Grace Matthews

MILWAUKEE • BOSTON

NEWSLETTER

Summer 2003

Mergers, Acquisitions and Corporate Finance

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info@gracematthews.com

Multiple Magic: High Multiples Don't Necessarily Mean Better Values

As investment bankers regularly engaged to sell companies, we're used to hearing something like the following from new clients: "I read in *Widgets Week* that Acme Widgets, a competitor to my company, was acquired last year by Amalgamated Conglomerates, at 16 times earnings! And last year, it was reported in *Forbes* that General Widgets was sold at a multiple of 14 times earnings; so I can expect to get what, say something like 15 to 18 times earnings for my company? …" Well, maybe yes, maybe no.

Transaction multiples are the most dangerous tool in the dealmaker's toolkit: the problem is that they usually tell only part of the story. First, just what is meant by "earnings?" It could mean net income, pre-tax earnings, EBIT (Earnings Before Interest and Taxes), EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization), or even "free cash flow" (EBITDA minus capital expenditures). These are all popularly accepted measures, and journalists, even those in the financial press who should know better, don't always say which one they are using. Also, over what time period are the earnings measured? Trailing twelve months? Last reported fiscal year? Next year's projections? Are the earnings reported in conformance with GAAP or are they "pro-forma?" Depending on the answers to these questions, "earnings", and hence purchase price multiples, can vary significantly.

> ***…Purchase Price Multiples, without an accurate understanding of how they are calculated or a thorough analysis of how a transaction is structured, say nothing about the value of a deal.***

And what about the purchase price? Often, published accounts will equate the purchase price with the cash paid at closing. That's fine for all-cash asset deals where the buyer acquires the seller's net assets. The situation gets more complicated when it's a stock deal or when the transaction structure is something more than plain vanilla (as almost all are these days). For example, you will often read something like: "…In a stock-for-stock transaction, the shareholders of Company XYZ received shares of Company ABC worth $45 million…" Many people will assume that the purchase price was $45 million. But what if the seller had $15 million in debt on its books? In that case, the buyer really paid $60 million: $45 million for the equity, and an additional $15 million in assumed debt. What if a portion of the cash payment was deferred and made dependent on the acquired company's future performance (an "earn-out")? Contingent payments are clearly a part of the purchase price, but they often can't be measured at closing. And suppose a company was acquired in a down year, when its revenues and earnings were temporarily depressed? Assuming the underperformance was an anomaly, wouldn't the purchase price multiples be artificially overstated?

We could go on, but the point's been made that there's a lot more to M&A multiples than meets the eye. All this leads to one of investment banking's great unspoken truths: purchase price multiples, without an accurate understanding of how they are calculated or a thorough analysis of how a transaction is structured, say nothing about the value of a deal.

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Milwaukee: *219 North Milwaukee Street, 7th Floor • Milwaukee, Wisconsin 53202 • 414-278-1120 (p) • 414-278-1119 (f)*
Boston: *2 Oliver Street, 8th Floor • Boston, Massachusetts 02109 • 888-325-4575*

Multiple Magic: High Multiples Don't Necessarily Mean Better Values

(Continued from page 1)

Investment bankers use multiples as a kind of shorthand, a glib way to evaluate the pricing of a deal given their knowledge of the current economic environment and their experience of how similar deals have been priced in the past. They recognize the limitations of multiples and, truth be told, experienced investment bankers work multiples like professional card sharks work a deck of cards: by a careful "shuffling" of all the variables, they generally can get a result that suits their purpose.

To show how this works, consider the following example where two companies, Company A and Company B, are sold for $95 million and $90 million respectively. Assume that both have virtually identical balance sheets and income statements, but that the transactions are structured differently. In the case of Company A, net assets are sold for $95 million with the selling shareholders retaining long-term debt of $25 million. In the case of Company B, the shareholders sell stock for $65 million and the buyer assumes $25 million in long-term debt. Transaction data is as follows:

(Amounts in $millions)	Company A	Company B
	(Asset Deal)	(Stock Deal)
Cash Consideration	$95.0	$65.0
Plus: Assumed Debt	-	$25.0
Purchase Price	**$95.0**	**$90.0**
Revenues	$60.0	$60.0
EBITDA	$19.0	$19.0
EBIT	$14.0	$14.0
Pre-Tax Income	$12.0	$12.0
Net Income	$7.2	$7.2
Multiples		
Price/EBITDA	**5.0**	4.7
Price/EBIT	**6.8**	6.4
Price/Pre-Tax Income	**7.9**	7.5
Price/Net Income	**13.2**	12.5

Though both companies performed identically from a financial perspective, Company A was rewarded with a higher valuation. Should Company B shareholders be disappointed that their company was valued at $5 million less? Not necessarily. Let's take a closer look at the hypothetical deal structures from the perspective of the selling shareholders:

(Amounts in $millions)	Company A	Company B
	(Asset Deal)	(Stock Deal)
Cash at Closing	$60.0	$65.0
Less: Retire Long-Term Debt	($ 25.0)	
Net Cash at Closing	$35.0	$65.0
Sellers' Note (Payable over 5 years)	$25.0	
Non-Compete/Consulting (Payable over 5 years)	$10.0	
Net Cash to Sellers (Pre-Tax)	$70.0	$65.0

Now it isn't so clear, since some people would prefer more cash at closing, whereas others would want the larger sum total. Also, the deal for Company A is riskier: if the buyer subsequently goes bankrupt, the seller's note and non-compete/consulting contract would likely be subordinate to other forms of corporate debt and the former shareholders of Company A could be left with nothing. They would also have to consider that the seller's note and non-compete/consulting payments would be paid out over time, so they would have to discount them back to their present values to make them comparable to the cash they received at closing.

After discounting, it might be that the values received by the shareholders of both Company A and Company B would be nearly equal. Except that they aren't. Because taxes haven't been considered:

(Amounts in $millions)	Company A	Company B
	(Asset Deal)	(Stock Deal)
Total Cash Consideration	$70.0	$65.0
Less Corporate Tax*	($12.0)	
Distributions to Shareholders	$58.0	$65.0
Less: Personal Capital Gain Tax **	($5.0)	($6.0)
Net to Shareholders After Taxes	**$53.0**	**$59.0**

** Assume 40% corp. tax rate on $30 million gain on sale of assets.*
***Assume 15% capital gains tax rate on $25.0 million tax basis.*

Of course, we have grossly simplified some of the finer points of the tax code as it may pertain to our hypothetical transactions, and completely ignored others. Still, our examples illustrate the general principle that in asset deals, there is usually an issue of double taxation: the corporation has to pay taxes at the ordinary rate on the gain on the assets it sells; then if the remaining proceeds are distributed to shareholders, they have to pay personal capital gains taxes. Selling stock is usually more tax efficient for sellers, since they have to pay taxes only once. Taxes in general are an area of special expertise, and should be considered early on in negotiating a deal's structure. One piece of advice that should never be forgotten: *never* close a deal until all aspects of the transaction have been scrutinized by competent tax attorneys and accountants who are well versed in mergers and acquisitions.

So the stockholders of Company B didn't do so badly after all. Though the deal for Company B had lower multiples than the deal for Company A, the shareholders of Company B, by virtue of having a more carefully considered transaction structure, were able to take home more cash – *and* they were able to take it home at closing. Shareholders of Company A can brag about their multiples, but the shareholders of Company B can enjoy the extra $6 million they received! Thus, while multiples may be attractive because of their simplicity, relying on them too much as a guide to a deal's "value" is generally more dangerous than it is useful.

"I conceive that the great part of the miseries of mankind are brought upon them by false estimates they have made of the value of things."

– Benjamin Franklin

(1706-1790)

Tammie Miller joins Grace Matthews as Vice President

Grace Matthews announces that Tammie Miller has joined Grace Matthews as a Vice President. Tammie has over a decade of experience in mergers and acquisitions and corporate finance with an extensive background in manufacturing and healthcare services. Before joining Grace Matthews, Tammie was a Senior Vice President of Operations at Innovative Resource Group, a former subsidiary of Cobalt Corporation (now APS Healthcare), where she oversaw 400 employees and $50 million in revenues. Tammie's prior investment banking experience includes positions at Alex Brown & Sons, First National Bank of Chicago and Lehman Brothers.

At Grace Matthews, Tammie will advise corporate clients on buy- and sell-side engagements. "With her strong corporate finance and healthcare background, Tammie Miller will be a timely addition to Grace Matthews' experienced staff," said Managing Director John Beagle. "Tammie will help us continue to expand, and she represents the kind of deep, experienced professional our investing banking clients seek when they engage our firm."

Tammie is a Chartered Financial Analyst and holds both an M.B.A. and a B.A. – with High Honors – from the University of Chicago. Tammie sits on the boards of the Walker's Point Youth & Family Center and Alpha Omicron Pi Fraternity, and is a member of the Milwaukee Investment Analysts Society.

Private Equity: State of the LBO/MBO Markets

The lead investors in leveraged and management buy-out ("LBO/MBO") deals are typically private equity, or "buy-out", firms – companies that raise capital from institutional investors and then invest it in a portfolio of privately-held companies. In a typical deal, the buy-out firm puts up most of the equity capital – often reserving a significant share for management – and then seeks to maximize its returns by layering as much debt on the deal as the target company can reasonably service given its level of risk and cash flows.

Over the past few years, there has been a decline in the volume of LBO/MBO transactions completed by private equity funds, but recently activity in these markets has begun to pick up. One reason for this is that, as the economy slowed, these funds continued to take in cash from investors – especially so as institutional investors suffered big losses in the stock markets and turned to private equity funds in search of better returns. Now, the buy-out firms have a lot of cash to place – over $100 billion by some estimates - and since their managers are paid based on the returns they generate, there is a great deal of pressure to put that capital to work. Another reason for the rebound in the LBO/MBO markets is that many strategic acquirers have remained weak. Companies that are cyclical, have excess capacity, or deteriorating balance sheets often can't be competitive with the financial firms that are willing to pay up for quality companies.

There is a high degree of competition for larger, high quality companies that come on the market – say, those where the purchase price is $50 million and up. For a buy-out firm with $750 million to invest, it's simply easier to buy and manage a portfolio of 10 – 15 large companies than it is to buy and manage 20-30 smaller ones. Larger companies also tend to be more well-established, may be in more stable industries, and can be easier to grow through additional "bolt-on" acquisitions. Banks are more likely to lend in these situations because there is less perceived risk and a greater predictability for future cash flows.

Debt financing continues to be a major issue for buy-out firms. It's not that debt is expensive – indeed, interest rates are at 30-year lows – but debt covenants, borrowing capacities, and other financing terms are much more stringent than they were in the late 1990s. Five years ago, senior lenders would routinely loan 3 to 3.5 times a company's EBITDA in an LBO/MBO deal. Since then, debt multiples have contracted, with senior debt now being capped at 2 – 2.5 times EBITDA, except on larger deals or those with higher asset coverage. In fact, in many cases the senior lenders are the real drivers of a deal's structure: by writing restrictive covenants that dictate how much total debt can be put on a company, they in essence control the capital structure.

Equity sponsors faced with contracting lending multiples have two choices: they can pay less for a company, or they can put more cash into the transaction and accept lower potential returns. Since 2000, we have seen a little bit of both: purchase price multiples have come down for most LBO/MBO deals while the percentage of equity relative to total capitalization has steadily increased. Lately, we have seen an improvement in valuations as the banks have made steps toward easing access to credit.

What appears to have really changed is the mix of the companies involved in deals. Since buy-out firms usually have minimum "hurdle" rates of return, they are requiring that their portfolio companies generate proportionately higher cash flows to compensate for their increased investment. In other words, the deals that are getting done are the ones with high ratios of "free cash flow" (defined as EBITDA less capital expenditures) to equity. This situation appears to favor high-margin service firms that don't have significant capital spending requirements as opposed to capital-intensive manufacturers.

Where do we see the private equity markets going from here? With the war on Iraq over and Congress having passed a tax cut, many of the uncertainties surrounding the economy have been removed. Many economists believe GDP growth will come in at a 1.0% - 2.0% annual rate through the end of the summer and then will accelerate in the fall, to about a 3.5% - 4.0% annual rate. Assuming this scenario plays out as expected, banks should continue to ease their lending covenants and the current trend toward higher valuations and transaction volumes should pick up, though it is unlikely that we will see the same high levels that characterized the late 1990s.

Case Study: Dock Resins Corporation

Dock Resins, Linden, New Jersey, is a specialty manufacturer of high-performance acrylic resins for the coatings, adhesives, and graphic arts markets. Dock was acquired by Landec Corporation (NASDAQ: LNDC) in 1997 to provide Landec with a secure source of supply for a proprietary resin product and as an economical means to enter the specialty chemical market. Several years after the acquisition, Landec refocused its strategic direction around its core strengths in the agricultural and food markets and, as a result, Dock no longer fit with Landec's long-term strategic interests. In 2001, Landec made the decision to consider a divestiture of Dock Resins.

The Challenge

Landec Corporation engaged Grace Matthews to manage the divestiture process and negotiate the sale of Dock to a strategic buyer. Grace Matthews understood that the key to optimizing Dock's value was to identify synergistic buyers that would benefit the most from Dock's strong position as a supplier of proprietary and custom acrylic resins. After a thorough review of the markets, Grace Matthews identified several strong candidates that would have an interest in Dock. The issue was that from the second quarter of 2001 on, the economy went into recession and many of the best strategic acquirers had begun to see a sharp decline in their end markets. Specialty chemicals is a classic cyclical industry, and many of the potential buyers responded to the downturn by closing plants and laying off workers. Acquisitions were put on hold or de-emphasized in order to conserve cash flows.

The Solution

After reviewing all its options, Landec's management and Grace Matthews decided not to take Dock off the market, but to dig deeper to find a good partner for Dock. Strategic fit was still the primary criteria, but a strong balance sheet and the financial flexibility to complete an acquisition in the midst of a recession were considered as well. In the end, Lubrizol Corporation, a global fluid technology company that develops, produces and sells high-performance chemicals, purchased Dock in October 2002. Though the transaction process took longer than is usual, the result was a "win-win" for both sides: Landec achieved its goal of realizing a fair value for Dock so it could strengthen its balance sheet and focus on its core markets, while Lubrizol gained a strong platform in resins that will enhance its coatings and ink additives business.

LANDEC

Menlo Park, CA

has sold its specialty chemical subsidiary

DOCKRESINSCORPORATION
A Landec Company

Linden, NJ

to

LUBRIZOL
Fluid technologies for a better world™

Wickliffe, OH

Grace Matthews, Inc. advised Landec Corporation on this transaction

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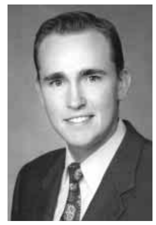
• • • *About Grace Matthews* • • •

Grace Matthews, Inc. is a Milwaukee- and Boston-based investment bank providing divestiture, acquisition search and corporate finance advisory services to private and public companies. Grace Matthews focuses on middle-market companies with revenues between $5,000,000 and $250,000,000, a market that we believe is underserved by the investment banking community. Representative Grace Matthews engagements include sales of privately held businesses, corporate divestitures, acquisition searches, acquisitions of specific target companies, management and leveraged buy-outs, venture capital and private equity, and recapitalizations. Grace Matthews' business philosophy is to take on a limited number of clients at a time, so that each project gets the attention and resources necessary for success. We believe that our reputation is our most valuable asset, and that successful transactions occur through a combination of experience and hard work. Our former clients provide our best testimonials, and we encourage prospective clients to talk to them prior to engaging our firm.

John Beagle
Managing Director

John Beagle has served as the principal investment banker on over 40 merger, acquisition, and venture capital transactions, and has participated in dozens of others in various roles. He focuses primarily on manufacturing and technology deals, and has completed transactions in chemicals, coatings and adhesives, electronic materials, consumer goods, the Internet, software, and information technology. Before becoming an investment banker, John was a research engineer in Digital Equipment Corporation's Advanced Semiconductor Development Group. John received his B.S. in Materials Science and Engineering from Cornell University and his M.B.A. from the Johnson Graduate School of Management at Cornell University.



Ben Scharff
Vice President

Ben Scharff has served as an analyst and/or negotiator on over 15 M&A transactions and private capital fundraisings involving Internet-based businesses, consumer goods, and manufacturing. Ben's prior professional experience includes finance positions at John Hancock Financial Services (Madison, WI) and Einhorn Associates, Inc. (Milwaukee, WI). Ben graduated from the University of Wisconsin with B.S. degrees in both Economics and Communications. Ben is a member of the Association for Corporate Growth (Wisconsin Chapter) and has served in the United States Marines.

Doug Mitman
Managing Director

Douglas Mitman has worked in mergers, acquisitions and capital fundraising since 1993, and has served as the principal investment banker on over 35 transactions. He has completed transactions ranging in value from $5 million to $150 million and is a specialist in management and leveraged buy-outs. Doug previously worked as an option trader for Fidelity Investments in Boston and as a Market Maker for Susquehanna Investment Group in New York. Doug received his B.A. in Economics from Dartmouth College and his M.B.A. (with Highest Distinction) from the Johnson Graduate School of Management at Cornell University.

Tammie Miller
Vice President

Tammie Miller has over a decade of experience in mergers and acquisitions and corporate finance with an extensive background in manufacturing and healthcare services. Before joining Grace Matthews, Tammie was a Senior Vice President of Operations at Innovative Resource Group, a former subsidiary of Cobalt Corporation (now APS Healthcare), where she oversaw 400 employees and $50 million in revenues. Tammie's prior investment banking experience includes positions at Alex Brown & Sons, First National Bank of Chicago and Lehman Brothers. Tammie is a Chartered Financial Analyst and holds both an M.B.A. and a B.A. – with High Honors – from the University of Chicago.

Tim Oleszczuk
Managing Director

Tim Oleszczuk has worked as an attorney and investment banker on over 60 transactions that include mergers and acquisitions, joint ventures, management and leveraged buy-outs, public offerings, private placements, and strategic alliances. He has completed transactions in telecommunications, publishing, manufacturing, retailing and professional services. Prior to joining Grace Matthews, Tim was a Vice President and General Counsel for Resource Financial Corporation, and a Partner in the law firm of Godfrey & Kahn, S.C. Tim received a B.B.A. and an M.B.A. (*both Summa Cum Laude*) in Risk Management, Insurance and Finance from the University of Wisconsin – Madison. He also holds a Juris Doctorate from the University of Michigan.

Craig Heim
Vice President

Craig Heim provides corporate finance and analytical support for Grace Matthews' technology and manufacturing clients. Craig, a chemical engineer, spent five years in operations management and product development at International Paper prior to joining Grace Matthews. Craig holds both an M.B.A. and a B.S. in Chemical Engineering (with Honors) from the University of Wisconsin. While in graduate school, Craig participated in the Weinert Applied Ventures in Entrepreneurship program and represented the University of Wisconsin in the Venture Capital Investment Competition, where his team reached the National Finals.

Mike D'Amelio
Managing Director

Michael D'Amelio manages Grace Matthews' Boston office, and specializes in corporate finance projects and industry consolidations. Mike's expertise in transaction financing and business recapitalizations includes numerous negotiations at the senior debt, subordinated debt, and equity levels. Mike was formerly the owner and CEO of TACC International (Rockland, MA), a construction chemicals company that was acquired by Illinois Tool Works in 1998. Mike received his B.S. in Business and his M.B.A. in Management from Northeastern University, Boston, MA.

Trent Myers
Vice President

Trent Myers has been a specialist in corporate finance and financial modeling for over 12 years. Trent has been the lead analyst on over 50 transactions in the areas of chemicals, manufacturing, software and technology. Trent has served as a monthly columnist for several industry trade magazines, including *Adhesives Age* and *Modern Paint & Coatings*. Trent holds an M.B.A. degree from the University of Wisconsin, an M.A. from the University of Virginia, and a B.A. from the University of Georgia.

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Recent Transactions

LANDEC
INTELLIGENT MATERIALS

Menlo Park, CA

has sold its specialty chemical subsidiary

DOCKRESINSCORPORATION
A Landec Company

Linden, NJ

to

LUBRIZOL
Fluid technologies for a better world™

Wickliffe, OH

Grace Matthews, Inc. advised Landec Corporation on this transaction

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Environmental Coatings, Inc.

Grand Rapids, MI

has acquired certain assets of the Specialty Coatings operations of

AKZO NOBEL

Akzo Nobel nv

Arnhem, Netherlands

Grace Matthews, Inc. advised Akzo Nobel nv on this transaction

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PKWARE INC.
The Data Compression Experts

PKW Acquisition Corp.

Brown Deer, WI

and

Ascent Solutions, Inc.

Dayton, OH

have become subsidiaries of

PKW Holdings, Inc.

Brown Deer, WI

through contributions of stock.

Grace Matthews, Inc. advised PKW Acquisition Corp. on this transaction

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TELUS®

TELUS Ventures

Vancouver, British Columbia

has made an investment in

LAVASTORM technologies

Lavastorm Technologies, Inc.

Boston, MA

Grace Matthews, Inc. advised Lavastorm on this transaction

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Recent Transactions

Main Steel Polishing Company, Inc.
Tinton Falls, New Jersey

Senior Financing Facility
Issued by

Sovereign Bank
Iselin, New Jersey

Grace Matthews, Inc. advised Main Steel Polishing on this transaction

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Openfirst
Reaching Millions. Touching Individuals.

Milwaukee, WI and Fredericksburg, VA
has been acquired by Management and

Prairie Capital

River Cities Capital Funds

with debt financing provided by

Greyrock Capital Group

Associated Bank

Grace Matthews, Inc. advised Openfirst, Inc. on this transaction

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LAVASTORM™

Waltham, MA

has sold its San Jose operations, including its Internet consulting and software engineering practice to San Jose's management under the name of

Lavastorm Engineering, Inc.
San Jose, CA

Grace Matthews, Inc. advised Lavastorm on this transaction

Grace Matthews
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ACT Technologies, Inc.
Committed To Excellence

ACT Technologies
Dalton, GA

has acquired certain assets of the Foam Latex operations, located in Calhoun, GA, of

BOSTIK FINDLEY

Bostik Findley, Inc.
Wauwatosa, WI

Grace Matthews, Inc. advised Bostik Findley Inc. on this transaction

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