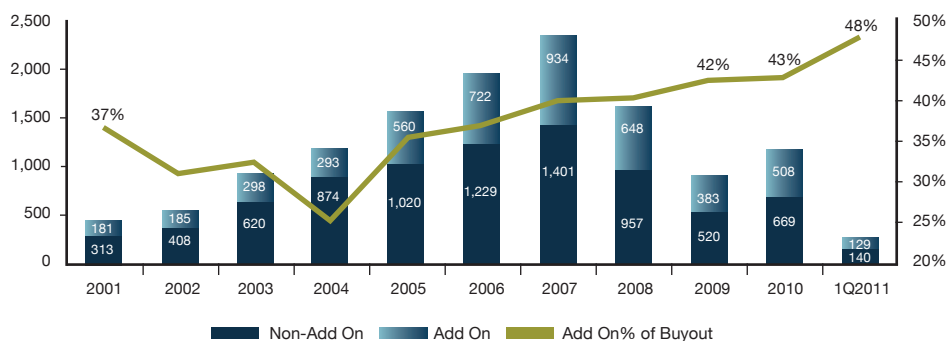


Figure 3
Strategic Add-ons continuing to be a favored plan by private equity investors

PitchBook research shows that private equity participation in M&A activity is now approximately 35% of all deals in the \$50 - \$250 million valuation segment. This figure is consistent with The DAK Group's experience; private equity participation is increasing overall, but the majority of transactions still involve strategic buyers.

As private equity investors join strategic acquirers in aggressively seeking attractive options in the middle market, valuations trend higher. Middle market enterprises occupying unique niches or offering market knowledge or access will continue to be highly attractive to bidders.

Relaxing credit terms fund activity

During the recession, willing lenders were scarce. As banks refused or were unable to lend, non-bank private lenders addressed the market to offer viable funding options.

These alternative sources, including non-bank asset-based lenders, commercial finance lenders, and factors, are somewhat more lenient and flexible in their lending terms. They are generally willing to accept more volatility in a company's historical performance; for example, instead of requiring a full year of positive earnings performance, they often will request as little as three to six months.

Eager to resume active lending and remain competitive, banks began to refine their focus more narrowly on specific industries or capital requirements. As a result, they tailored their terms, and loosened access to credit markets primarily for enterprises with demonstrable sales or earning figures.

With the greater availability of competitively priced lending options, corporations regaining credit access can once again expand, support growth or fund acquisition activity.

Excess cash on hand drives competition and demand

Due to the recent unimpressive outlook for investment opportunities, many entities hoarded cash. Funds sat idle. For example, total S&P500 cash holdings have grown 26% in one year, from \$1.5 trillion at the end of 1Q2010 to \$1.9 trillion at the end of 1Q2011. Cash now represents 8.6% of total assets compared to 4.3% in pre-recession 2007.

Private equity firms raised capital, but faced limited options for deployment. At year-end 2010, investors were sitting on \$485 billion waiting to be invested, according to PitchBook research. This translates to exceptional buying power of well over \$1 trillion, given greater acceptable balance sheet leverage.

Foreign buyers seek U.S. investment opportunities

Favorable foreign currency valuations and the push for geographic expansion have continued to feed international interest in U.S. companies. Specifically, an 85% increase in total deal value for U.S. transactions of all sizes for 1Q2011 presented a better picture than the same period a year ago. Cross-border transactions represented more than 40% of all global M&A activity in 1Q2011. A weakened dollar translates to greater buying power for international firms. Keenly aware of the value of access to the U.S. market gained through acquisition, foreign buyers seek attractive opportunities for investment.

Valuations are improving

With increasing competition for strong performers in which to invest, demand is driving higher valuations. Considering current research, as well as the experience of The DAK Group in recent transactions, generalized EBITDA multiples now hover in the 5x – 7x range for middle market enterprises.

Analysis of data from CapitalIQ, PitchBook, Mergermarket and the DAK Group's proprietary transactions indicates EBITDA multiples of 5-6x for enterprise valuations of \$10 - \$50 million, and 6-7x for valuations of \$50 - \$100 million, with outliers seen for specific, high growth industries. Greater premiums are being paid for quality enterprises with robust financial performance and low risk factors. These multiples are a welcome break from recessionary levels of less than 5x EBITDA.

Implications for middle market business owners

As the markets turn favorable, consider potential actions to take:

- Re-evaluate credit terms and structure for consistency with current market rates and conditions; refinance if existing rates are above market
- Explore strategic acquisition opportunities that support the corporate growth strategy
- Capitalize on rising market valuations; consider the possibility of divesting ownership, or disposing of non-core assets, since many buyers are actively proffering attractive bids
- Assess the company's financial fitness to undergo a transaction, and consider remedial steps if necessary

To discuss possibilities, please contact an advisor at The DAK Group or visit www.dakgroup.com

About the authors

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The DAK Group

Since 1984, The DAK Group has executed hundreds of transactions across a wide range of industries, including industrial manufacturing and distribution, telecommunications and technology, business services, packaging, consumer products and healthcare. As a leading investment bank serving the needs of middle market enterprises, it advises clients on mergers and acquisitions, financial restructuring, capital advisory, valuations and fairness opinions.

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