CONFIDENTIAL DISCUSSION MATERIALS

# THE ESSENTIAL CFO
## Leading and Executing Growth Strategies

February 26, 2014

DELANCEY STREET
PARTNERS, LLC

THE CFO ALLIANCE

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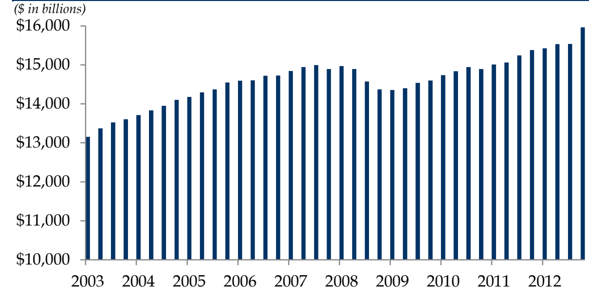
# Introduction

# Market Comments

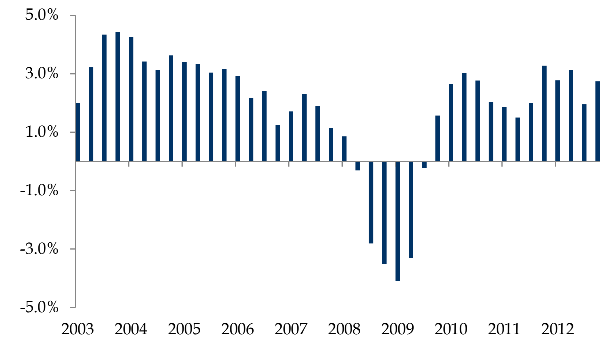
- **Recession: December 2007 – June 2009**
  - Cost cutting
  - Survival
- **Economic recovery: June 2009 – Present**
  - Revenue growth driven by market share gains
  - Weak competitors suffer at the expense of stronger, well-positioned competitors
  - Modest organic growth
- **Result: Net profit grows faster than revenue**
- **As revenue growth slows, companies are exploring means to accelerate growth in a continued weak economy**
  - No more costs to cut
  - Market share gains completed
  - Limited organic growth
- **Q4 2013 GDP growth: 2.7%**

## U.S. Real GDP[1]



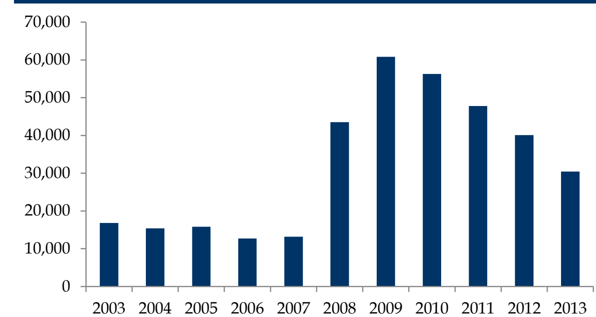

(1) Source: Capital IQ

## U.S. Real GDP YoY Growth[1]




(1) Source: Capital IQ

## U.S. Corporate Bankruptcies[1]

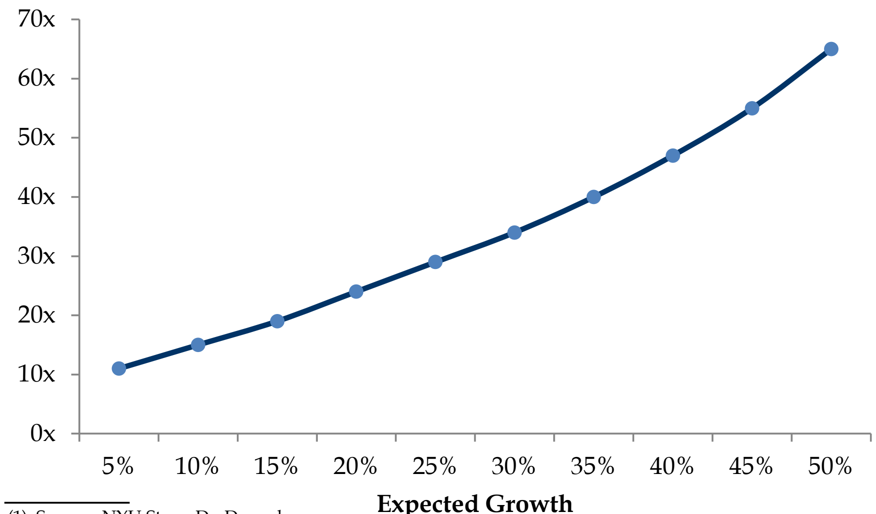



(1) Source: American Bankruptcy Institute

# Why is Growth Important?

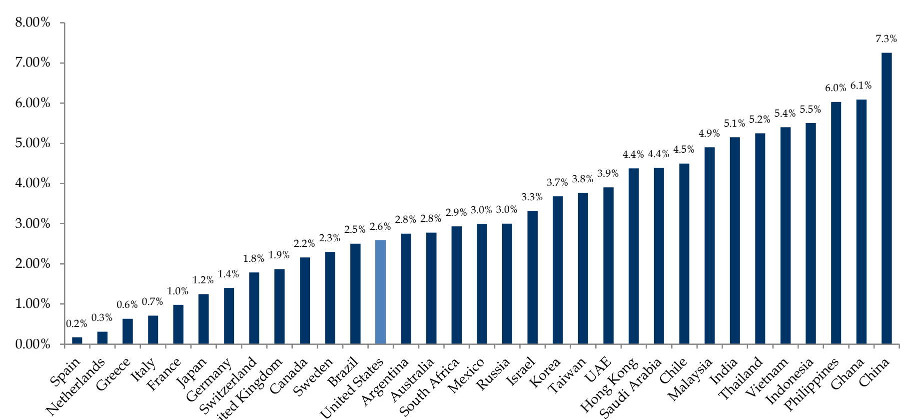
- **Value creation**
  - Private company wealth
  - Public company market capitalization
- **Risk mitigation**
  - Obsolescence
  - Customer concentration
  - Management depth
- **Multiple sources of growth**
  - Geography
  - Products / Services
  - New customers
  - New markets
- **Methods**
  - Organic
  - Acquisition
- **Ideal: Forward multiple valuation**

## Price / Earnings Ratio[1]




(1) Source: NYU Stern, Dr. Damodaran

## Projected Global GDP Growth: 2014[1]




(1) Source: IMF

## Considerations When Planning for Growth

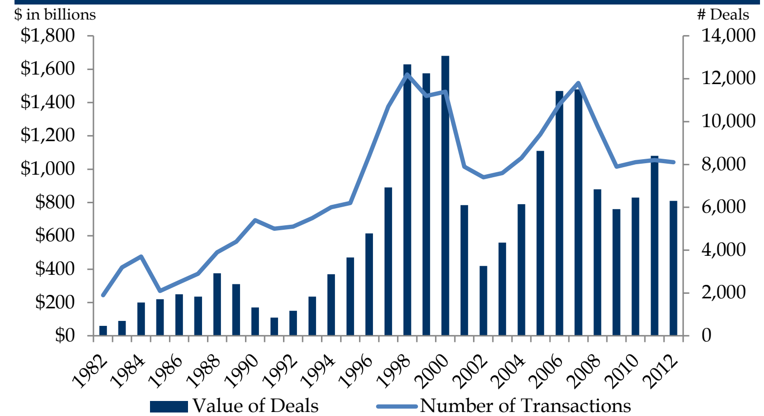
| | |
|---|---|
| **Avoid single source of growth** | **Your competition is growing** |
| **Status quo has inherent / hidden risk** | **Requires: Hard work, planning and diligence** |

# M&A Market Overview

# Historical M&A Market Overview

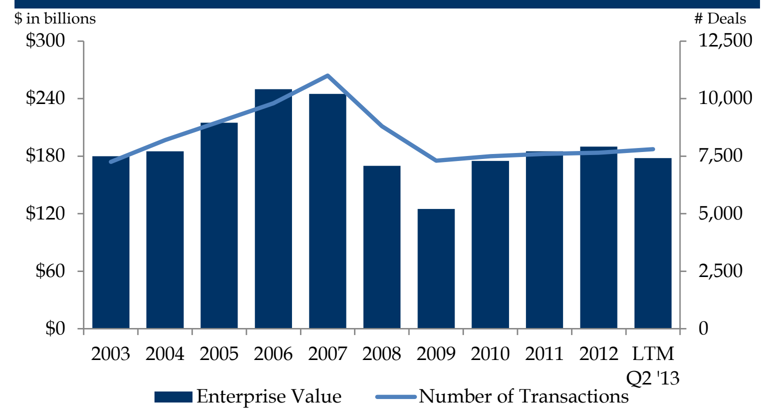
- **Over the past 20 years, the number of middle market M&A transactions has increased significantly**
  - M&A activity in the middle market has bounced back more strongly than the broader market
  - Multi-billion dollar, "headline" transactions have been more scarce, but are picking up
- **A variety of factors have contributed to increased interest in middle market acquisitions**
  - Public markets have become less hospitable to middle market companies
  - Private equity firms have raised significant capital
  - Public corporations have fewer options for generating growth
  - The U.S. economy continues to attract foreign capital
- **Modest economic recovery has created a positive backdrop for M&A**
  - Operating and financial visibility have returned
  - Businesses are gaining confidence in projections and growth
  - With cost reductions and efficiencies gained during the recession, buyers are looking for external growth through acquisitions
  - Sellers are looking to capitalize on improved financials

## Historical U.S. M&A Activity: 1982 – 2012[1]




(1) Source: Thomson Reuters, as of 12/31/12.

## Historical Middle Market M&A Volume[1]

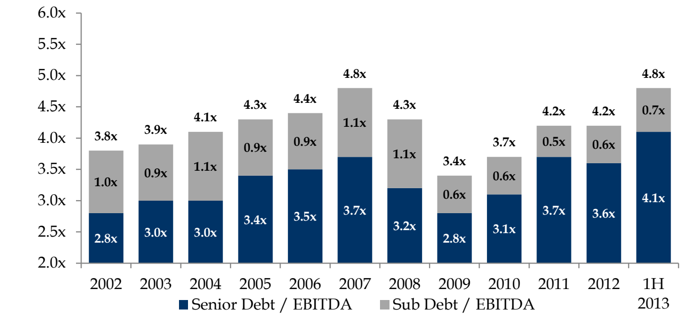



(1) Source: Thomson Financial, Middle Market defined as deals < $500MM.

# Current M&A Environment

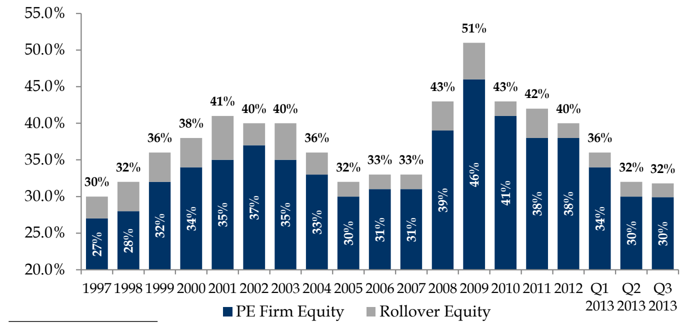
- **Strategic acquirors and private equity funds are under pressure to deploy accumulated cash**
  - PE funds largely spent much of 2008 and 2009 on the sidelines
  - Corporations hoarded cash while slashing costs during the recession
  - There is a sense of urgency to deploy capital for acquisitions that yield a higher return
- **Return of leverage supports acquisition financing and allows PE funds to be more competitive in auctions**
  - Bank lending has resumed, especially for larger transactions
  - Leverage multiples of 3.5x – 5.0x are sustainable and supportable
- **Valuations have begun to rise as competition for deals increases**
  - Deal terms favor sellers in competitive auctions
  - Supply / demand imbalance not expected to be resolved in the near term
- **There is a distinctive <u>scarcity premium</u> in the market for quality companies**

**Middle Market Leverage Multiples[1]**



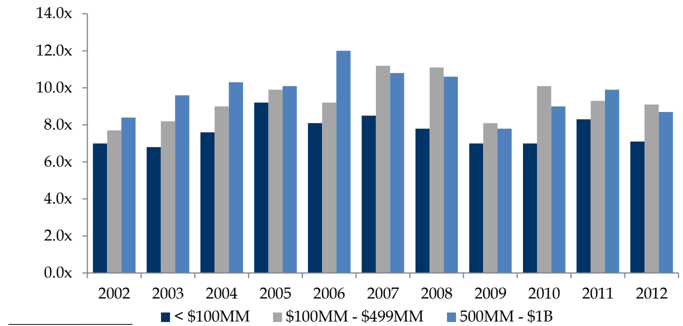

(1) Source: S&P LCD: Transactions with EBITDA less than $50MM.

**Average LBO Equity Contributions[1]**




(1) Source: S&P LCD.

**EV/EBITDA Multiple[1]**



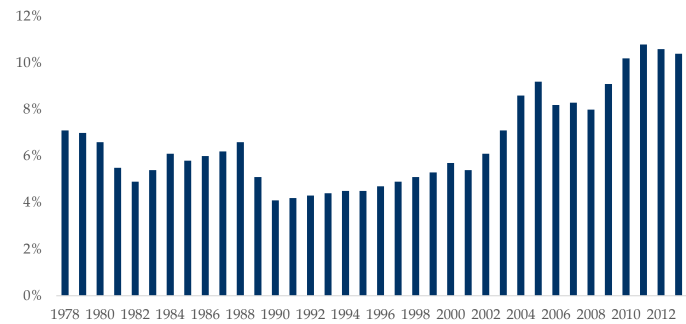

(1) Source: Capital IQ.

# Equity Market Reaction to M&A Transactions

- **In general, public companies are well-capitalized with significant cash on the balance sheet and access to capital at a low cost**
- **However, these companies need to show investors EPS growth to continue to increase stock prices**
- **In a low-growth macro environment, public companies are exhausting alternatives to fuel EPS growth:**
    - Cost-cutting
    - Share buybacks
    - Market share gains
- **Investors are increasingly awarding acquirors; the stock price of the acquiror is frequently rising at announcement**
- **Management teams and Boards of Directors are more aggressively seeking acquisition opportunities**

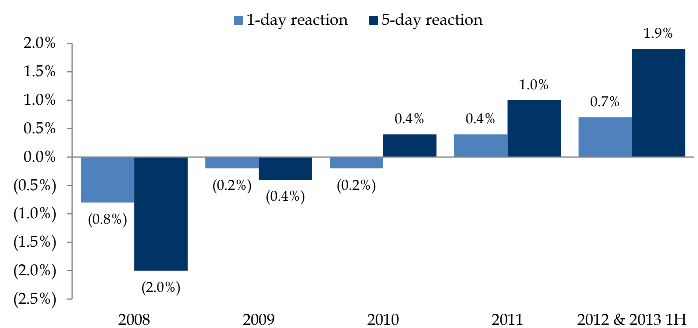
(2) Source: FactSet and company filings as of 6/30/2013. Includes acquisitions by U.S. buyers with minimum deal value of $500mm, % owned <20%, % acquired >80% and target >5% of the size of the acquiror.

**Cash as % of Assets for Non-Financial Members of the S&P 500 Index(1)**

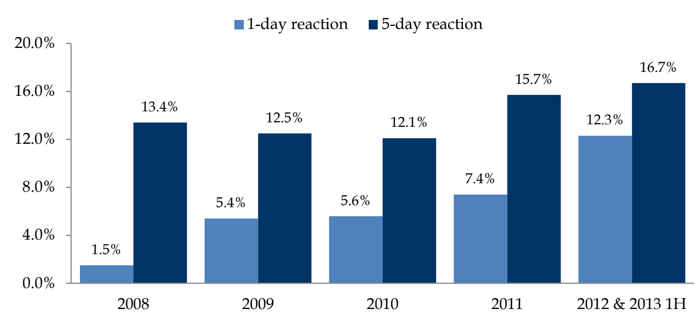



(1) Source: Compustat and Wall Street Research.

**Median Acquiror Stock Price Reaction(2)**




**Percentages of Acquisitions with Market Reaction > 10%(2)**

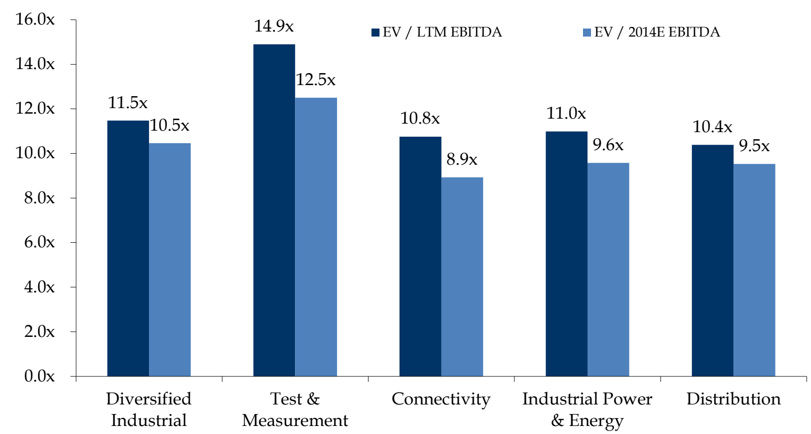


# Industrial Technology: Summary Public Company Data[1]

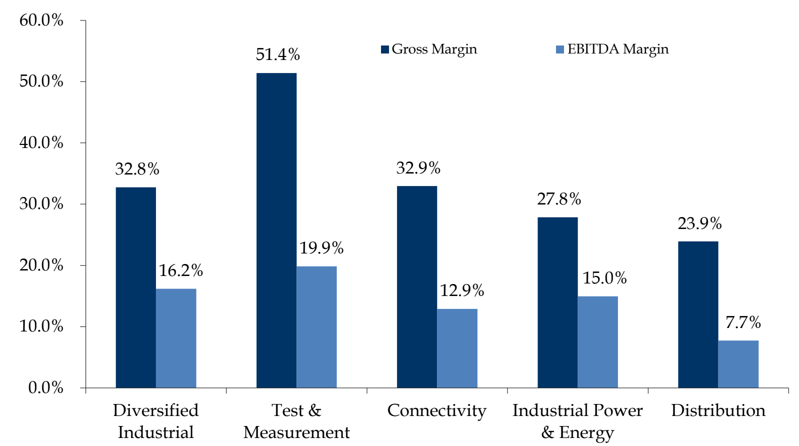
**Strategic multiples are strong across the Industrial Technology sector. Companies are rewarded for value-added services and growth through acquisitions.**

| Metric | Diversified Industrial | Test & Measurement | Connectivity | Industrial Power & Energy | Distribution |
|---|---|---|---|---|---|
| EV / LTM EBITDA | 11.5x | 14.9x | 10.8x | 11.0x | 10.4x |
| EV / 2014E EBITDA | 10.5x | 12.5x | 8.9x | 9.6x | 9.5x |
| 2014E P/E | 17.9x | 21.2x | 17.3x | 16.3x | 16.2x |
| EV / LTM Revenues | 1.91x | 2.75x | 1.42x | 1.71x | 0.77x |
| 3-Yr. Revs CAGR | 6.8% | 11.6% | 5.9% | 7.9% | 7.7% |
| Est. 5-Yr. EPS Growth | 12.8% | 13.4% | 12.7% | 11.5% | 13.0% |
| Gross Margin | 32.8% | 51.4% | 32.9% | 27.8% | 23.9% |
| EBITDA Margin | 16.2% | 19.9% | 12.9% | 15.0% | 7.7% |
| YTD Stock Price Change | (3.1%) | (0.2%) | (0.5%) | (4.1%) | 2.1% |
| 30 Day Stock Price Change | (3.5%) | (0.6%) | (0.9%) | (4.6%) | (0.7%) |

## Industry Valuation Metrics




## Industry Profitability

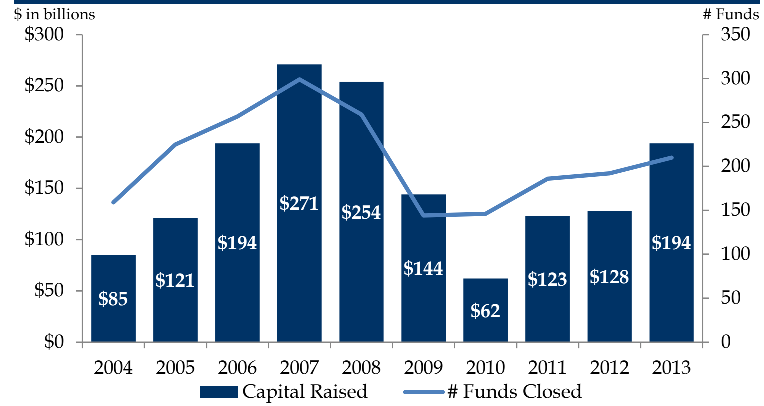



(1) Source: S&P Capital IQ.

# Evolution of Private Equity

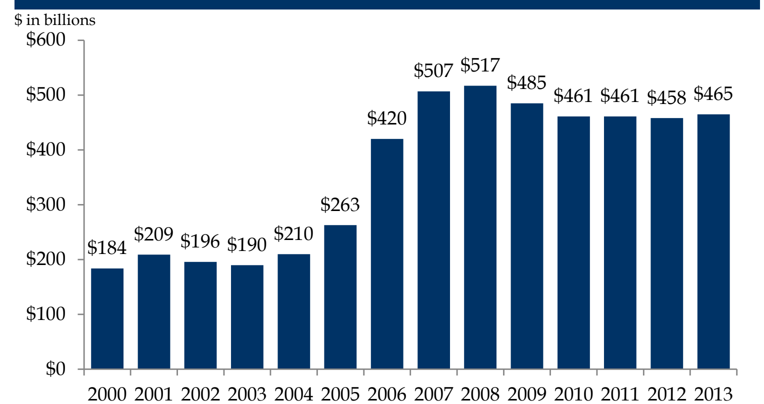
- **Financial sponsors have proliferated**
  - A continuum of capital is accessible
    - Venture
    - Growth
    - Buyout
  - The number of dedicated funds has increased to more than 3,500 in the U.S.
  - The number of companies owned by financial sponsors has increased to more than 32,000
  - To achieve expected returns, funds often specialize by industry, type of company and strategy
  - Many funds have become "strategic" buyers
- **A significant PE overhang persists**
  - After record fundraising years in 2007 and 2008, the gap between funds raised and equity invested widened
  - Since the recession, the overhang has declined modestly
  - The capital overhang is estimated to be $465 billion

## U.S. Private Equity Capital Raised[1]




(1) Source: Pitchbook Data.

## U.S. PE Overhang[1]

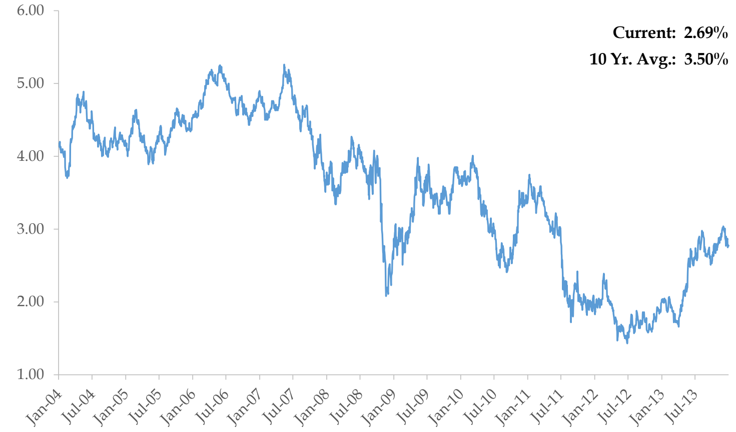



(1) Source: Pitchbook Data.

# Middle Market Leveraged Finance Overview

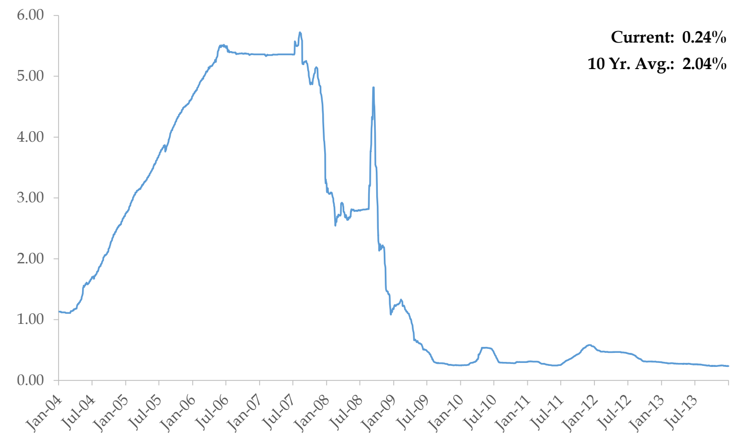
- **Leveraged finance market conditions remain favorable for middle market companies**
  - Robust investor demand for yield
  - Historically low interest rates
  - Significant supply of capital through CLO issuances and newly raised BDCs
  - Competitive pricing
  - Flexible terms, covenant structures and maturities
- **Leveraged loan new issue volume continues to be strong in 2014, particularly with interest rates remaining at low levels despite "taper talk," supporting a favorable environment for borrowers**
- **Favorable debt capital markets and lending conditions have middle market debt providers seeking to deploy capital in various structures beyond straight senior debt:**
  - UniTranche / "One-stop"
  - Second Lien
  - Mezzanine

## 10 Year US Treasury Yield[1]




(1) Source: S&P Capital IQ

## 3 Month LIBOR[1]




(1) Source: S&P Capital IQ

# Case Study & Roundtable Discussion: Positioning for Growth

ABC Company – Niche Electronics Component Manufacturer

# DSP’s Private Company “Valuation Score Card ™”

*Valuation Multiple*

| Team | *LOW* | *HIGH* |
| --- | --- | --- |
| Team Depth | Gaps in functional areas; shared resources | Full C-level team; standalone |
| Executive Leadership | Reliant on one person | Strong, seamless team |
| “Scalability” (and Processes) | Have not managed growth | Proven track record |
| Sales Execution (People and Plan) | Limited sales team | Head of Sales/ replicable processes |
| **Product Offering** | | |
| Differentiated Offering | Partial solution/ limited differentiation | Full suite/ proprietary/ pricing power |
| Solution Suite | Partial or “plug” solution | End-to-end solution |
| Product Development/Innovation | Limited new product intro’s or refresh | Multiple new products |
| **Financial** | | |
| Revenue Scale | < $25 million | > $100 + million |
| EBITDA Scale | < $10 million | > $20 million |
| Organic Growth (unit/ total) | < 5% | > 10% |
| Recurring Revenue | No recurring revenue | Replacement, spares, services business |
| EBITDA Profitability | < 10% EBITDA margin | > 20% EBITDA margin |
| Pipeline | Limited NTM coverage | Strong visibility |
| Business Mix | Concentrated | Multiple products/ services |
| Customer Concentration | Top 10 > 50% revenues/ profit | No customer > 10% revenue/profit |
| Organic Growth Ability | Limited organic growth | Growth from existing and new customers |
| Financial Controls | Limited controls, reporting | Strong CFO, full audit |
| **Industry** | | |
| Addressable Market Size | < $500 million | > $5 billion |
| Competitive Dynamics | Dominated by few players | Highly fragmented |
| Regulatory/ Economic Climate | Negative trends | Favors outsourcing solutions |
| Acquired Growth | Limited acquisition opportunities | Target-rich consolidation opportunities |

# Summary Company Highlights

## ABC Company Overview

**ABC Company Summary**

Manufacturer and supplier of connectivity solutions (wired and wireless) for mission-critical systems with high quality, immediately available product and an intense focus on service to the customer

- **Quality products for demanding customers:**
  - Product reliability and performance is paramount; zero tolerance for product failures
  - Demanding OEM customers purchase from trusted suppliers
  - Price is not the primary purchase criterion (small part of total overall cost)
- **Immediate availability of stock, custom and hard-to-find products**
  - Broadest offering of innovative product designs; small average order size
  - "Do you have the product in stock and when can I get it?"
- **High commitment to customer service: technical expertise, responsiveness and solution selling**
- **Multi-channel sales and marketing: i) direct (catalogue); ii) direct sales force; iii) distribution; iv) web**
- **On-shore and off-shore manufacturing (plant in Asia for higher volume opportunities)**
- **Strong management team; "pledge fund" private equity investors (invested for 5 years)**
- **Above industry average profitability: ~ 25.0% EBITDA margins**
- **Attractive cash flow characteristics and credit profile**
- **One historical acquisition to extend product line: significant post-acquisition challenges**

# ABC Company – "What's Our Plan?"

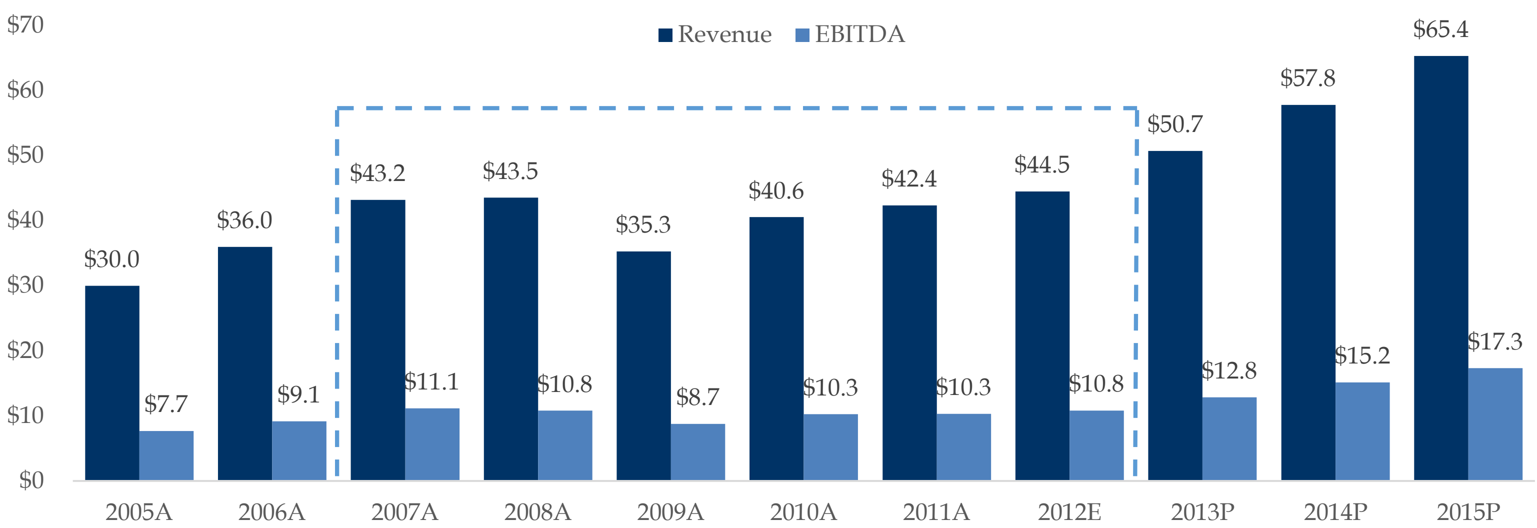
## ABC Company Situation Overview

| | |
|---|---|
| **Situation Analysis: 2011** | ■ Management and investors stepping back post downturn: "what's our strategy…world is not crumbling…how do we grow…what are our alternatives…what are our next steps?"<br>■ Top line back to 2007 revenue and EBITDA levels ($50.0mm in revenue, $12.5mm EBITDA)<br>■ "Just scratching surface" in a very large market; highly fragmented connectivity market<br>■ Great job managing EBITDA margin maintenance through downturn<br>■ Healthy balance sheet and credit profile; 2.5x total debt / EBITDA; low capex requirements |
| **Growth Considerations and Questions** | **Management and shareholders considered a series of questions regarding growth**<br>■ "How to grow business >10% annually with 20,000+ customers that purchase low volumes?"<br>■ "We can get more volume with distributor partners – do we tap that channel more? How? What is strategy?"<br>■ "Do we pick up some high quality direct sales executives with key account relationships? What is payback?"<br>■ "If we stray too far from our direct sales roots, what are the potential challenges?"<br>■ "We now have manufacturing base in Asia – do we tackle Asia market with same model as U.S. strategy?"<br>■ "The last acquisition was a lessons learned exercise – do we go down that path given our experience?"<br>■ "We clear have a healthy balance sheet and ample access to capital (debt and equity) – what are our alternatives from a capital structure and capital markets perspective?"<br>■ "What do our shareholders want to accomplish?"<br>■ "Do we consider a sale of the Company? Do we consider a recap?" |
| **Challenges** | ■ Despite investment in several growth initiatives….top line was slow to reflect investment<br>■ "We're a better company than just a GDP growth company"<br>■ Is it possible to replicate a successful business model in the U.S. and take that success overseas?<br>■ "What are we trying to accomplish: i) aggressive revenue growth or ii) maintenance of 25% EBITDA margins?"<br>■ "Is our multi-channel model the right model for aggressive growth?" |

# Long Term Financial Profile

- **Observations**
  - Strong EBITDA margins
  - Consistent performance through business cycles
  - Low capex requirements
  - Strong credit profile
  - Need to focus on turn-around of an acquired business line
  - Considering various growth initiatives: i) sales and marketing; ii) new product development; iii) acquisitions; iv) overseas growth
- **"The business is like investing in a bond (..albeit a high quality bond..)"**

**Revenue & EBITDA**

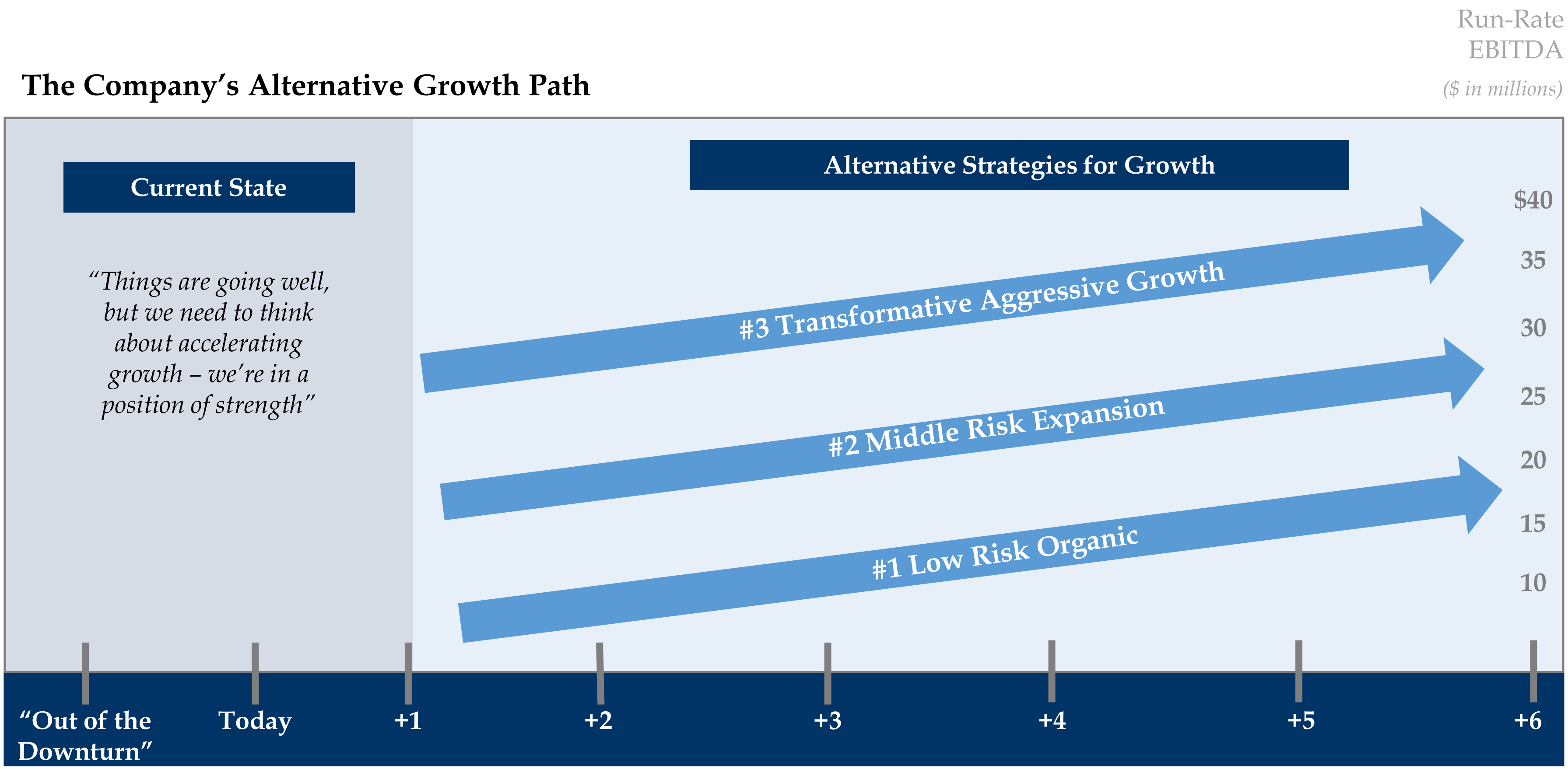


# ABC Company Strategic Considerations

- **With a strong financial profile, ABC Company is well positioned to consider a wide variety of strategic alternatives**
  - Clearly in a position of strength to make a fully informed decision
  - There are various growth opportunities (organic and inorganic)
  - Capital structure considerations (dividend recap for shareholders)
- **Key inputs to determining the "trajectory" of your growth path include**
  - Your ultimate "exit" plan and timing
  - Risk tolerance (business-level, ownership)
  - Prioritization of growth strategies (organic, geographic expansion, through acquisition)
- **Potential growth alternatives**
  - **Lower risk organic:** Execute on existing plan (no change to business model)
  - **Middle risk expansion:** Organic growth driven but with more emphasis on a strategic expansion of the Company's channel initiatives, overseas expansion and/or lower risk tuck-in acquisition(s)
  - **Aggressive growth:** Above scenarios PLUS business model changes to increase addressable market AND complete a "transformative" acquisition of significant scale

# ABC Company Alternative Paths for Growth

**The Company's Alternative Growth Path**



# Highlights for Discussion Exercise

- **Company Highlights**
  - Dynamic leadership team capable of executing growth strategies
  - Low share of the total market / high share of addressable market
  - Deep expertise in the industry; no single end market concentration
  - Very sound business model, but trying to find avenues of growth, “no simple strategy to execute”
  - Large customer database; no single order or customer will significantly move the needle
  - Recent comparable M&A transactions completed at 8.0x – 10.0x EBITDA
  - Attractive financing environment
  - Limited competition – larger strategics focus on high volume applications
  - Shareholder and management dynamics: “everything is on the table for discussion”
- **Case Study Questions**
  - What could ABC Company do to increase its valuation? What growth opportunities should it consider?
  - What risks should the Company consider in executing its growth plan?
  - How would you mitigate these risks?
  - What course of action do you think ABC Company pursued: i) recap; ii) sale; iii) organic growth; iv) growth through acquisition? Why?
  - What is your estimate of the Company’s Enterprise Valuation? How much total debt do you think is available to this Company (as a multiple of EBITDA)?
- **Discussion Thoughts**
  - What is your biggest obstacle to growth?
  - Is growth an offensive or defensive strategy for your business?

# Conclusion

- **Growth is a critical topic of discussion for every company of every size, private or public**
- **Without growth:**
  - May limit strategic alternatives; prevent execution of key initiatives
  - Limited upside to valuation
  - Significant risk to future valuation
    - Lack of track record of growth puts a ceiling on valuation
    - Size and scale helps valuation and also facilitates access to alternative forms of capital
- **Organic growth - analyze core competencies and leverage them to:**
  - Penetrate new markets
  - Consider further penetration of key markets or customer segments that drive the highest profitability; create "sticky" customers; increase level of ongoing revenues from these key customers
  - Consider pricing strategies; financial sponsors address pricing power as a first topic with a new portfolio company
  - Manufacturing strategy: fully captive, "variable" or fully outsourced; what is the right strategy?
  - Diversify revenue stream by geography, customers and end market
- **External growth - identify acquisition targets to:**
  - Accelerate diversification of geographies, customers, and markets
  - Potentially transform the Company dramatically
- **A successful acquisition program requires a methodical, diligent and strategic long-term approach by senior management**