

The Strategic Alternatives Review

Strategic Advisors

Middle Market Investment Bankers

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Objectives of Presentation

- **Introduce *The Strategic Alternatives Review***
- **Review examples of *The Strategic Alternatives Review***
- **Review the benefits of *The Strategic Alternatives Review***
- **Overview of Strategic Advisors, Inc.**

The Strategic Alternatives Review - Approach

Objective:

- **Provide a framework for** middle market **business owners** (\$20 to \$200MM in sales) **to explore** the **capital market alternatives** available to meet their goals & objectives
- **Establishes** the **owners' current equity value as a "portfolio asset"** on a **"mark to market"** basis

Strategic Alternatives:

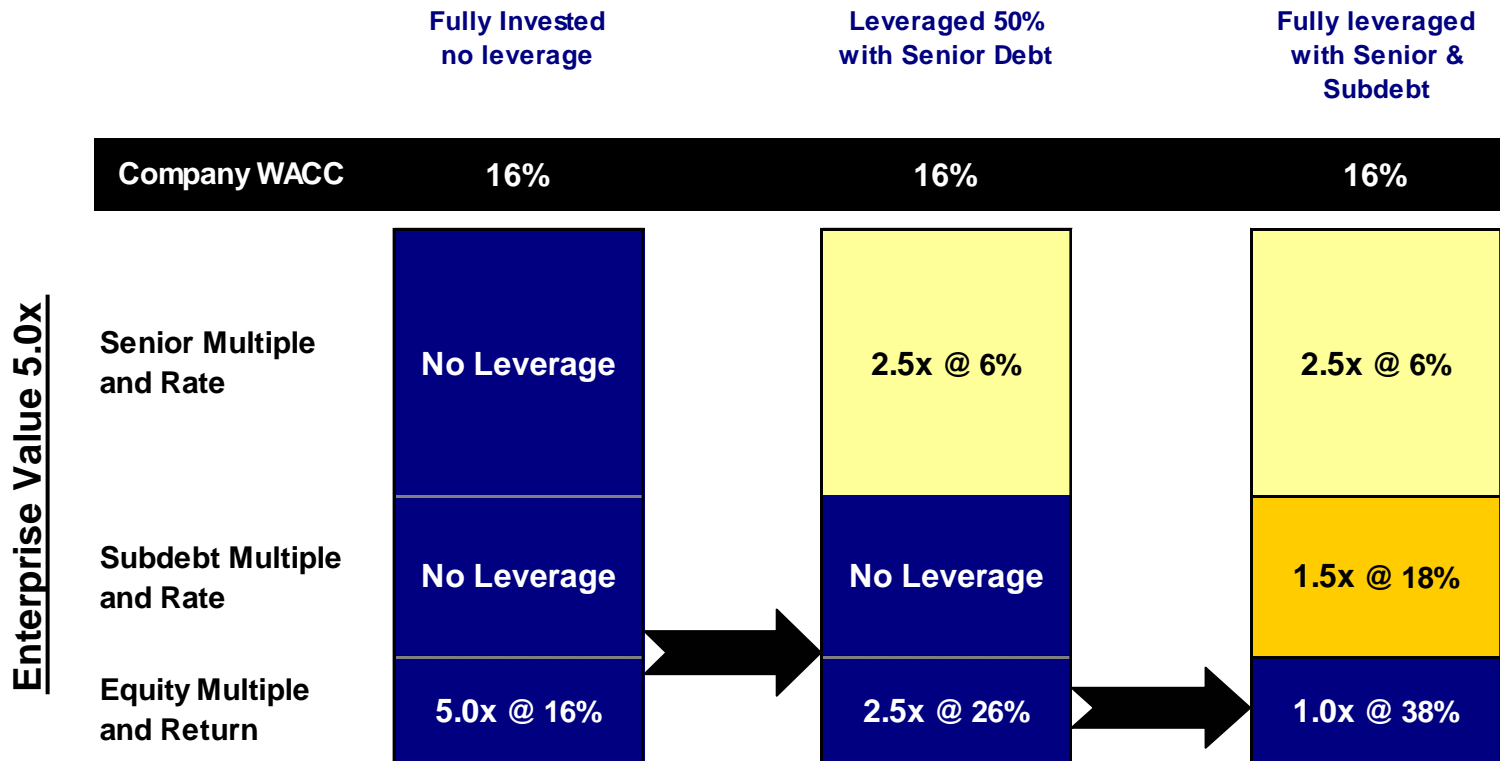
- Status Quo
- Recapitalization
- Acquisition(s)
- Divestiture

Approach:

- Understand the goals and objectives of the shareholders and managers
- Establish a "Status Quo" alternative of the business based upon a five year projection
- Determine Value (DCF, Market Comps and Leverage Test)
- Develop other Strategic alternatives that meet shareholder objectives
- Summarize alternatives and review financial and business impacts of implementing each alternative
- Compare alternatives on the basis of wealth creation, risk, and meeting owners' objectives
- Recommend and assist in selecting the most appropriate alternative

The Risk / Return Profile of Invested Capital – The Effects of Leverage

- Illustration displays effect of returns on equity under various leverage scenarios
- Illustration assumes Enterprise Value equals 5x EBITDA- Typical WACC is 14- 16%
- IRRs are based on Current Market Equity Value & cash flows over 5 years including 5th year termination value
- Fully leveraged model used by most buyout funds



The Strategic Alternatives Developed

Status Quo:

- Determines return on equity based on a 5 year projection
 - Projection provided by management or based on industry estimates - organic growth only

Recapitalization:

- Determines debt capacity and analyzes various leverage scenarios
 - On under leveraged entities, recap could be an alternative to sale
 - On leveraged entities, recap could create liquidity and/or reduce overall cost of capital
- Determines ability to pay dividend to diversify “portfolio holdings”
 - Example: Potential ability to liquefy up to 80% of equity while giving up little or no ownership
- Potential to increase return on equity on reinvested capital

Acquisition(s):

- Establishes maximum acquisition size based on:
 - Current equity value that can be used to fund an acquisition
 - Current capital market constraints (leverage multiples)
 - Shareholders’ risk tolerance
- Allows for a diversification of “portfolio holdings” on a tax deferred basis
- Enhances return on equity on invested capital through increased leverage
- Enhances wealth creation potential

Divestiture:

- Explores sale to financial buyers, strategic buyers & management
- Buyers targeted determined by goals & objectives of owners

Developing the Status Quo Analysis

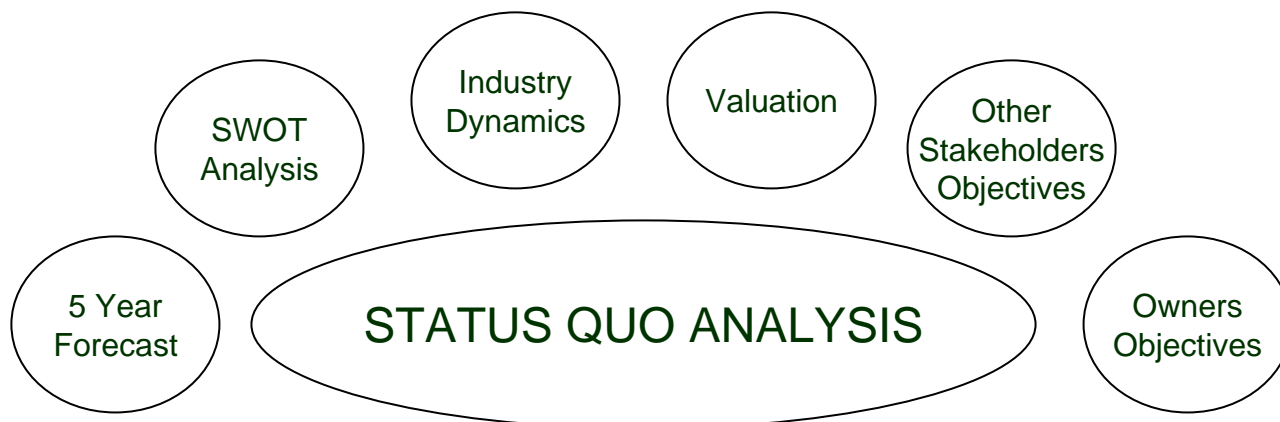
Six Step Approach

- 1) Identify specific shareholder goals and objectives**
- 2) Establish a 5 year “normalized” projection**
- 3) Formulate a SWOT analysis (Strengths, Weaknesses, Opportunities & Threats)**
- 4) Develop an industry & competitive profile**
- 5) Determine Value (DCF, Market Comps & Leverage Test)**
- 6) Assesses other stakeholder objectives**

The Strategic Alternatives Review

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STATUS QUO	RECAP	ACQUISITION GROWTH	DIVESTITURE
<ul style="list-style-type: none"> •No major changes •Normal growth •Base case •5 year forecast •Current equity value •Future equity value •Determines 5 yr IRR •Used as "hurdle rate" 	<ul style="list-style-type: none"> •Tests debt capacity •Max leverage figured •Could use sub debt •Diversifies holdings •Min. equity dilution •Max. current cash •Retains control •Reinvestment IRR 	<ul style="list-style-type: none"> •Models acquisitions •Leverages equity •Tests debt capacity •Establishes criteria •Max deal size •5 year forecast •Determines 5 yr IRR •Proj. wealth created 	<ul style="list-style-type: none"> •Market comps •Val: financial buyer •Val: strategic buyer •Max. current \$\$ •Diversifies all risk

Example – Pinnacle Electronics – EMS contract manufacturer

<p>Scenario</p>	<p>Purchased by Main Street Capital (MSC) in 2001 for \$7MM In 2003 Sales equaled \$38MM & EBITDA was \$7MM; SA valuation was at \$37 to \$41MM Company had no debt therefore value to owners equaled \$37 to \$41MM (\$39MM) Company faced potential “Asia threat” in future; manager (25% owner) wanted to explore exit MSC hired SA in June 2003 to explore strategic alternatives</p>
<p>Alternatives</p>	<p>Status Quo: Estimated a 5 year IRR on equity at 14.8%</p> <p>Recap: Estimated a dividend of \$21MM (58% of value) while giving up 9% warrant Total debt to EBITDA of 3.75x IRR on reinvested capital increased from 14.8% to 23.1%</p> <p>Acquisition: Acquire two smaller EMS firms over next two years @ \$6MM each Leverage with senior debt Diversify customer base IRR on reinvested \$39MM equity increased to 28.3% 5th year equity value increases to \$136MM vs \$77MM on Status Quo</p> <p>Divestiture: Sale to financial buyer estimated @ \$37MM; sale to strategic buyer @ \$41MM MBO not considered as manager desired exit</p>
<p>Conclusion</p>	<p>SA hired in August to sell company Goal was to maximize proceeds while keeping entity intact in Pittsburgh Sale was complete to strategic buyer @ \$43MM in February 2004</p>

Example - Project Tool

<p>Scenario</p>	<p>Family owned 2nd generation controlled business 2003 Sales equaled \$60MM & EBITDA was \$6.6MM; SA valuation was at \$35MM to \$39MM Company had \$4.3MM of debt therefore equity value to owners equaled \$31MM to \$35MM Company forecasts 3.7% growth over next 5 years; faces cyclical risks SA completed <i>Strategic Alternatives Review</i> Company concluded acquisition strategy was optimal to meet objectives</p>
<p>Alternatives</p>	<p>Status Quo: Estimated a 5 year IRR on \$31MM equity value estimated at 14%</p> <p>Recap: Estimated a dividend of \$20MM (75% of value) while giving up 15% warrant Total debt to EBITDA of 3.75x; IRR on reinvested capital increased from 14% to 25%</p> <p>Acquisition: Model one acquisition maximizing senior debt. Purchase price \$31MM 5th year equity value increased to \$75MM IRR on \$31MM equity increases from 14% to 19%</p> <p>Divestiture: Sale to financial buyer estimated @ \$35MM; sale to strategic buyer @ \$39MM</p> <p>MBO: Modeled Management Buyout at \$31MM.</p>
<p>Conclusion</p>	<p>SA hired to conduct acquisition search</p>

Summary

Example Summary of *The Strategic Alternatives Review*

Statistics	Prior Year
Sales	\$60.0
EBITDA	\$6.5

Value	Financial	Strategic
Enterprise Value	\$35.6	\$39.2
Less Debt	(\$4.3)	(\$4.3)
Equity Value	\$31.3	\$34.9

Alternative	Reinvested Equity	5th Year Equity Value	Return on Reinvested Equity	Equity PV at Hurdle Rate	Comments
Status Quo	\$31.3	\$60.6	14.1% (Hurdle Rate)	\$31.3	<ul style="list-style-type: none"> Concentration of wealth remains Must continue to grow at 3.7% Does not diversify strategy
Recapitalization \$19.5MM pre-tax dividend \$0.9MM transaction costs	\$31.3 (19.5) (0.9) \$10.9	\$36.4	24.8%	\$17.1 <u>19.5</u> \$36.6	<ul style="list-style-type: none"> Increases equity return via leverage Addresses concentration of wealth Conservatively utilizes mezzanine debt Retention of 85% economic equity
Acquisition Purchase Price of \$30.7MM No synergies	\$31.3	\$74.8	19.0%	\$38.7	<ul style="list-style-type: none"> Increases IRR through leverage Potential for diversification of earnings Could address Asian issue Concentration of wealth remains
Management Buyout Sale to Mgmt. for \$31.3MM Financial Buyer price	NA	NA	NA	\$31.3	<ul style="list-style-type: none"> Addresses concentration of wealth Allows for Management succession Keep company intact \$1.0MM required investment by Mgmt.
Divestiture Sale to Strategic Buyer @ \$34.9MM	NA	NA	NA	\$34.9	<ul style="list-style-type: none"> Goal is to keep the company intact Maximizes shareholder's current wealth Owners have reinvestment risks

Benefits to Clients

- Establishes a five year baseline projection
- Determines market value of enterprise and ownership equity
- Brings management & owners together on an agreed upon projection
- Helps owners view their equity in their business as an “IRR portfolio asset”
- Begins process of long term financial planning by establishing goals & objectives
- Provides framework to explore strategic capital market alternatives
- Concludes with selection of agreed upon strategy

Timetable for completing the *Strategic Alternatives Review*

Execution of engagement letter	
On-site due diligence	2 – 3 days
Industry research, Financial modeling & Valuation	2 weeks
Report preparation	1 week
Preliminary review with management	3 days
Final presentation to Board of Directors	<u>1 day</u>
Estimated time to complete	One month

Strategic Advisors' Pricing

- A) Stand Alone Project: \$25,000 with 10% retainer
- B) In context of an transaction engagement we are flexible