M&A Series Pt. 2: Strategic Liquidity Alternatives

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Agenda

- Strategic Liquidity Alternatives
- Strategic & Private Equity Structures
- Financial Buyer Structures
- M&A Activity by Buyer Type
- Private Equity Buy-Out Activity
- Leveraged Buyout Multiples
- LBO Mechanics, Sample Model, Case Study & Recap

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Strategic Liquidity Alternatives

- **Non-Financial Factors**
  - Retirement of one or more primary shareholders
  - Death or illness of the owner
  - Divorce or conflicting interests between the Shareholders
  - Readiness of heirs to take over the business

- **Financial Factors**
  - Desire for liquidity and asset diversification
  - Optimal market timing / pricing / approached by buyer
  - Competitive market pressures / changing industry dynamics
  - Tax Policy Change

- **Most external factors drive a “reactive” response**
  - Suboptimal result – “fire sale” situation
  - Need to be proactive to optimize outcome
  - Planned exit allows for a smooth transition to defined transition team or buyer

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Strategic Liquidity Alternatives

- **Key Sale Determinants**
  - Maximization of business value
  - Liquidity or asset diversification
  - Market pressures / changing industry dynamics
  - Growth capital

- **Family / Employee Succession**
  - Transfer to family members / legacy and reputation
  - Employee ownership and stakeholder concerns
  - Transfer issues / tax implications

- **Third-Party Sale**
  - Financial investors
  - Strategic / Competitor – synergistic combination
  - On-going role in the business for management / Shareholders
  - Greater opportunity for advancement / equity participation for employees

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Strategic Liquidity Alternatives

	Traditional ESOP	Private Equity Minority LBO	Private Equity Majority LBO	Strategic Buyers
Valuation / Up-Front Liquidity	+	+	++	+++
Tax Minimization	+++	++	++	+
Time to Full Liquidity	+	++	++	+++
Management Incentives	++	++	+++	+
Employee Ownership	+++	++	++	+
Minimize Cultural Disruption	+++	+++	+++	+
Maintain Operating Control	+++	++	++	+
Transaction/Compliance Costs	+++	++	++	+
Minimize Debt	+	++	++	+++

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Strategic & Private Equity Structures

Acquiror	Transaction Structure	Valuation	Considerations
Strategic Buyer	○ Simple structure ○ Normally purchase of 100% ○ Synergistic acquisition rationale	○ Highest value (synergies) ○ Stock or cash ○ Highest probability of close	○ Stock or Asset Sale ○ Stock options ○ High probability of employee ○ / facility rationalization
Financial Sponsor (PE Firm)	○ Leveraged recapitalization: ○ —Equity roll between 10 – 15% ○ —Leveraged corporation – 3.0x – 4.0x EBITDA ○ —3.0x senior / 1.0x mezz debt ○ 60 – 80% sale of Company ○ Investment in Management ○ 3-5 year commitment	○ Competitive or better pricing – if platform acquisition ○ “Second bite of the apple” ○ Lender verification ○ Lower probability of close	○ Cash and rolled (tax-deferred) equity ○ Co-invest in new acquisitions ○ Equity promotes 10%-15% ○ Continuity of management ○ Transparency to market

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Financial Buyer Structures

Acquiror	Transaction Structure	Valuation	Considerations
Financial-Strategic	○ Financial buyer with existing (strategic) platform investment ○ Add-on / "bolt-on" investment ○ Industry roll-up strategy or acquisition growth	○ Typically, less than "premium platform" multiple ○ Synergies may increase value	○ Stock or Asset Sale ○ Stock options ○ Retention of employees ○ Non-compete period + employment agreement
Financial Sponsor (PE Firm)	○ No existing platform portfolio company ○ Company would be acquired as a "platform" investment ○ Typically has a prior investment or strong mandate to pursue target's industry	○ Competitive pricing with strategics in "today's" market ○ Potentially significantly higher value over the long-term ○ "Second bite of the apple"	○ Leveraged recapitalization ○ Cash and rolled (tax-deferred) equity ○ Co-invest in new acquisitions ○ Equity promotes 10%-15% ○ Continuity of management

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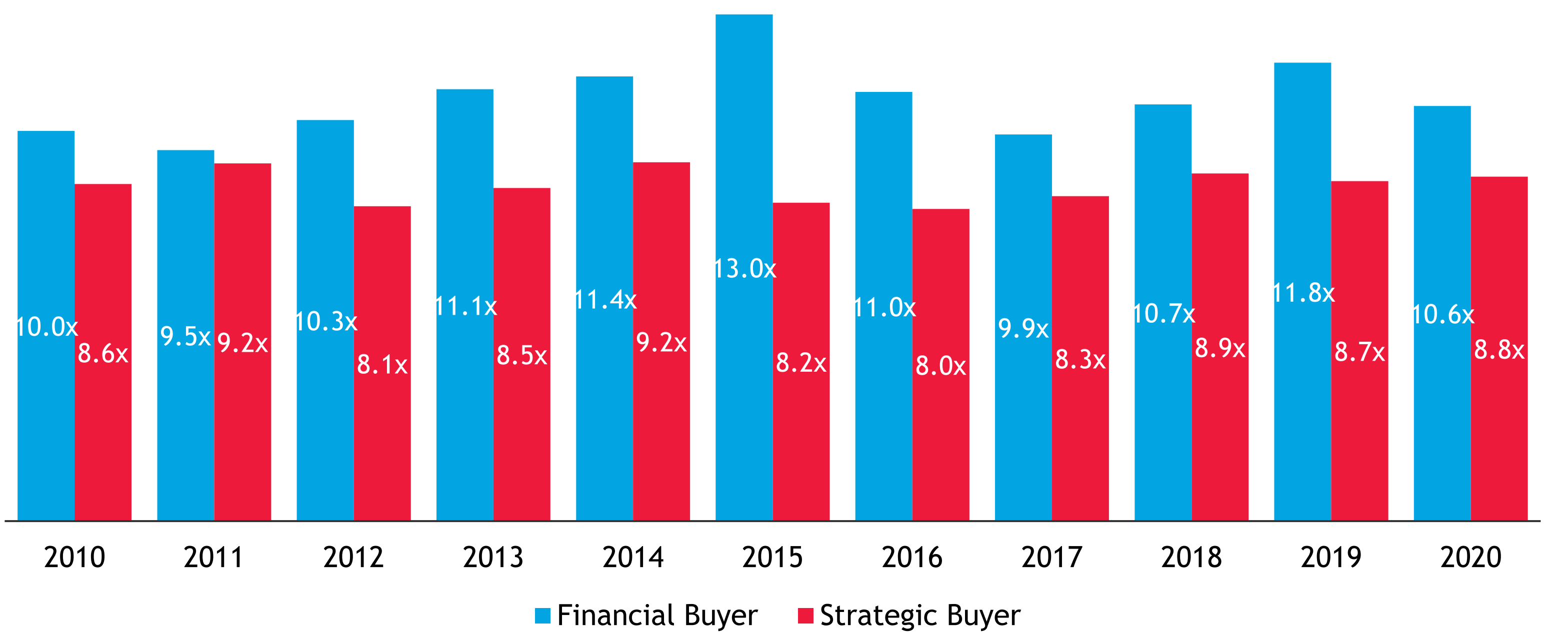
M&A Activity by Buyer Type

Financial Buyers Continue to Pay More

- Financial buyers are feeling pressure to deploy capital, which has caused them to continue to pay more than strategic buyers.
- Financial buyers paid a median EV/EBITDA transaction multiple of 10.6x in 2020 compared to 11.8x in 2019, down slightly driven by the pandemic. Strategic buyer transaction multiples were up slightly in the same period.

U.S. Median EV/EBITDA by Buyer Type



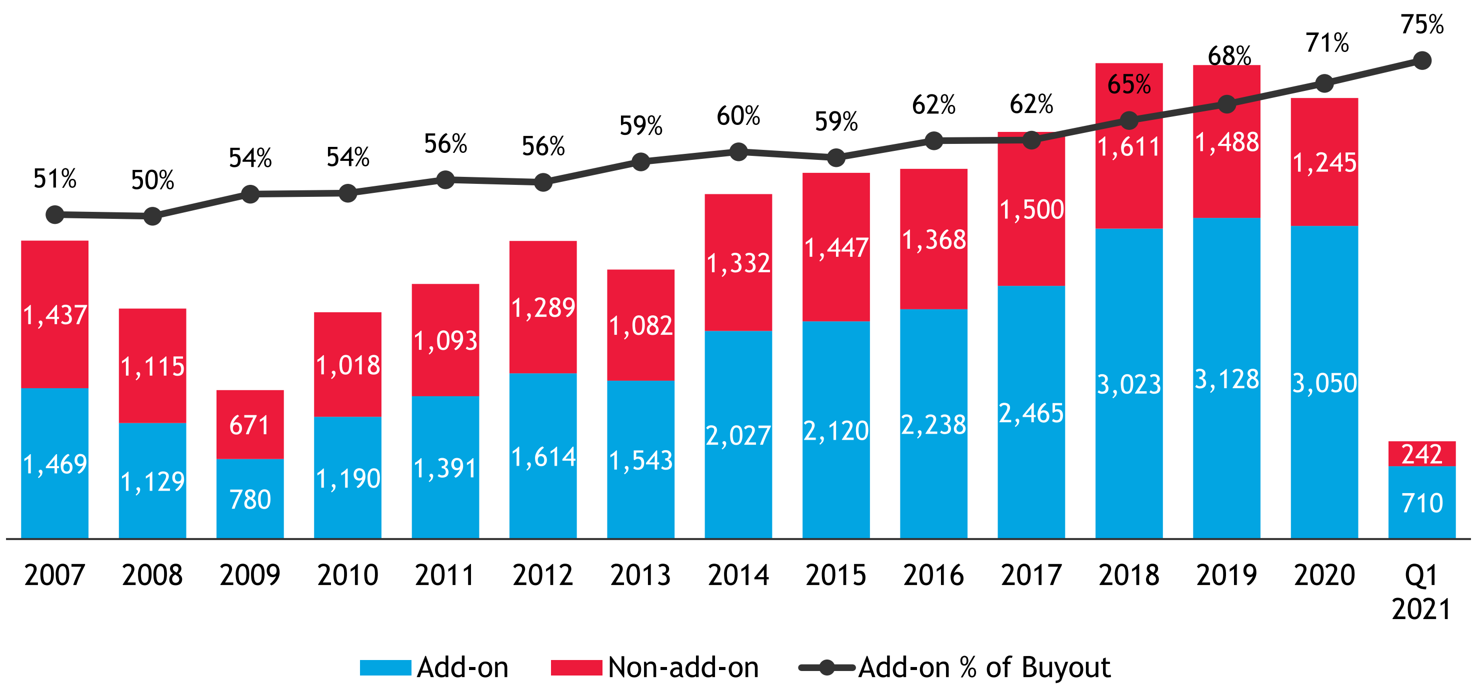
Source: S&P Capital IQ; includes deals <$500M and EBITDA multiples between 3x and 20x

Private Equity Buy-Out Activity

Private Equity Add-Ons Increase and Portfolio Risk Mitigation Continues

- Private equity add-on transactions continue to make up a larger share of US M&A activity, constituting 75% of total buyouts in Q1 2021 versus 71% for the year 2020.
- Tuck-in acquisitions were the prevailing investment strategy during a period of internal portfolio risk mitigation throughout the pandemic. Firms will likely begin refocusing on new platform investments in Q2'21.

U.S. Add-On % of Buyout Activity



Source: PitchBook; 1/1/2007 through 3/31/2021

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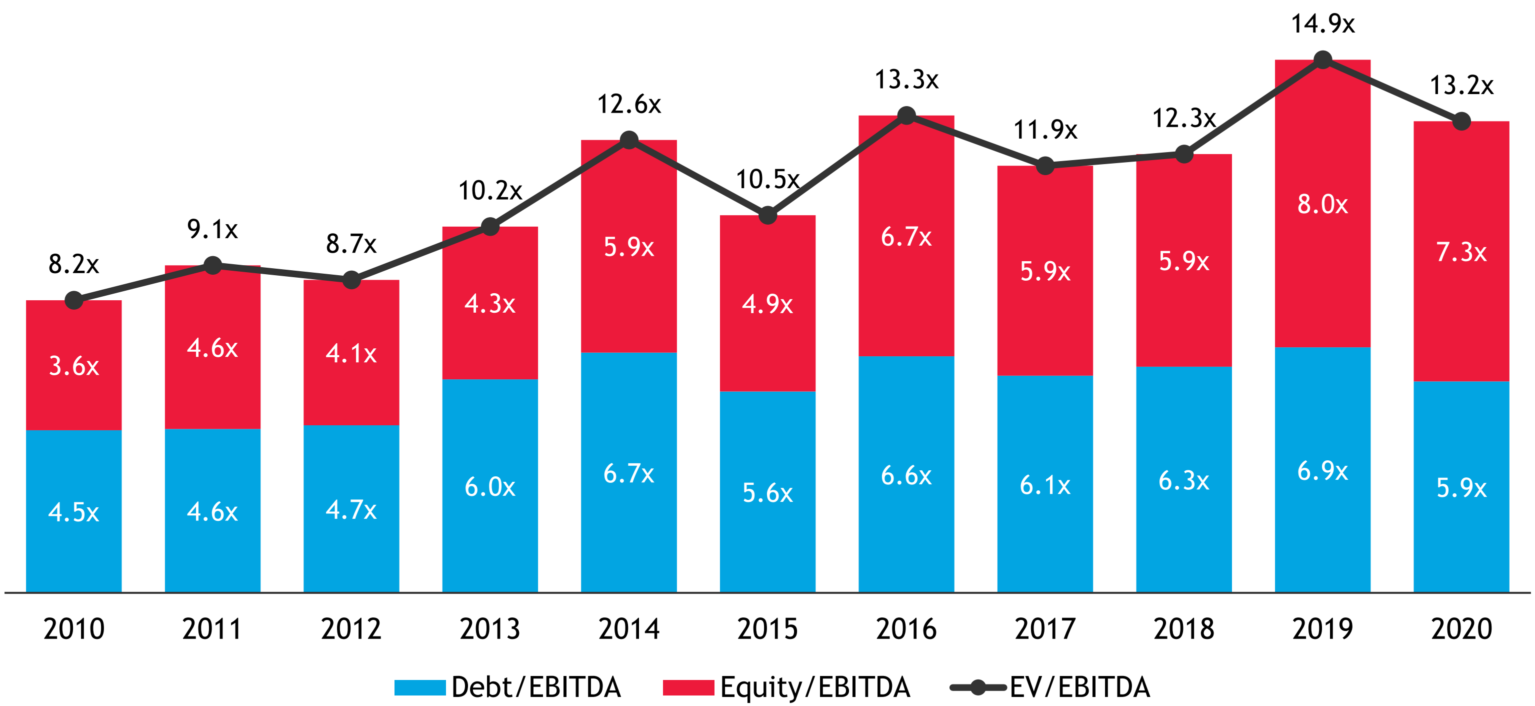
Leveraged Buyout Multiples

Market Factors Create Favorable Environment for Leveraged Buyouts

- Private equity capitalized on favorably priced deals during the pandemic, which resulted in median EBITDA multiples falling slightly in 2020 to 13.2x versus 14.9x in 2019.
- As market confidence increases and banks have a firmer view on future company performance, leverage multiples are expected to return to levels experienced pre-COVID.

U.S. Median EBITDA Multiples for Buyouts



Source: PitchBook; 1/1/2010 through 12/31/2020

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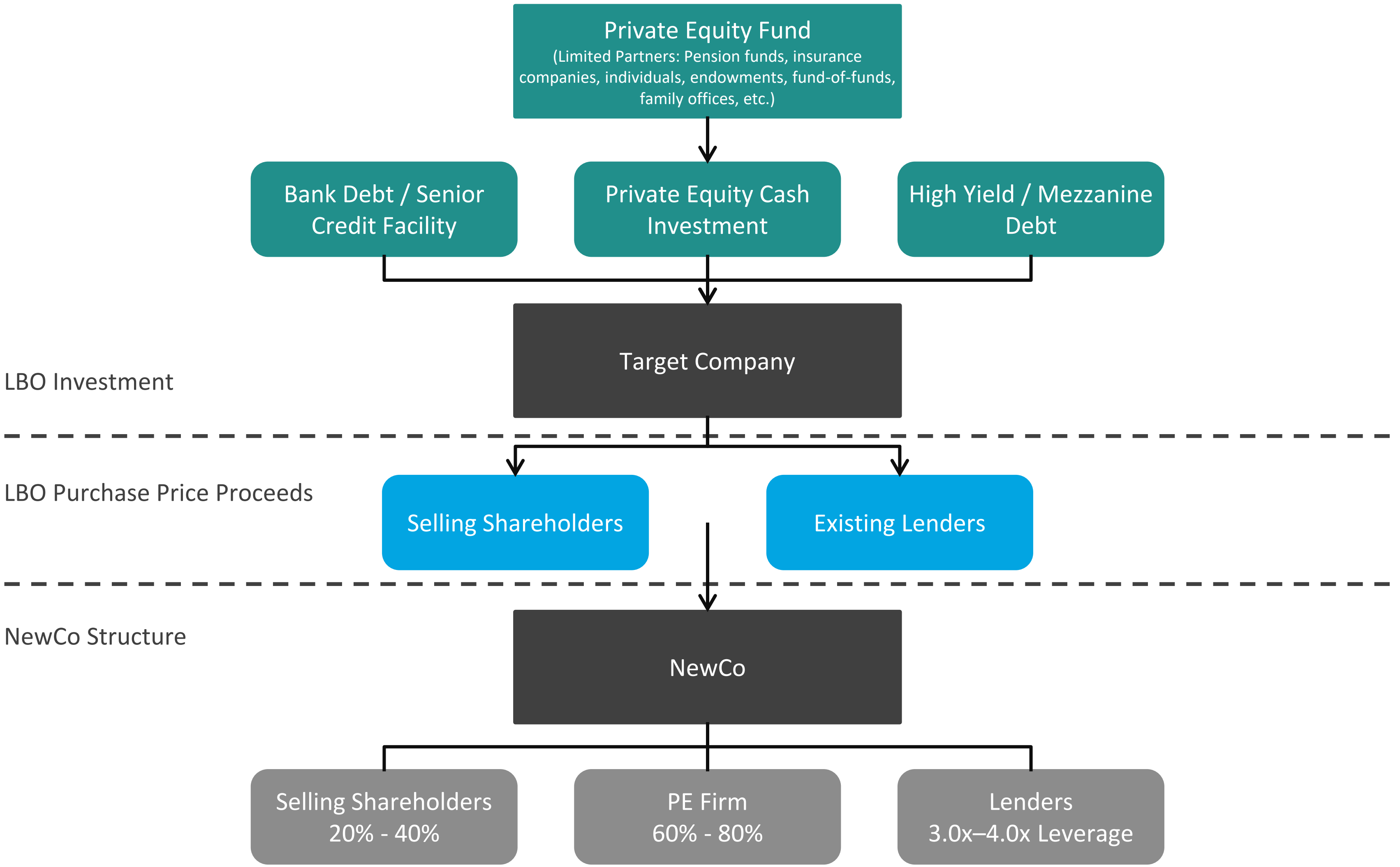
LBO Mechanics



Sample LBO Model

Transaction Assumptions

USD 000's

Purchase Price	
Adj. EBITDA	$5,736
Multiple	6.5x
Enterprise Value	**37,285**
(-) Debt (i)	(3,561)
(+) Cash	2,371
Equity Value	**36,095**

Rollover Leverage Effect	
Rollover Equity	4,215
% of Purchase Price	11.3%
PF Ownership	**20.0%**

Sources of Funds

	$	x EBITDA	% Total	% Equity	FD Eq %
Senior Debt	11,472	2.0x	30.0%		
Sub Debt	5,736	1.0x	15.0%		
Total Debt	**17,208**	**3.0x**	**44.9%**		*Options*
					10.0%
Rollover Equity	4,215	0.7x	11.0%	20.0%	18.0%
Investor Equity	16,861	2.9x	44.0%	80.0%	72.0%
Total Equity	**21,076**	**3.7x**	**55.1%**	**100.0%**	**100.0%**
Total Sources	**38,285**	**6.7x**	**100.0%**	**100.0%**	**100.0%**

Uses of Funds

	$	x EBITDA	% Total
Cash Proceeds to Seller	33,070	5.8x	86.4%
Rollover Equity	4,215	0.7x	11.0%
Purchase Price	**37,285**	**6.5x**	**97.4%**
Transaction Fees	1,000	0.2x	2.6%
Total Uses	**38,285**	**6.7x**	**100.0%**

<u>*Notes*</u>

(i) Debt and cash balances per Dec-17 balance sheet

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Sample LBO Model

Financial Summary

		Closing	Year 1	Year 2	Year 3	Year 4	Year 5	CAGR
	USD 000's	2018E	2019P	2020P	2021P	2022P	2023P	'18-'23
Select Income Statement and Cash Flow Items	Revenue	$85,943	$90,000	$99,000	$103,950	$109,148	$114,605	*5.9%*
	growth	*21.2%*	*4.7%*	*10.0%*	*5.0%*	*5.0%*	*5.0%*	
	Adj. EBITDA	5,736	6,007	6,608	6,938	7,285	7,649	*5.9%*
	margin	*6.7%*	*6.7%*	*6.7%*	*6.7%*	*6.7%*	*6.7%*	
	Adj. EBIT		5,796	6,327	6,584	6,853	7,137	
	Amortization of Financing Fees		(49)	(49)	(49)	(49)	(49)	
	Net Interest Expense		(1,379)	(1,140)	(863)	(474)	63	
	Taxes @ 26.0%		(1,136)	(1,336)	(1,475)	(1,646)	(1,859)	
	Net Income		3,232	3,802	4,197	4,684	5,292	
	(+) D&A		211	281	354	432	512	
	(-) Change in NWC		(60)	(132)	(73)	(76)	(80)	
	(-) Capex		(381)	(420)	(441)	(463)	(486)	
	Cash Available to Repay Debt		3,003	3,531	4,038	4,577	5,238	
Illustrative Debt Paydown and Capital Structure	Senior Debt	11,472	8,470	4,938	900	0	0	
	Sub Debt	5,736	5,736	5,736	5,736	2,059	(3,179)	
	Total Debt	17,208	14,206	10,674	6,636	2,059	(3,179)	
	Cumulative Debt Paydown		3,003	6,534	10,572	15,149	20,388	
	% of Total Debt Paydown		*17.4%*	*38.0%*	*61.4%*	*88.0%*	*118.5%*	
	Shareholders' Equity	21,076	24,309	28,111	32,308	36,993	42,284	
	Total Capitalization	38,285	38,515	38,785	38,944	39,052	39,105	
	Total Debt / Total Capitalization	*44.9%*	*36.9%*	*27.5%*	*17.0%*	*5.3%*	*n/m*	
Credit Metrics	Senior Debt / EBITDA	2.0x	1.4x	0.7x	0.1x	0.0x	0.0x	
	Total Debt / EBITDA	3.0x	2.4x	1.6x	1.0x	0.3x	*n/m*	
	EBITDA / Net Interest		4.4x	5.8x	8.0x	15.4x	*n/m*	

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Sample LBO Model

Illustrative Returns → "Second Bite of the Apple"

USD 000's		Base Case Scenario			Acquisition Growth Case		
	Entry	Exit (Year 5)			Exit (Year 5)		
Adj. EBITDA	$5,736	$7,649	$7,649	$7,649	$15,000	$15,000	$15,000
Multiple	6.5x	6.0x	6.5x	7.0x	6.5x	7.0x	7.5x
Implied Enterprise Value	$37,285	$45,895	$49,719	$53,544	$97,500	$105,000	$112,500
(-) Net Debt	2,371	3,179	3,179	3,179	(16,117)	(16,117)	(16,117)
Implied Equity Value	$39,656	$49,074	$52,899	$56,723	$81,383	$88,883	$96,383
IRR		*4.4%*	*5.9%*	*7.4%*	*15.5%*	*17.5%*	*19.4%*
Rollover Equity	$4,215	$8,833	$9,522	$10,210	$14,649	$15,999	$17,349
Option Value	-	4,907	5,290	5,672	8,138	8,888	9,638
Value to Management	**$4,215**	**$13,741**	**$14,812**	**$15,882**	**$22,787**	**$24,887**	**$26,987**
Cash on Cash Return		*3.3x*	*3.5x*	*3.8x*	*5.4x*	*5.9x*	*6.4x*
Proceeds from First Sale	$33,070	$33,070	$33,070	$33,070	$33,070	$33,070	$33,070
Value of Rollover Equity	4,215	13,741	14,812	15,882	22,787	24,887	26,987
Total Proceeds	**$37,285**	**$46,810**	**$47,881**	**$48,952**	**$55,857**	**$57,957**	**$60,057**

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LBO Case Study

Neptune-Benson

The Situation

- BDO Capital was introduced to Neptune-Benson in 2011 (GFC)
- Neptune-Benson, Inc. (“Neptune-Benson”) engages in the design and manufacture of filtration equipment, pool recirculation systems and aquatic components
- The Company is a family-owned business with a single shareholder (59 years old)that owned 100%
- The shareholder was seeking a liquidity event and investment diversification as well as a transition away from the Company within 2 years of the sale.

The Process

- BDO Capital contacted more than 110 potential strategic and financial buyers
- BDO Capital distributed close to 100 summaries and/or information memoranda to interested parties
- The marketing campaign resulted in the submission of <u>24 Letters of Interest</u>
- We held 10 management meetings with selected parties and provided access to a virtual data room
- We received <u>5 Letters of Intent</u> - there were no strategics in the process
- Audax Group, a leading Boston-based private equity firm, made a significant equity investment to partner with Neptune-Benson, while Neptune-Benson’s selling shareholder remained a large investor in the company

LBO Case Study

Neptune-Benson

The Outcome

- Since being acquired, Neptune-Benson:
  - <u>Tripled its EBITDA in five years - $8.0M to $22M</u>
  - Completed <u>6 tuck-in acquisitions</u> in five years
    - Two core-product related acquisitions
    - 1 vertical industry expansion – Industrial sector
    - 2 ancillary product line acquisitions
    - 1 technology acquisition
- Four years later Audax put the Company back on the market
  - Height of the M&A cycle
  - Tripled the Company's original size
  - Strong strategic interest

- In 2016 Evoqua Water Technologies agreed to acquire Neptune Benson. Evoqua is a portfolio company of AEA Investors LP.
  - Deal value approximated <u>6x the original value of the deal</u>
  - Rolled equity plus management incentives provide a significant second bite of the apple for the Shareholder

LBO Recap with a Financial Strategic

Neutronics, Inc.

The Situation

- BDO Capital was introduced to Neutronics in 2017
- World-class manufacturer and developer of refrigerant and gas analysis instrumentation, including complementary non-dispersive infrared (NDIR) sensor technology as well as gas handling technologies.
- Through three operating divisions, Neutronics provides state-of-the-art test and measurement products and services to the automotive and commercial HVAC markets, high-purity oxygen analyzers to the semi-conductor industry, and self-contained breathing units to the safety and rescue industry.
- Previously owned by a PE-firm then bought back out by Shareholder team

Neutronics Incorporated

Neutronics, Inc. has been acquired by Bacharach, Inc.

BACHARACH

A portfolio company of FFL Partners

FFL PARTNERS

Served as exclusive financial advisor to Neutronics, Inc.

Ownership Objectives

- The four shareholders of Neutronics were seeking a sale of the business to allow for investment diversification and future growth for the business. Two of the four Shareholders were desirous of staying on with the Company
- Neutronics engaged BDO Capital in 2017 to conduct a two-step sales process.
- BDO launched its marketing process in January 2018 and contacted 68 potential foreign and domestic strategics and 81 private equity groups
- Non-financial objectives included minimizing disruption to the business, preserving a positive culture, and positioning the company for continued growth

LBO Recap with a Financial Strategic

Neutronics, Inc.

The Outcome

- The competitive marketing process for Neutronics resulted in 17 indications of interest (“IOIs”)
- The initial valuation range varied by 183%
- Final purchase price was 68% higher than average offer at indications of interest stage
- Neutronics consummated a transaction with Bacharach, Inc. a portfolio company of FFL in July 2018 – primarily an all-cash deal, with a minimal seller note and attractive rollover equity structure
- No reduction in purchase price despite diligence challenges, timely management transition plan, highly proactive PE buyer with good cultural fit.

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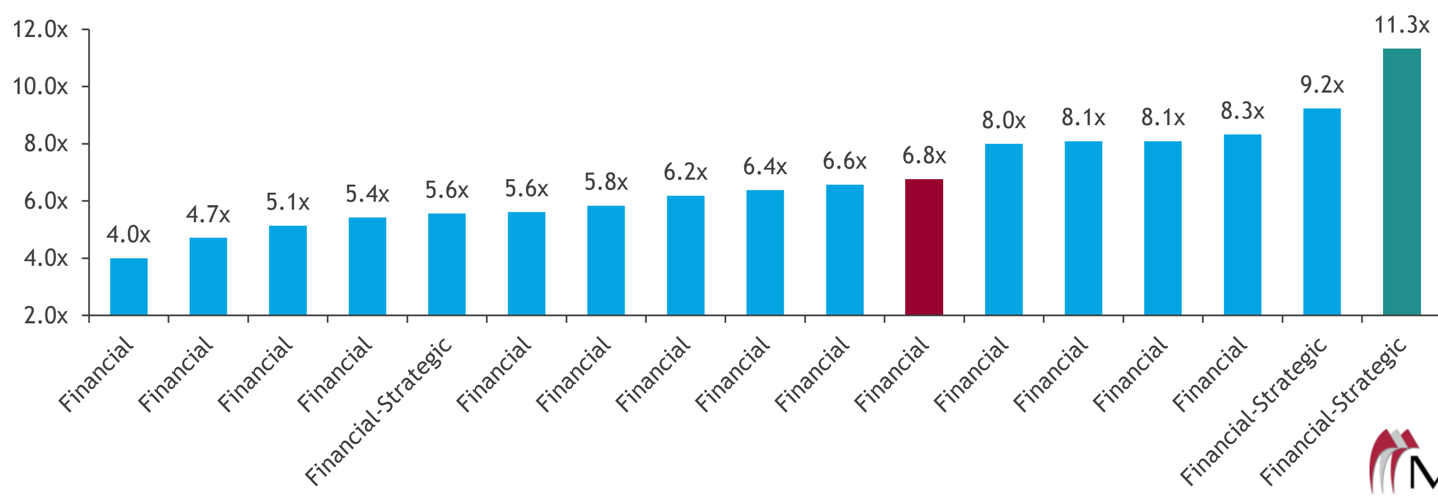
Indications of Interest



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Questions?

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