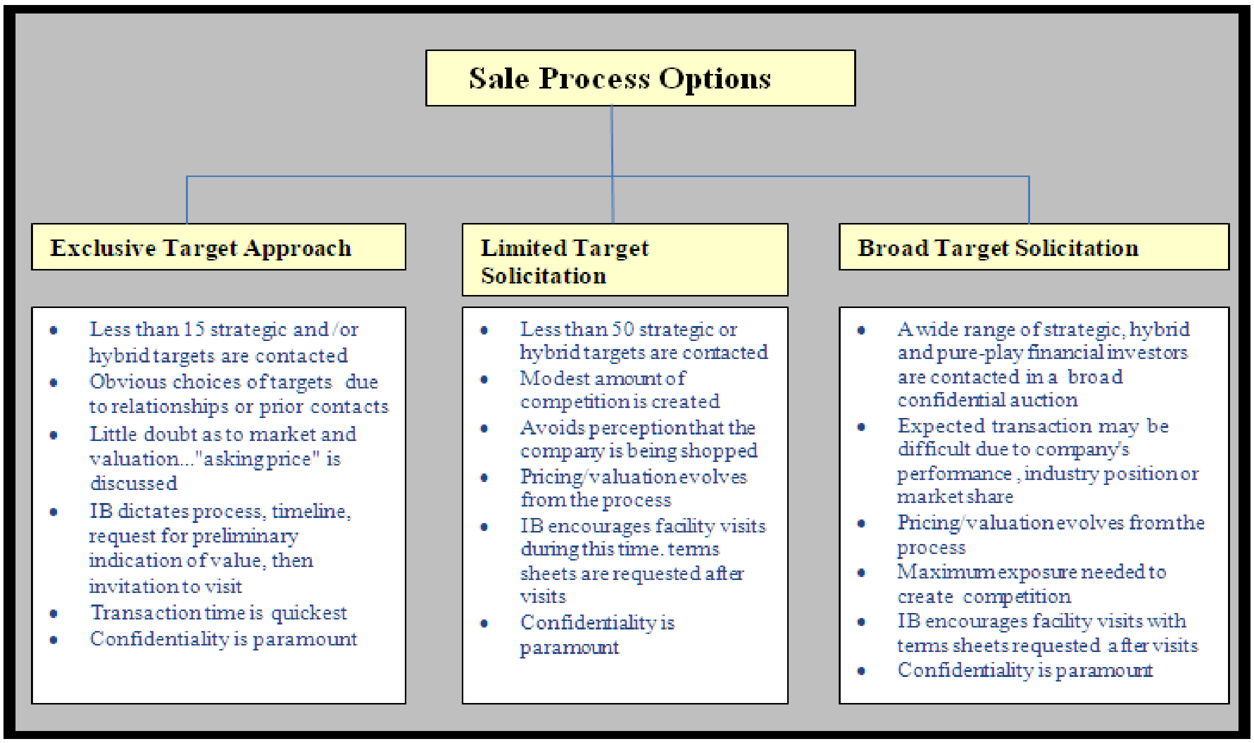
Profile of Investors / Acquirers

In a professionally managed confidential marketing campaign, your investment banker should design the marketing, tailored to the business and industry. Generally, the "sales process" can be charted as follows:



The investor / acquirer universe can include any or all of the following:

Strategic Investors

Strategic investors are those companies that want to enter or expand their existing product lines, add related channels of distribution, add new markets, expand geographically (even internationally), acquire technology from a competitor, or other strategic reasons.

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Companies in this category of acquirers are generally strong and financially capable investors from any geographic area and can be larger competitors or companies seeking complimentary products.

Generally, the strategic acquirers will have the highest valuation (but not always) and will bring greatest operating synergies. The acquired companies must realize that the strategic acquirer will not pay the seller for those savings and synergies that they bring to the table. However, through negotiation, valuations for these reasons tend to be higher than other investor groups.

Some of these prospects will be suggested by Grand Avenue Capital; many will be suggested by the client. In some cases, the client will not want to approach a competitor or a specific target. While confidentiality is paramount, some logical targets may be merely fishing for information and will be excluded from the campaign.

Financial Investors ("pure play")

Pure-play financial investors / private equity funds are those institutional investors that generally have no "platform" investment in their portfolio. They will tend to be industry agnostic and will be searching for acquisitions that make sound financial sense consistent with their investment return criteria.

These investors target “niche manufacturing” companies, for example. Over half of Grand Avenue Capital’s private equity contacts are those seeking “niche manufacturing firms”.

Valuations reflect little or no synergistic opportunities given the absence of a portfolio company in the client's industry group. These financial investors will acquire the target with the intention of substantially improving the profitability and free cash flow generated through their efforts. This investor will seek a trade sale or, if the ultimate company is large enough, an IPO in 4-6 years.

The investors rely on providing returns to their limited financial partners, and have a clock running within which to accomplish a valuation improvement.

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Financial Investors ("hybrid")

These "hybrid investors" can be viewed as a class of institutional financial investors with a current industry platform investment that they own in the same or related industry/market as the client. These firms seek growth opportunities via bolt-on acquisitions.

Valuations will be strong since the investor's platform company is the strategic entity to which the new target will be "bolted-on", or at least, share synergies that a strategic would enjoy. Valuations will be similar to the strategic group of M&A acquirers.

These financial investors share the same investment time line as noted above and are contractually obligated to provide financial returns to the limited investors within a specified time.

Family Offices

A family office is a privately held company that handles the investment management and wealth management for a wealthy family. Often the investment management role in the larger offices (those with at least $100 million in investable assets) will include corporate acquisitions, frequently in a similar area that the original wealth was created.

Family offices are investing the financial capital that is the family's own wealth and therefore, the family office has no timeline generally to have a liquidity event. This feature is used effectively in marketing their investment strategy to owners who could be concerned at the pace of change an institutional financial investor must take to keep on the return timeline required in their limited partner agreements.

Because the goal of the family office is to effectively grow and transfer wealth across generations, investments (and therefore valuations) tend to be relatively more conservative than the investors above. Family offices themselves will invest in private equity funds, hedge funds, early stage venture funds, angel funds and commercial real estate.

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Search Funds

Search funds are investment vehicles, more recently conceived than the investors above, through which typically financial investors support an entrepreneur's efforts to locate, acquire, manage and grow a privately held company. These entrepreneurs are typically newly minted (but highly qualified and generally experienced) MBAs from top business schools.

The Center for Entrepreneurial Studies at Stanford (which is one of the schools that has promoted these funds) has found recently that the aggregate pre-tax internal rate of return of over 400 search funds to be 32.6%, and the aggregate pre-tax return on invested capital to be 5.5x. This is a tribute to the experience, hard work and investor support of the entrepreneurs who have acquired companies.

The process the entrepreneur manages is summarized as:

- raise capital from 5-20 investors to fund the search for a company
- identify and make the acquisition
- operate the company and create value
- exit the investment and provide a return to themselves and their investors.

There are three types of search funds—traditional, self-funded, and fundless sponsors:

- With traditional funds, searchers raise capital from a group of investors to look for a company with certain agreed upon attributes. The investors have the right of first refusal on any deals the searcher may find, according to searchfunder.com.

- Self-funded searchers finance their own search efforts. Once they find a deal they look for outside capital. The terms are negotiated on a deal-by-deal basis, according to searchfunder.com. Self-funded searchers often choose to use SBA loans to finance the acquisition because of the favorable and flexible terms offered.

- Fundless sponsors raise search capital on a deal-by-deal basis often from a single source or a group of investors. Fundless sponsors are more seasoned. They know how to structure deals, and people will back them based on their prior track record.

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Individual Investors / Industry Executives

Many industry executives are seeking the acquisition of private companies today for a number of reasons (their companies have been sold, for instance). These are experienced individuals who are nowhere near retirement and seek new careers or investment opportunities where their operating experience can create value.

Some of these executives will join private equity groups as operating partners. Alternatively, they can become attached to other institutional investors as "executives in residence" tasked with finding a company to acquire, financed in part with institutional financial backing.

Investment banking firms record the availability of these skilled executives and note their acquisition criteria. When the banker has a client that matches these criteria, an excellent fit can be closed.

Management Buyouts

Grand Avenue has been engaged by management in the buyout of the companies for whom they work. (see Services provided by Grand Avenue Capital).

Management is in a privileged position given that they are typically the movers of the growth and success of the companies they manage. Frequently, the opportunity arises wherein management is allowed to invest into or take over the majority ownership of their companies.

While existing management is a ready-source of possible acquirers of the businesses they run, owners need to establish a fair market valuation and an arm's length set of terms and conditions for the change of control.

ESOP

An employee stock ownership plan (ESOP) is an employee benefit plan that gives workers ownership interest in the company. ESOPs give the sponsoring company, the selling shareholder, and participants receive various tax benefits, making them qualified plans. An ESOP can be an exit strategy for owners as opposed to

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putting the company on the market; however, the price that an ESOP can offer per share is limited to the fair market value of those shares. This price may be lower than what could be paid by a strategic buyer.

An ESOP is usually formed to facilitate succession planning in a closely held company by allowing employees the opportunity to buy stock. ESOPs are set up as trust funds and can be funded by companies putting newly issued shares into them, putting cash in to buy existing company shares, or borrowing money through the entity to buy company shares. ESOPs are used by companies of all sizes including a number of large publicly traded corporations.

Some pros and cons:

Pros: Tax advantages: can be significant for the selling shareholders and for the company. For the **selling shareholders**, the primary tax benefit can only be realized if the ESOP is purchasing shares from a C corporation, through the utilization of section 1042 of the Internal Revenue Code, otherwise known as a "1042 rollover." In this circumstance (assuming the ESOP owns more than 30 percent of the outstanding shares post-transaction), the selling shareholders have the ability to roll the proceeds from the sale of their shares into other investments tax free. The greater tax advantage is to the **company**. For all companies, payments made to the ESOP are tax deductible.

Cons: Valuations: While ESOPs can pay a competitive price to the selling shareholders, the ESOP cannot pay a strategic premium for the shares it acquires

Cons: Repurchase obligations: The company has an obligation to repurchase vested shares from ESOP participants who terminate employment. Therefore, careful cash flow planning should take into account the funds necessary to meet ESOP repurchase obligations. Without adequate planning, repurchase obligations can compete with other capital needs, thereby limiting the growth and potentially the viability of the company.

Family Successions

Private companies as family businesses often have insider family members that can take over the business from retiring family members. As in the case of

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management buyouts, owners need to establish a fair market valuation and an arm's length set of terms and conditions for the change of control.

While a family member succession provides the advantage of continuity and the confidence that the business is in the hands of someone committed to its success, it is important for the owners to establish fair market valuations and terms and conditions. These market features can then matched by the family owners.

Family business owners need to recognize the inherent risks to their ultimate liquidity. Business owners dealing with independent acquirers will be less likely to forgive or relent to the need to support the business during a downturn compared to a son or daughter who has a future hiccup. Business owners who are planning their retirement from the business they have built and run for years, need to have arm's length position with respect to seller (family insider) financing, removal of third party debt obligations and guarantees, vendor financing, etc.

Strategic Alternatives and Investor profiles can be summarized as follows:

Strategic Alternatives for Shareholder Owners

	Explanation	Benefits	Other Considerations
Status Quo	◦ "staying the course" ◦ management focuses attention on existing business plans ◦ possible stagnation / mgt. burnout	◦ focus on existing plans ◦ possibly minimizes risk ◦ no change in ownership or capital structure	◦ no liquidity event for shareholders who wish to retire ◦ without growth plan and new capital, company may lose competitive advantage
Sale / Divestiture	◦ sale of more than 50% of the business **Private Equity hybrid/pure play** investors… **Strategic** acquirers will require typically want 100%	◦ liquidity for shareholders ◦ synergies brought by strategic acquirer ◦ financial acquirer brings discipline for managing toward another exit	◦ loss of control ◦ limits to future appreciation (or none) ◦ execution risk ◦ possibility of "second bite of the apple" ◦ estate planning and tax considerations
Sale / Divestiture MBO alternative	◦ sale of more than 50% of the business to management or family members	◦ liquidity for shareholders	◦ risk that full value will never be achieved, due to lenient enforcement of the deal ◦ risk of exiting shareholders having to return to business or providing credit guarantees
Acquisition(s) Expansion	◦ shareholders "double down" and invest for growth and expansion through equity and debt ◦ may require recapitalization	◦ create more value through scale and fixed cost coverage ◦ company becomes more attractive to larger acquirer with improved valuation	◦ financing and execution risk ◦ additional leverage increases risk ◦ may require equity partner, dilution ◦ strain to existing management capabilities
Recapitalization	◦ change in capital structure ◦ possible change in control (dilution) ◦ debt / equity infusion to fund business plan	◦ new capital is brought to grow ◦ **ESOP** option ◦ another vehicle for achieving growth plans where new capital is required	◦ dilution ◦ new equity partner (if equity) will have motives not similar to existing owners

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Connecting the Prospective Investor / Acquirer to the Shareholders of the Business

Once a seriously interested party wants to visit the client company, Grand Avenue Capital and key executives will prepare a confidential Management Presentation that will be delivered by the client CEO (and possibly key executives / shareholders). Clients realize they have one opportunity to make a critical impression.

Purpose & Goal of the Management Presentations

- Must be consistent with the CIM
- Provides an opportunity for management to tell their story
- Provides details above and beyond what is contained in the CIM
- Allows acquirer to be one-on one with the seller to ask detailed questions
- Rehearsal of the presentation is important
- Generally: CEO, Marketing, Operations, Finance, HR will present

Outline of Presentation

- Introduction to the management team
- Investment Highlights
- Business overview
- Markets / Competition
- Growth Strategy
- Financial performance and forecast presentation
- Q&A throughout

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