The Strategic Alternatives Review

Strategic Advisors

Middle Market Investment Bankers

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- **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

Enterprise Value 5.0x

	Fully Invested no leverage	Leveraged 50% with Senior Debt	Fully leveraged with Senior & Subdebt
Company WACC	**16%**	**16%**	**16%**
Senior Multiple and Rate	**No Leverage**	**2.5x @ 6%**	**2.5x @ 6%**
Subdebt Multiple and Rate	**No Leverage**	**No Leverage**	**1.5x @ 18%**
Equity Multiple and Return	**5.0x @ 16%**	**2.5x @ 26%**	**1.0x @ 38%**

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)

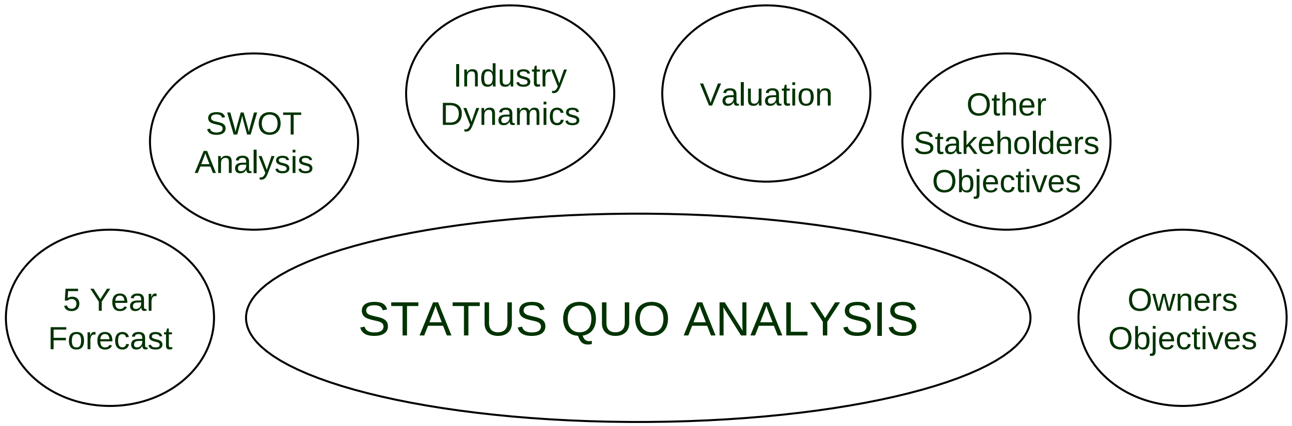
4) Develop an industry & competitive profile

5) Determine Value (DCF, Market Comps & Leverage Test)

6) Assesses other stakeholder objectives

The Strategic Alternatives Review

CURRENT STATUS



FUTURE ALTERNATIVES

STATUS QUO

- No major changes
- Normal growth
- Base case
- 5 year forecast
- Current equity value
- Future equity value
- Determines 5 yr IRR
- Used as "hurdle rate"

RECAP

- Tests debt capacity
- Max leverage figured
- Could use sub debt
- Diversifies holdings
- Min. equity dilution
- Max. current cash
- Retains control
- Reinvestment IRR

ACQUISITION GROWTH

- Models acquisitions
- Leverages equity
- Tests debt capacity
- Establishes criteria
- Max deal size
- 5 year forecast
- Determines 5 yr IRR
- Proj. wealth created

DIVESTITURE

- Market comps
- Val: financial buyer
- Val: strategic buyer
- Max. current $$
- Diversifies all risk

Example – Pinnacle Electronics – EMS contract manufacturer

Scenario	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
Alternatives	**Status Quo**: Estimated a 5 year IRR on equity at 14.8% **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% **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 **Divestiture**: Sale to financial buyer estimated @ \$37MM; sale to strategic buyer @ \$41MM MBO not considered as manager desired exit
Conclusion	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

Example - Project Tool

Scenario	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 cyclicality risks SA completed *Strategic Alternatives Review* Company concluded acquisition strategy was optimal to meet objectives
Alternatives	**Status Quo**: Estimated a 5 year IRR on \$31MM equity value estimated at 14% **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% **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% **Divestiture**: Sale to financial buyer estimated @ \$35MM; sale to strategic buyer @ \$39MM **MBO:** Modeled Management Buyout at \$31MM.
Conclusion	SA hired to conduct acquisition search

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	• 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 19.5 $36.6	• 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	• 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	• 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	• 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	1 day
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