

NEWSLETTER

Spring 2001

Mergers, Acquisitions and Corporate Finance

2001 • Issue I

CONTENTS

Selling a Business: Three Alternatives
Page 1

Some Thoughts on Valuation Multiples
Page 2

Stocks and the Economy: Rebound in 2001?
Page 3

The Big Picture
Page 3

About Grace Matthews
Page 4

• • •

Visit our Website at:

www.gracematthews.com

Or email us at:

info@gracematthews.com

Selling a Business: Three Alternatives

At Grace Matthews, we are often approached by business owners or managers when they are making one of the most important business decisions of their lives – when and how to sell their business. While we always support setting up a competitive process for the sale of a business, the decision as to which type of competitive process to follow is not an easy one. The decision depends upon the shareholders' objectives, and is a result of understanding how the pros and cons of each method fits those objectives.

In general, business owners have three options: (1) a Broad Auction, (2) a Targeted Auction, or (3) a Negotiated Process. Each method involves various trade-offs relating to timing, confidentiality and other issues:

	Broad Auction	Targeted Auction	Negotiated Process
# of Potential Buyers	• Widest range of buyers	• 5-15 targeted buyers	• 2-5 selected buyers
Confidentiality	• Limited	• Contained	• High
Control	• Buyers control process	• Seller maintains control	• Seller maintains control
Structure	• Formal 2-stage auction process	• Managed process	• Accelerated process; Direct negotiations
Timing	• 6-8 months	• 5-7 months	• 3-5 months
Process	<ul style="list-style-type: none"> • General Information Memorandum • Preliminary bids with general terms • Manageable group of buyers selected for due diligence • Definitive bids submitted based on due 	<ul style="list-style-type: none"> • General or Customized Information Memorandum • Preliminary bids with general terms • Seller proceeds with small group of buyers on separate tracks • Seller selects one candidate for final negotiations with 	<ul style="list-style-type: none"> • Custom Information Memorandum prepared for each buyer • Negotiated agreement followed by due diligence and closing

Selling A Business: Three Alternatives

(Continued from page 1)

Most business owners assume that a broad auction is the way to go. After all, putting the business up for the "highest bidder" appears to guarantee getting the highest possible price. Actually, that's not the case; any of the three methods, properly managed and executed, should result in the shareholders getting the best value. And, while a broad auction may be appropriate for some businesses, it also can be one of the most risky ways to sell a business. Suppose the owner has to withdraw the business from the market – say, due to an economic downturn, or because the initial bids were not as high as anticipated. Everyone -- customers and competitors alike -- will know that the business was for sale and, even worse, that the process broke down. This can lead to all kinds of rumors that could disrupt the business and cripple efforts to sell the business in the future.

Because of these considerations, Grace Matthews rarely advises clients to use a broad auction process. We prefer targeted auctions or negotiated processes

mainly because we believe control of the process is a key to success; if a seller maintains control, he or she is more likely to uphold confidentiality, develop the appropriate level of competition, and receive the value they want.

Grace Matthews works with clients to understand what divestiture method is most appropriate based on the business' strengths and weaknesses, its industry and markets, and the M&A environment. We have developed an informal framework that outlines the key issues involved, some

of which are included in the table below.

In most cases, the method of taking a company to market becomes clear based on an analysis of the company and the markets in which it operates. While each situation is unique, the key point is that the selection of a divestiture method is the first question that should be answered when selling a business. Choosing the wrong method can inhibit the process before it even begins and put the company at undue risk.

	Broad Auction	Targeted Auction	Negotiated Process
Potential Buyers	• Is there a diverse range of potential	• Is there a clear and visible group of buyers who	• Are there a few strong strategic buyers that are
Negotiating Flexibility	• Does the seller want to cash out no mat-	• Are there other factors besides price the seller	• Are there alternatives to a sale? (e.g. MBO, partial
Confidentiality	• Is confidentiality clearly secondary relative to other con-	• Is there potential for disruption in the business if it were known that it is	• Would disclosure that the business is for sale seriously compromise its
M&A Environment	• Are there a large number of recent transactions and a competitive market	• Are there a fair number of recent transactions? Is there an active market for the business?	• Are there only a few recent transactions? Are potential buyers more opportunistic?

Some Thoughts on Valuation Multiples

In the past year, we have seen purchase price multiples come down from the highs they obtained under the "irrational exuberance" of the late '90s. (Purchase price multiples are a valuation metric equal to the purchase price divided by company earnings.) According to our data, multiples have fallen by about 1 times EBITDA (Earnings Before Interest, Taxes, Depreciation & Amortization) over the past year. In the credit markets, senior lenders appear to have reduced their lending multiples by as much as 1.5 times EBITDA for deal financings, making higher priced deals much more expensive from the equity side.

Tighter credit is partly responsible for the lower values, as it becomes more

difficult for financial buyers (e.g. equity funds and buy-out firms) to compete with strategic buyers who already have an established presence in an industry. Also responsible are downward revisions in projected corporate earnings, which affect all industries and causes companies scale back on new productivity-enhancing capital investments.

We believe a return to the high valuation multiples of a year ago is unlikely, mostly because they were the result of an anomalous situation: an unjustified optimism among investors that the business cycle no longer applied in the "new economy".

Nevertheless, values paid by strategic buyers remain strong. While there has

certainly been a reduction in purchase prices over the last nine months, values are still higher today than in the mid-1990s. In most cases, strategic buyers are still willing to pay up for a portion of the "synergies" that result from cost savings when businesses are consolidated.

With the Fed's recent cuts in short-term rates, and additional rate cuts likely in store over the next year, we expect the economy will have its much hoped for "soft landing". We believe that this is the most likely scenario and, as evidence of an improving economic climate mounts over the next quarter or two, we would expect purchase multiples to stabilize at current levels and even show some rebound toward the latter part of 2001.

Stocks and the Economy: Rebound in 2001?

Last year, the stock market behaved like a manic depressive who had forgotten to take his medication – it climbed frenetically until March, and then bounced between dramatic highs and lows before settling into a relentless descent that took it much lower than anyone had ever projected. By December it was clear that there wasn't going to be a rally anytime soon, and that it was going to be one of the worst years for the markets since 1973. Technology stocks, especially the dot.coms, saw their market caps fall by as much 50% - 95%. Towards the end of the year, defensive issues such as pharmaceuticals and energy stocks gained ground, but both the Dow and the NASDAQ still struggled to find their support levels.

While we don't have a crystal ball, we believe that 2001 will be better, and maybe a lot better. We think there are three factors in place now that will drive the market and the economy higher.

First, the Federal Reserve's dramatic interest rate cuts in January signaled that Greenspan and the FOMC will do whatever it takes to prevent the country from

sliding into a recession. While rate cuts, depending on which economist you listen to, take anywhere from 3 to 18 months to have a widespread impact on the general economy, it pays to keep in mind that the stock market is a leading indicator of economic activity. It is also one of the most accurate leading indicators, and we should expect the markets to turn up six to nine months before the economy does. And in fact, the NASDAQ has been trending up since the beginning of the year; as this issue went to press, it closed over 2800 — a 22% advance since January 1st.

Second, enactment of tax cuts proposed by the Bush administration looks increasingly probable. Though there is likely to be some partisan bickering in Congress over the size and scope of the cuts, Greenspan's recent endorsement of the concept lends it an aura of inevitability. Regardless, the general economy will not be affected by any such tax cuts for some time. However, consistent movement towards cuts should provide encouraging sentiment that may drive the markets higher.

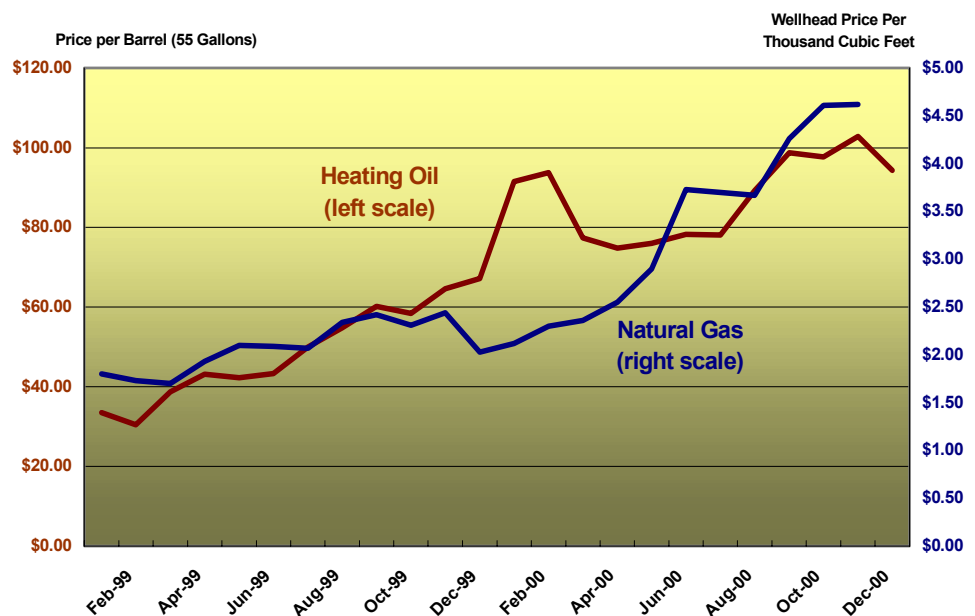
Finally, we believe the Bush administration will make a comprehensive energy policy a priority. This winter, Americans have been hit with unexpectedly high energy bills for heating oil and natural gas. These bills, as well as the increased cost of gasoline, have effectively reduced disposable income on a dollar-for-dollar basis. The effect on the economy, while likely already reflected in stock prices, has not yet hit the earnings reports of individual companies. This negative impact will emerge in first and second quarter earnings reports. The new administration is likely to take steps to mitigate the impact of high energy costs for the winter of 2001-2002, especially if it appears that oil and natural gas prices are likely to stay relatively high. If there is clear progress on an energy policy, just as the case with interest rate and tax cuts, business optimism will increase and provide support for the markets and corporate profits.

In sum, we expect the first two quarters of 2001 to be volatile, with no real market direction. In the latter half of the year, we expect the markets to improve and corporate profits to show renewed growth.

The Big Picture

Heating Oil and Natural Gas Prices 1999-2000

Just how much have energy prices gone up? Since the beginning of 1999, heating oil is up over 180% and natural gas is up over 150%. There are no simple explanations for these run-ups, though much of heating oil's rise can be traced to OPEC's newfound discipline at keeping crude oil at over \$25 a barrel. The case with natural gas is more complicated, but can be explained by a combination of tightening supplies, lower levels of storage stocks, and increases in consumption. The prognosis for next year is for some moderation in prices, but they are still expected to remain well over mid-1990s levels.



Source: Energy Information Administration

• • • *About Grace Matthews* • • •

Grace Matthews, Inc. is a Milwaukee- and Boston-based investment bank providing divestiture, acquisition search and capital raising advisory services to private and public companies. Grace Matthews focuses on middle market companies with revenues between \$5,000,000 and \$150,000,000, 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 placements, and recapitalizations. Grace Matthews principals have successfully completed over 60 transactions on behalf of clients ranging from private, middle market companies to large foreign or U.S.-based multi-nationals.

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. A Partner leads every project, and is supported by a team of experienced analysts and other talented professionals.

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
Partner

John Beagle has served as the principal investment banker on over 30 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. Prior to founding Grace Matthews, John spent seven years at the mergers & acquisitions firm Einhorn Associates as a Partner. 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 in 1987, and his M.B.A. from the Johnson Graduate School of Management at Cornell University in 1992.



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 and technology. Trent is a recognized expert in adhesives and sealants and 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 (1989), an M.A. from the University of Virginia (1979), and a B.A. from the University of Georgia (1973).



Doug Mitman
Partner

Douglas Mitman has worked in mergers, acquisitions and capital fundraising since 1993, and has served as the principal investment banker on over 20 transactions. He has completed transactions involving technology and manufacturing firms ranging in value from \$5 million to \$150 million and is a specialist in management and leveraged buy-outs. Doug was a Partner at Einhorn Associates before founding Grace Matthews, and 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 in 1986 and his M.B.A. (with Highest Distinction) from the Johnson Graduate School of Management at Cornell University in 1992.



Ben Scharff
Vice President

Ben Scharff has served as an analyst and/or negotiator on over 15 M&A transactions and venture capital fundraisings. Ben's prior professional experience includes finance positions at John Hancock Financial Services (Madison, WI) and Einhorn Associates, Inc. (Milwaukee, WI). Ben has completed transactions involving Internet-based businesses, consumer goods, and manufacturers in a variety of industries. 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.



Mike D'Amelio
Partner

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 President and CEO of TACC International (Rockland, MA), a construction chemicals company which was acquired by Illinois Tool Works in 1998. Mike was head of TACC from 1991 to 1999, a period in which the company grew from \$10 million to over \$120 million in revenue through a series of acquisitions. Mike received his B.S. in Business and his M.B.A. in Management from Northeastern University, Boston, MA.



Craig Heim
Associate

Craig Heim provides corporate finance and analytical support for Grace Matthews' technology, Internet 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.