

Dealmaker

Providing business owners and managers
with M&A market insight

Grant Thornton 

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M&A activity in the consumer industry heats up

While overall deal volume was up 16 percent in the twelve months ending July 31, 2004, the largest increase by wide margin was the consumer industry, which grew at a brisk 38 percent pace. Included in this general industry grouping are segments such as retail, apparel, entertainment & leisure, food processing, beverages and broadcasting.

Broadcasting

Partially explaining the increase in consumer transactions was the large number of deals in the broadcasting segment. In fact, transactions in the broadcasting space more than doubled in the last twelve months (up 110 percent), due mainly to an abundance of relatively small radio station deals. Several players have made a host of radio station acquisitions including: Educational Media Foundation, Simmons Media Group, Salem Communications and Saga Communications.

Retail

The retail sub-sector witnessed a 16 percent rise in transactions on a fairly large base, with no one trend explaining the increase. However, we've noticed a number of interesting themes, including:

- **Cleaning out the attic** - Several multi-unit groups of non-core stores were sold separately by many large players. Some such as Wickes, Kmart and Penn Traffic sold store groups as part of their restructuring efforts, with the buyer more influenced by real estate. Others, such as Albertsons, decided to divest store groups in several non-core markets where it was not the number 1 or number 2 player. In another interesting example, J.C. Penney finally divested its non-core Eckerd Drug chain. Too big to sell to a strategic buyer due to Federal Trade Commission concerns, the chain was sold off in two pieces; one to CVS and the other to Jean Coutu Group.
- **Gasing up** - The Roll-up still appears to be around, at least in two areas of retail: auto dealerships and propane gas distribution. Several players are consolidating the auto dealer space, such as AutoNation, United Auto, Group 1, Lithia Motors and Freedom Roads.
- **Birds of a feather** - Most retail transactions continue to be very synergistic, often sharing similarities in store concept, target demographic, or merchandise. Obvious recent examples include May Company purchasing Marshall Fields, Foot Locker purchasing Footaction, and Dick's Sporting Goods purchasing Galyan's Trading Co.

Beverage

The beverage sector, with a 62 percent increase in deals, also saw several themes arise, including:

- California dreaming - Independent California wineries were gobbled up at a rapid pace, some by the large beverage players like Gallo, Constellation Brands, Allied Domecq and Fortune Brands. In addition, Robert Mondavi Corp. recently accepted a cash and debt offer for its premium wine assets from Constellation Brands Inc. This followed the acquisition of Chalone Wine Group Ltd. by Domaines Barons de Rothschild (Lafite) only days before.
- Water makes a splash - Bottled water companies have become attractive acquisition targets for both private equity and strategic buyers.

- Soda players bubbling up - Pepsi Bottling Group was active in buying several independent Pepsi bottlers. Cott, the largest bottler of private label soft drinks, has also been aggressive in expanding its bottling capacity in the U.S. through acquisition.

Entertainment and leisure

Up 49 percent, the entertainment and leisure sector, which consists of the restaurants, hotels, and casino sub-segments, also had heightened M&A activity. While sales of hotel properties comprised the bulk of transactions, multi-unit restaurant franchise deals also ranked.

M&A sector activity - what's hot

Target Industry Group	LTM 07/31/04 Deal Count	LTM 07/31/03 Deal Count	Change	Growth
Consumer	1,975	1,436	539	38%
Utilities	472	386	86	22%
Technology	1,894	1,611	283	18%
Healthcare	506	458	48	10%
Industrial	2,489	2,271	218	10%
Financials	1,390	1,301	89	7%
Materials	492	465	27	6%
Energy	140	136	4	3%
Totals	9,358	8,064	1,294	16%

Source: Grant Thornton analysis, MergerStat©

The Leveraged ESOP: Another option for obtaining shareholder liquidity

In the summer issue of *Dealmaker*, the Leveraged Recapitalization was highlighted as an overlooked tool for achieving shareholder liquidity. Another such liquidity option is the Leveraged Employee Stock Ownership Plan (Leveraged ESOP).

The Leveraged ESOP is a tax advantaged vehicle that provides a partial liquidity event for shareholders, which can be particularly useful where a limited market exists for the sale of the company. "The Leveraged ESOP offers companies a means for preserving management control and continuing as an independent entity," explains Christopher Kampe, Grant Thornton Corporate Finance director.

"In addition, the ESOP provides employees with ownership in the company, adding an intangible benefit to the business that many believe raises productivity and lowers turnover."

According to Kampe, under an ESOP transaction, the owners seeking liquidity typically sell some portion of their shares in the company to a newly created ESOP trust. To fund the purchase, the ESOP trust borrows the funds from the company, which in turn borrows these funds from a newly acquired bank loan. "In this respect, the amount of liquidity attained by the selling shareholders is limited by the company's borrowing capacity," says Kampe.

Following the creation of the ESOP, the company makes annual contributions to the ESOP trust, much like annual 401K contributions. Annual contributions will equal the annual debt service payments owed by the ESOP trust to the company, which allows the bank loan to be repaid.

"The ESOP trust releases shares to employees based on contributions, so that over time a transfer of shares occurs to employees from the trust," says Kampe. "For the company, 100 percent of these contributions are tax deductible."

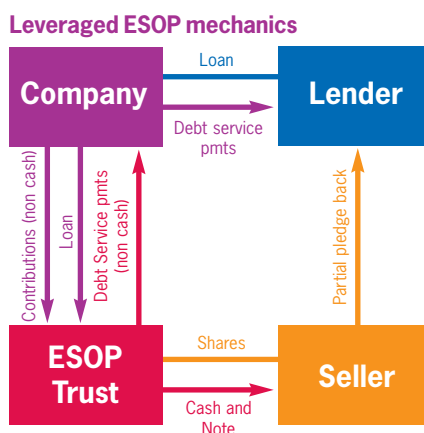
Companies should be aware, however, that establishing an ESOP is not easy, taking time and money to setup and patience to unwind. As a result, companies

should consider the following issues before pursuing an ESOP:

- It generally provides only a partial liquidity event for shareholders, relative to an outright sale or leveraged recapitalization.
- The ESOP increases the financial leverage of a company, which can put cash flow strains on the business and increase risk.
- Selling shareholders can not participate in the ESOP.
- Employee buy back agreements have the potential to create unexpected cash flow drains.
- The ESOP plan invests in company stock, so that failure of the business enterprise will have a significant negative impact on employee's retirement assets.

- As a qualified retirement plan, certain payroll-related criteria must be met in order for an ESOP to be feasible and the plan is subject to payroll related restrictions.
- For certain additional tax benefits to be enjoyed (tax-deferred rollover treatment on sale to ESOP), at least 30 percent of the company's share must be contributed to the ESOP trust.

“The Leveraged ESOP can be a powerful tool for providing shareholders with liquidity, benefiting employees, the sponsoring corporation, commercial lenders and certain estates,” says Kampe. “But, conducting such a complex transaction should not be undertaken without expert advice from legal, tax and financial advisors.”



Deal of the quarter

In July 2004, Air Evac Lifeteam, an air ambulance provider, was recapitalized by their management and an investor group led by Brockway Moran & Partners, a private equity firm located in Boca Raton, Fla., that acquires middle-market companies valued up to \$200 million.

Founded in 1985, Air Evac Lifeteam began with one helicopter and a civic-minded vision of providing desperately needed emergency medical care to the residents of West Plains, Mo. Today, Air Evac Lifeteam has become the preeminent, low-cost provider of air ambulance services to rural markets across the central United States. With over 800 employees, utilizing 50 helicopters based at 40 rural field locations in 11 states, the company provides immediate response to life-threatening medical emergencies.

With a history of providing value and high-quality care to its patients, Air Evac was an attractive candidate for a recapitalization for a variety of reasons, including:

- the company's strong management team wanted to build upon the success of the founder's vision, but was in need of additional capital that the founder was uncomfortable in securing;
- Air Evac is market leader in nearly all the states in which it competes;
- the company has multiple growth options including opening new bases and acquiring smaller local competitors; and
- it was consistently profitable.

According to Patrick Boroian, a partner at Brockway Moran & Partners who now serves on Air Evac Lifeteam's Board of Directors, “The leveraged recapitalization of Air Evac helped achieve the objectives of the founder and his original investors who were seeking substantial liquidity, as well as giving management the opportunity to grow the business more aggressively and to obtain a meaningful ownership stake, while preserving the company's mission to give better access to emergency medical care in rural markets.”

How to value a company: Part I

By Rebecca Tarby, Grant Thornton Corporate Finance senior associate

Valuation is on the minds of most middle-market business owners today, whether or not they are contemplating an M&A transaction. The reasoning is simple. When the majority of an individual's personal wealth is represented by their business, who wouldn't want to know "What's my company worth?" Valuation, however, is an art rather than a science, with the company's worth being what someone is willing to pay for it. Sound familiar? Well, for the most part, it is true.

In any M&A transaction there are usually two valuation multiples - the one the seller thinks he received for his business and the one the buyer thinks he paid for it. The difference between the two is typically reflected by what the buyer thinks they can do with the acquired business under their ownership and the impact that has on the company's profitability. It may be as simple as the elimination of duplicated overheads or as involved as leveraging existing products across newly acquired distribution channels.

In this first of a series of articles, we are going to look at some of the more common

valuation methodologies that are used to value middle-market companies. The most frequently used techniques are public company comparables, precedent M&A transactions, discounted cash flow, and leveraged buyout modeling. In this article we will focus on public company comparables.

Public company comparables analysis

A public company comparables analysis ("comparables analysis"), in essence, examines how the investment community values a set of companies that are similar to the subject company. Looking at what an informed buyer is willing to pay for a share of a similar company's stock can provide insight into relative value for a middle-market private company and guidance for an expected valuation.

Choosing a peer group

When conducting a comparables analysis, publicly-traded companies are selected that resemble, as closely as possible, the subject company and its value drivers - typically by either type of business conducted (e.g. widget manufacturer,

clothing retailer) or primary markets served (e.g. government contractor, retail consumer).

Calculation mechanics

Once the universe of comparable companies is established, determining the value placed on each company from an EBITDA multiple standpoint is calculated according to the following 'basic' formula:

$$\frac{\text{Enterprise Value}}{\text{EBITDA}}$$

(stock price x shares outstanding + funded debt (including minority interests) - cash and equivalents)

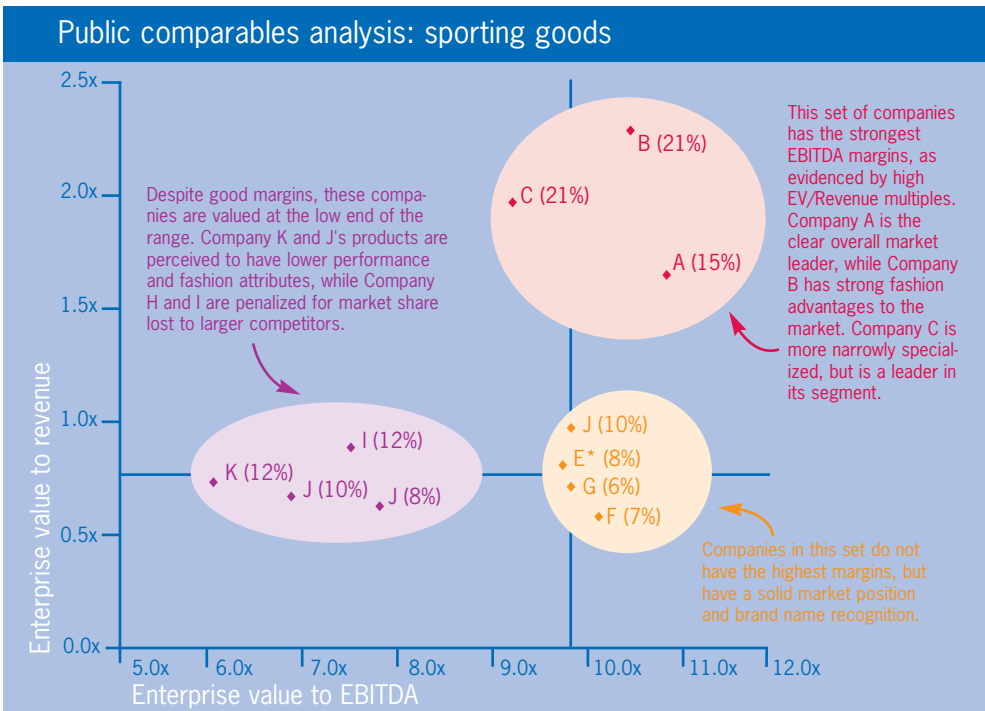
(earnings before interest, taxes, depreciation, and amortization)

Adjustments on this basic formula include modifying the shares outstanding to reflect the dilutive effect of in-the-money options or warrants, which is often the case with technology companies, and normalizing EBITDA to adjust for one-time or unusual circumstances such as restructuring charges.

Variations on this analysis can be conducted using a number of different denominators, depending on specific industry norms and can include multiples of EBIT (earnings before interest and taxes), revenue (e.g. for high tech companies), and Net Book Value (e.g. transportation companies). These multiples can be calculated on an annual, trailing twelve month (TTM) or projected (forward) basis.

Narrowing valuation ranges

The results, taken as a whole, can be used to not only develop an implied range of value for the subject company, but to compare the relative value of companies within the comparable set itself. In this way, one can determine what attributes are rewarded most in the public market. For example, in a recent comparables analysis



conducted for a sporting goods company, the results showed a distinct valuation pattern (as shown in the graph below).

Companies that commanded the highest EV/Revenue multiples were clearly those with the best EBITDA margins (over 15 percent). The companies that commanded higher EV/EBITDA multiples, however, tended to sell products that had the most perceived technical or fashion advantages, but were not necessarily those with the strongest EBITDA margins. The third tier of companies either had lower market share or sold products with low performance attributes.

Premiums and discounts

When using the public comparables approach to value a privately held business in conjunction with a proposed sale, adjustments are commonly made for three additional factors:

(i) Control premium - The comparables analysis methodology, by nature, values a minority stake, or non-control position in a company. To value a control position, a premium must be added to the minority stake valuation. This premium represents buyers' perceived ability to bring about positive change in operations with control. Examples of the benefits of control may

include the buyers' ability to change management, increase/decrease dividend policies, or streamline operations.

(ii) Liquidity discount - The comparables analysis methodology examines the value of publicly traded companies with relatively liquid shares. Because there is a ready market for the stock of these companies, selling shareholders can be reasonably assured of a quick - and efficient - sale. Often, however, it is much more difficult to find a buyer for stock in a private company and selling shareholders can not always be assured of receiving timely funds or fair value for their shares. As such, when valuing a private company vis-à-vis its public counterparts, a liquidity discount is often applied to account for this additional risk.

(iii) Size discount - Finally, companies used in a comparables analysis are often times significantly larger than the private, middle-market companies they are used to value. Theoretically, valuation differences related to company size are often attributable to risk. Larger companies often have more diversified revenue streams, deeper management, greater purchasing power, more efficient distribution, etc. Since the public market

tends to reward larger companies with higher relative valuations, an adjustment to comparables analysis multiples is often necessary.

As with all methods of valuation, the comparables analysis has distinct advantages and disadvantages:

Advantages:

- Readily available financial information
- Efficient market with well informed investors
- Real-time (daily) changes in market capitalization reflect current economic and other external factors

Disadvantages:

- Not always a clear/directly comparable universe of companies
- Companies are often significantly larger than subject company

It is important to note that no one valuation method should be relied on in a vacuum - multiple techniques should be considered. In the next part of the "How to value a company" series, we will discuss the precedent transaction methodology in more detail.

Other GTCF News

New Hires

Grant Thornton Corporate Finance is pleased to announce that John Ferro has joined the corporate finance team as a director in the New York office. John is highly experienced with more than 20 years of transaction and investment banking experience. He has advised on over 100 transactions involving U.S. and international clients, healthy and distressed companies (including companies in bankruptcy), publicly traded and privately held companies. John also has significant experience in providing valuations/fairness opinions and has provided expert testimony relating to valuation matters in arbitration disputes, jury trials and bankruptcy hearings. Prior to joining Grant Thornton Corporate Finance, John founded the investment banking business at FTI Consulting, Inc., a company traded on the NYSE.

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Content for Dealmaker is produced by Stephen McGee and Christopher Kampe, directors with Grant Thornton Corporate Finance. For more information on any of the topics covered in this newsletter, please send an e-mail to Stephen.Mcgee@gt.com or Christopher.Kampe@gt.com.

In 2003, Grant Thornton was credited with 109 M&A transactions worldwide, placing the firm 19th in the annual M&A league tables produced by Thomson Financial. This is the third year in succession that Grant Thornton has placed in the Top 20, ranking 18th in both 2001 and 2002. Grant Thornton has approximately 1,000 corporate finance professionals around the world.