RBS Citizens®

MIDDLE MARKET M&A OUTLOOK 2013

FOREWORD

We are pleased to share with you an in-depth report on the current state of mid-market M&A activity. It is based on a recent survey of more than 300 business owners and decision makers, supplemented by a series of in-depth interviews among the target population. This report and its findings are part of RBS Citizens' ongoing commitment to providing observations and insights to the business community, and in particular to our customers and other organizations that may be contemplating a significant transaction in the near future.

As you will see from the report itself, a unique set of factors has coalesced to form a "perfect storm" of M&A activity; a slow yet improving economy, historically low interest rates, and a strong appetite among many businesses for growth through acquisitions. Along with this heightened activity comes both opportunities and challenges, more competition for quality acquisitions, the risk of cutting corners in due-diligence, and real choices about whether to "buy it" or "build it."

As an active partner for mid-market companies in the M&A space, RBS Citizens is committed to ensuring that our clients understand all of their options, and make the right choices for them, from the early decisions on the optimal transaction, to identifying the right partners, to financing the transaction. We make a commitment not only to supporting you through every stage leading up to the deal, but standing behind you after the transaction is completed.

We trust this report will serve as an important resource for your organization as you head into 2013. If helpful, we would be happy to discuss this material with you and your team.

Bob Rubino
RBS Citizens
Executive Vice President
Corporate Finance & Capital Markets

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KEY FINDINGS

OVERVIEW

In today's slowly improving economy, many mid-market companies are finding it challenging to increase revenue through organic growth. As a result, acquisitions have become a common and sometimes essential strategy for increasing market share or improving distribution. Furthermore, for companies that decide to build it rather than buy it, their growth is being fueled, not only through reinvestment, but by leveraging low interest rates and increasingly available sources of outside capital from private equity and commercial banks.

While it would appear that the present environment makes completing a transaction easier than ever, buyers are wary of inheriting unexpected liabilities in the process of making an acquisition, perhaps in their haste to "do a deal" or their inability to conduct sufficient due-diligence. Meanwhile, sellers struggle to fully understand their many options for achieving liquidity or fueling growth, including the possibility of selling only a portion of their business to remain in control or provide the opportunity for a "second bite."

While not all buyers or sellers will rely on an external advisor for support meeting their M&A objectives, those that do will see a whole host of areas where their familiarity and knowledge of the process provides considerable value. While their number one concern is determining an appropriate valuation for their company, sellers (and buyers) also want a better understanding of bidding strategies, support with due diligence, and help to identify the widest possible set of potential target firms.

Whatever advisors, sources of capital, or course of action they elect to follow, buyers and sellers alike would be better served – especially as the expected pace of transactions accelerates – to carefully consider the increasing number of attractive options available to them in the age of transaction-driven growth.

THE BUYER'S PERSPECTIVE

"It's a buyer's market!" – or is it? Market conditions lead to opportunities for growth through acquisition, but competition is fierce and diligence is key.

- **Buy, buy, buy! Interest in acquisitions is widespread.** Nearly 80% of mid-market firms say they are currently engaged in or are open to making an acquisition. About one-quarter of these firms are currently in the process of making an acquisition, while an additional 14% are actively seeking purchase targets. The remaining four in ten firms are not actively looking to buy but would consider an acquisition if presented with the right opportunity. Regardless of their current status, all firms agree, the core objective of acquisitions is to drive revenue growth.
- **Businesses have (or can readily acquire) the means to make deals happen.** Mid-market firms making or looking to make an acquisition anticipate that the deals will be comprised of about equal portions cash (35%) and debt (35%), with a slightly smaller share of equity (30%). Given that executives perceive debt as easy to obtain (and the cash and equity equations are largely within their control), funding deals will not hamper deal activity.
- **Yet cash and enthusiasm are no substitutes for certainty or prudence.** Despite their zeal for acquisitions, only three in ten mid-market firms actively seeking a deal feel highly confident they will actually complete an acquisition in the upcoming year. There are some factors that likely contribute to firms' concerns about their ability to get the deal done, and those looking to extract commensurately greater value from their acquisitions should take heed:
  - *Don't rush the deal, do your diligence.* Chief among the concerns cited by all current or potential buyers is the prospect of inheriting liabilities and/or failing to conduct adequate due-diligence. Firms in a hurry to put cash to work may end up with a serious case of buyer's remorse, or worse, buying a ticking time bomb.
  - *Remember, you're not the only game in town.* With more likely buyers than sellers in the mid-market, firms will need to look below the mid-market to make acquisitions where competition is high and inventory is limited. Meanwhile, the low cost of debt is giving target firms an attractive alternative to selling. Identifying the most appropriate targets, developing considered value propositions, and bidding strategically are key to success in this buyer's market.
- **Easy debt and market optimism may obscure the value of external support.** Despite their trepidations, less than one in three mid-market firms intend to engage external advisors in their acquisition process. But of those bringing in an external partner, valuation is by far the top task where firms are looking for assistance.

THE SELLER'S PERSPECTIVE

"Valuation is king" — Yet many sellers unknowingly hinder their ability to maximize their valuation by failing to approach the market from a position of strength.

- **There's a lot of talk about selling, but little action.** Although current selling activity is low, interest is significant with one in three mid-market firms saying they are open to being fully or partially acquired by an outside investor. However, most firms open to a sale are not actively seeking a buyer, let alone entering into a full M&A process – running the risk that they will be undervalued or fail to find the best deal structure.
- **Many sellers are unsure of their value, and what the market will bear.** Being underpaid or undervalued is the top concern among current and potential sellers, especially among smaller firms with between $5MM and $25MM in annual revenue.
- **Getting the most out of a sale means avoiding these undervaluation pitfalls:**
  - *Misreading the market.* Nearly three-quarters of mid-market executives view conditions today as a buyer's market, and 55% believe that it will stay that way through 2013. In fact, the current market has led to a larger number – and wider array of – buyers, as well as an increasing number of appealing self-funding options.
  - *Misunderstanding the market.* Most executives surveyed anticipate wanting or needing to sell off their entire firms. Yet, the majority of active deals in the mid-market are for a partial sale. Executives seeking a full sale oftentimes lack a full understanding of the various structures available to maintain a majority or partial ownership stake while also raising the funds they need or providing the liquidity they desire. In many cases, the parts may be worth more than the whole in terms of long-term opportunity and the ability to maintain control.
  - *Showing your hand.* A desire for liquidity or fatigue continues to drive many to be interested in a full sale, leaving them vulnerable to taking less than they are worth, particularly if there is no formal process in place.
- **Only a minority of sellers engage "the experts."** About four out of 10 sellers have or would consider having an external provider manage their selling process. Among the number of tasks these firms would engage a provider to handle, valuation is by far the most mentioned, though help with bidding strategies and due-diligence is also widely sought.

METHODOLOGY

In the fall of 2012, RBS Citizens engaged Cogent Research to conduct a multi-phased research initiative from which the insights and commentary found in this report are derived. The quantitative data was derived from a web-survey, while commentary and quotes from mid-market executives were derived from telephone interviews.

SURVEY POPULATION	U.S.-based mid-market ($5MM – <$2B in revenue) business executives that are open to or are currently engaged in some form of corporate development activity, including mergers and acquisitions and raising capital in the New England, Mid-West, and Mid-Atlantic regions.
INCIDENCE	The survey respondent population is comprised of those mid-market executives at firms currently engaged in or open to considering M&A activity and/or raising capital, which represents 85% of the total mid-market executive population in the New England, Mid-West, and Mid-Atlantic regions.*
PROFILE OF SURVEY RESPONDENTS	Business executives directly involved in decision-making related to corporate development. • Core titles: Owners (42), CEOs/Presidents (48), CFOs (36), COOs/Other C-Level (42), Partner/Principals (5), EVP/SVP/Director (90) • Core industries: Manufacturing (57), Professional Services (50), Retail & Consumer Goods (24), Technology/Technical Services (24), Construction (23), Info Information Media & Communications (20)
DATA COLLECTION PERIOD	September 17, 2012 – October 18, 2012
QUANTITATIVE SURVEY METHOD	Web-based survey; ~10 minutes in length 330 Mid-market Firms; +/-5.4% points at the 95% confidence level
QUALITATIVE SURVEY METHOD	Telephone in-depth interviews; ~40 minutes in length 11 Mid-market Business Executives
RESEARCH FIRM	Cogent Research, Cambridge, MA

**Note: Throughout this report we refer to the target audience of 'U.S.-based mid-market firms/executives'. In doing so, we are referring to businesses and executives at businesses with revenues between $5MM – <$2B in revenue, that are open to or are currently engaged in some form of corporate development activity, in the New England, Mid-West, and Mid-Atlantic regions.*

GENERAL MARKET OUTLOOK

Key indicators reveal that markets are ripe for transaction-driven growth.

Corporate development departments are firing on all cylinders. In a sluggish economy, mid-market executives clearly see corporate development as essential to driving growth. With the vast majority of mid-market firms currently engaged in or open to a minimum of three corporate development activities in 2013, all options are on the table when it comes to driving growth.

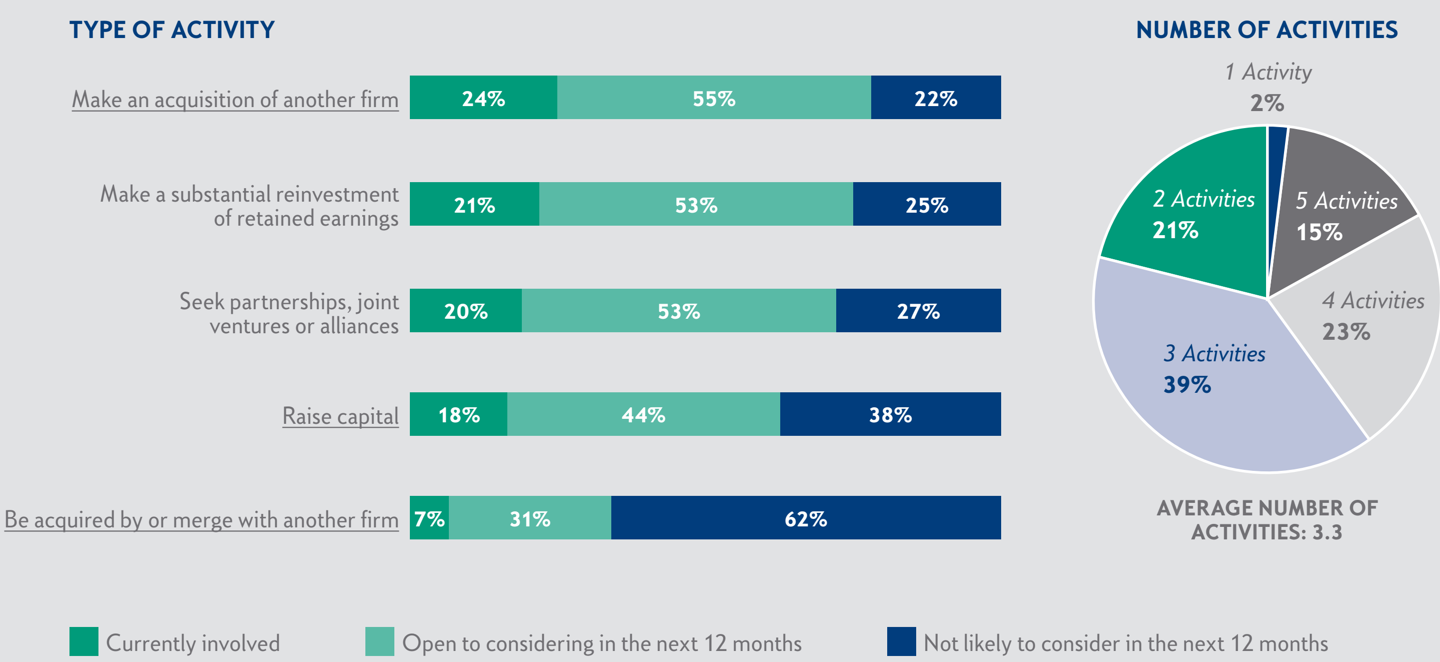
Acquisitions are clearly of greatest interest, with about eight in ten mid-market firms saying they are currently in the process of making an acquisition or are open to doing so within the next 12 months (*Figure 1*). In fact, mid-level managers say they are as likely to consider an acquisition as reinvesting earnings, further signaling that organic growth may be seen as less effective path to growth today than in previous cycles.

Buying is certainly more prevalent than selling in the mid-market, with less than one in ten reporting that they are currently the target of an acquisition. However, a sizeable proportion of the market (31%) is open to being acquired over the next 12 months.

FIGURE 1

CORPORATE DEVELOPMENT ACTIVITY INVOLVEMENT

Base = U.S.-based Mid-Market Firms (n=330)



Underlined activities are primary activities. Qualified respondents must be currently or potentially involved in at least one of these activities.

Meanwhile, about two in ten are currently attempting to raise capital, with an additional 44% saying they are open to doing so in 2013. With current interest rates being at an all-time low, many firms see leveraging external cash as a more appealing option to diminishing their working capital.

Optimism about the future M&A market dynamics is high. More than half of respondents anticipate that the environment for raising capital and seeking outside investment will improve over the next twelve months. Furthermore, deal volume is often driven by market participants' view of future asset values. Over half of mid-market executives believe today's prices will remain stable, and over a third believe they will increase.

The supply/demand equilibrium for M&A is likely to shift to support greater activity in 2013. On the supply side, demographic factors affecting private mid-market firms will emerge as a significant motivation for sales or equity offerings as we pass beyond the uncertainties of 2012: the election, the fiscal cliff, and tax law changes. Many aging baby boomers who have spent the past 20 years growing family businesses will look to monetize value for retirement. In addition, private equity firms that postponed selling portfolio companies in 2012 or took advantage of dividend recaps to return capital and buy time, will test the market for exits in 2013. On the demand side, larger companies will be under increasing pressure to show top and bottom line growth. Given current market conditions, organic growth will continue to face headwinds, resulting in further reliance on acquisitions to gain market share and/or expand operations.

OUTLOOK ON ACQUIRING

Buy, Buy, Buy!

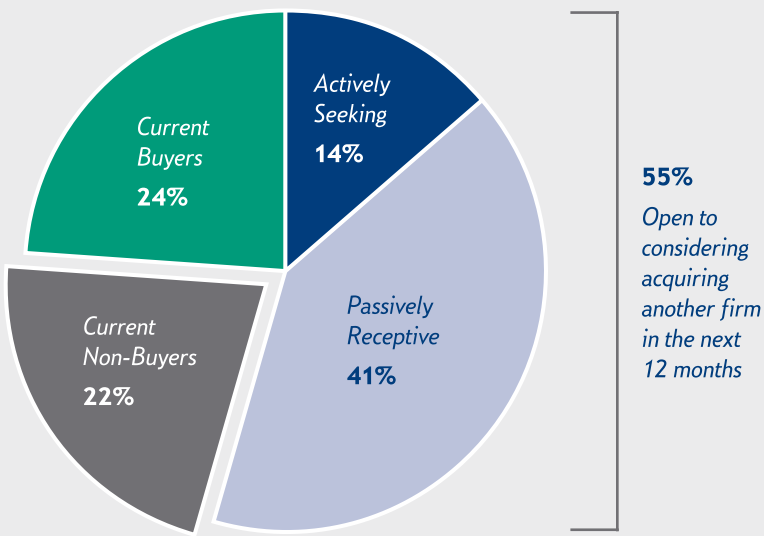
With a strong desire to grow and a positive view of the future M&A market, it's little surprise that interest in making acquisitions in 2013 is widespread in the mid-market. As mentioned, nearly 80% of mid-market firms are currently engaged in or are open to making an acquisition over the coming year (*Figure 2*). About a quarter of all firms are already in the process of acquiring another firm, while an additional 14% are actively seeking target firms to purchase. The remaining four in ten firms expressed their acquisitive approach as passively receptive or opportunistic. These firms have not initiated a formal search process nor the rigorous valuations of internal and external assets, but they would consider an acquisition if they were presented with the right opportunity or an attractive deal.

FIGURE 2

POTENTIAL ACQUISITION OPPORTUNITY SEARCH STATUS

Base = U.S.-based Mid-Market Firms (n=330)

**Passively receptive is defined as firms "not actively seeking organizations to acquire, but would consider an acquisition if presented with the right opportunity."*



Follow-up conversations with executives at mid-market firms shed light on what it means to be "passively receptive." For some, the approach is very passive, simply listening until they hear news that may work to their benefit:

> *"We know our competition pretty well. We know who is strong through our other vendors, who is paying their bills, who is not paying their bills, who is talking to the vendors saying, 'hey boy, if I had a way out I would get out.' And just through our sales people knowing if their sales people are aggressive or not aggressive. And by not being aggressive, we have an opportunity to go into their territory."* (*EVP of a $25MM – $50MM brick distributor & masonry supplier*)

For others, the line between active and passive is a bit more blurred, however, they are far from running a formal process with a core set of acquisition targets, desired timelines, and concrete objectives:

> *"I'm always looking, I'm always networking, I'm always asking, but it is closer to passive. If I come across friends or acquaintances, or my accountant says to me, 'hey, we were servicing a business the other day, and they're in your industry, and the owners are getting on a bit. And they talked to me about exit strategies.' That, then, could turn into a referral for me, and I'd talk to them. That, in a sense, was passive. I didn't seek them out. I didn't find them through calling, but they came in through my network. So it's more of a periodic reminder through my network, maybe an email blast every now and then. If they think about me and my company, I want the next thing for them to think about are my three cores of what I sell. The next I want them to think about is, 'he's always looking for something to buy.' I just want to create that mindset."* (*President and CEO of a $5MM – $10MM IT services firm*)

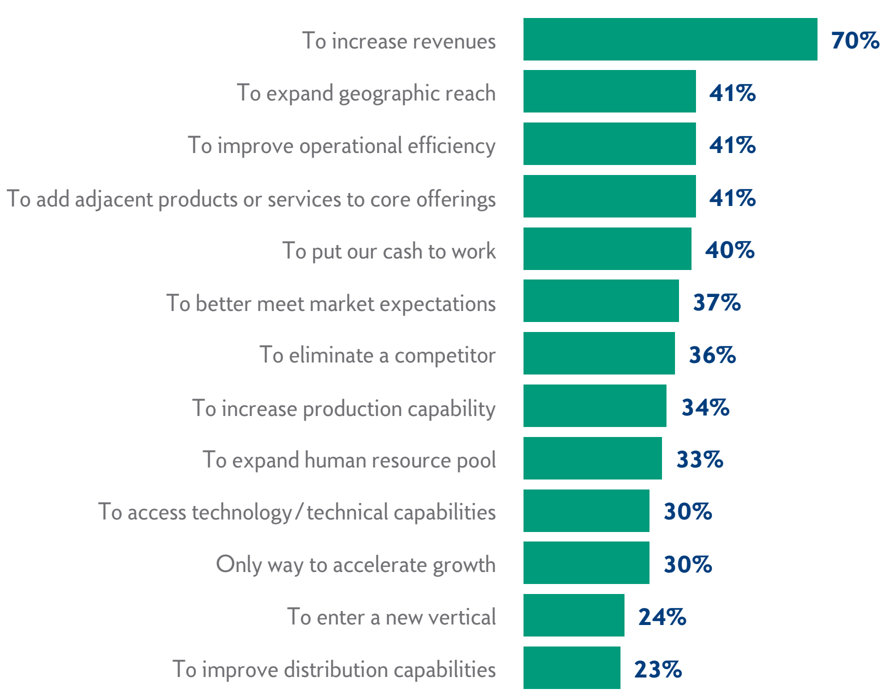
What better way to grow?

Regardless of their current acquisition status, all firms agree that the core objective of acquisitions is to drive revenue growth (70%) (*Figure 3*). Secondary objectives, including expanding geographic reach (41%), improving operational efficiency (41%), adding adjacent products or services to core offerings (41%), and putting cash to work (40%) are viewed with about equal import. Across industries and firm sizes, increasing revenues is always the dominant motivator to acquire. Following revenue, however, firms in different verticals or with different revenue sizes tend to focus on different reasons to buy. Smaller firms with between $5MM and $25MM in revenue, as well as firms in technology or science industries, are more apt than others to view acquisitions as a means to expand their staff and purchase new talent. Meanwhile, mid-sized firms of the mid-market (annual revenues of $25MM to $100MM), and many manufacturing companies are more likely to look to acquisitions to improve their distribution capabilities.

FIGURE 3

DRIVERS OF ACQUISITION

Base = Current and Potential Buyers (*n=258*)



HOW ACQUISITIONS ARE ACCELERATING GROWTH IN THE MID-MARKET:

In sectors where multiple players compete for the same pool of customers on a local and regional basis, M&A can be an especially powerful instrument for expanding market share and boosting revenues. Acquiring competitors, or even clients, can help companies strengthen their position in the industry.

"On three occasions we've acquired customers. Two were because they couldn't pay their bills, so we absorbed them. And one was because they had a good business model, but they were outgrowing what they were capable of handling, and so we took them in. [Our growth] is primarily through acquisitions. We've grown physically, as in purchased more acreage, but sales volume increases have been related to the acquiring of other companies."
CFO OF A $25MM - $50MM MAPLE MANUFACTURER

"We have had a challenging time growing organically. And so we needed to look for outside acquisitions to fuel some growth...We have made acquisitions in the past that have eliminated a competitor. [In one case,] it was a division of a company that just wasn't a fit for the direction that they wanted to go, yet they still had enough of the market that we were competing for the same client base in a particular segment. And so we brought them on, and were able to bring it all in under one roof and have one less person out there trying to feed the make market."
CFO AND VP OF A $10MM - $25MM ELECTROSTATIC TONER MANUFACTURER

For companies in specialized fields, acquisitions not only fuel growth, but relieve acquirers of the time and cost necessary for new product development.

"The long term strategy is to grow the business and double or triple the revenue. And the goal to do that is through acquisitions and through growing sales...Our [recently purchased competitor] had the technology we wanted. They were already in the market that we wanted and it was easier to acquire than to do it all up internally. Making new specialized products is very technical work that takes up to two to three years, so sometimes acquisitions short cut that by half."
FINANCE & TAX DIRECTOR OF A $500MM - $1B POLYURETHANE MANUFACTURER

Likewise, M&A can help companies broaden their sales reach while improving distribution efficiency.

"Our business is predicated on territories. So for us to grow, we have to acquire other companies that have territory rights [we want]. The easiest thing right now would be to acquire somebody that's in need to sell the business and then we have instant territory and an instant client base."
EVP OF A $25MM - $50MM BRICK DISTRIBUTOR & MASONRY SUPPLIER

Other firms may already possess a strong distribution network, but are looking for new products to sell via those channels.

"Last year we did about 6% growth on the top line. This year we're forecasting to be relatively flat, excluding growth via acquisition. We've made a couple acquisitions this year that will bump our growth rate up to 2% or so. But organically we've been flat year over year...We've already got a pretty strong distribution channel, so [our objective] is more about filling our product portfolio."
CFO AND SVP OF A $250MM - $500MM OPTOELECTRONICS PRODUCER

Companies with a strong focus on R&D actually rely on acquisitions to counteract risk and ensure more predictable profitability.

"We're looking for complimentary products to diversify and expand our sales force. It all starts with product, to be honest with you. [The ultimate goal of acquisitions is] more predictable revenue streams - take a lot of the risk away from R&D on our side. So we're looking for businesses basically on our up and down lines that could secure our revenue stream a little better."
CFO OF A $10MM - $20MM LIFE SCIENCES & MEDICAL DEVICE FIRM

And for some in the most stagnant industries, acquisitions are the only means to growth.

"We've solidified our core business over the past ten years and we're looking to add more offerings for our customers basically. We're trying to acquire market share in kind of a stagnant business condition. That's really what's driving the business, it's kind of a stagnant industry with not a whole lot of growth and the only way you can grow is by increasing your market share and we're doing that through acquisitions."
DVP OF A $25MM - $50MM RETAIL AND CONSUMER PRODUCTS COMPANY

Is That Your Best & Final Offer?

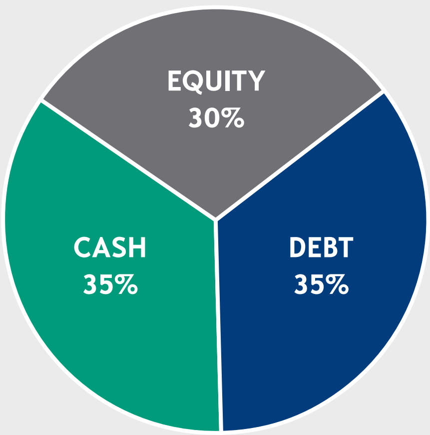
With plenty of opportunities in today's buyer's market and a variety of reasons to buy, the next question is whether or not businesses have the means to make deals happen. Overwhelmingly, the answer to this question is "yes." Half of all mid-market executives (50%) report that current interest rates make borrowing more attractive and even more (55%) believe that access to outside investments will improve over the next year.

A look at predicted acquisition behavior reveals that many mid-market businesses may also already be flush with cash, or "dry powder." Current and potential buyers anticipate that their deals will be comprised of nearly equal portions of cash (35%) and debt (35%), and a slightly smaller portion of equity (30%) (*Figure 4*).

FIGURE 4

MEDIAN COMPOSITION OF BIDS FOR ACQUISITIONS IN 2013

Base = Current and Actively Seeking Buyers (n=127)



Given that executives perceive debt as easy to obtain, and with cash and equity equations largely within their control, funding deals is not likely to hamper deal activity over the next year. On average, mid-market firms are looking to purchase 2.4 firms in 2013, with the majority of firms (56%) spending under $10MM to do so. About three out of ten firms intend to spend between $10MM and $50MM, and the remaining 16%, a group composed of the largest mid-market firms, expect a total spend of $50MM or more on acquisitions over the next twelve months.

Dotting Every "i"

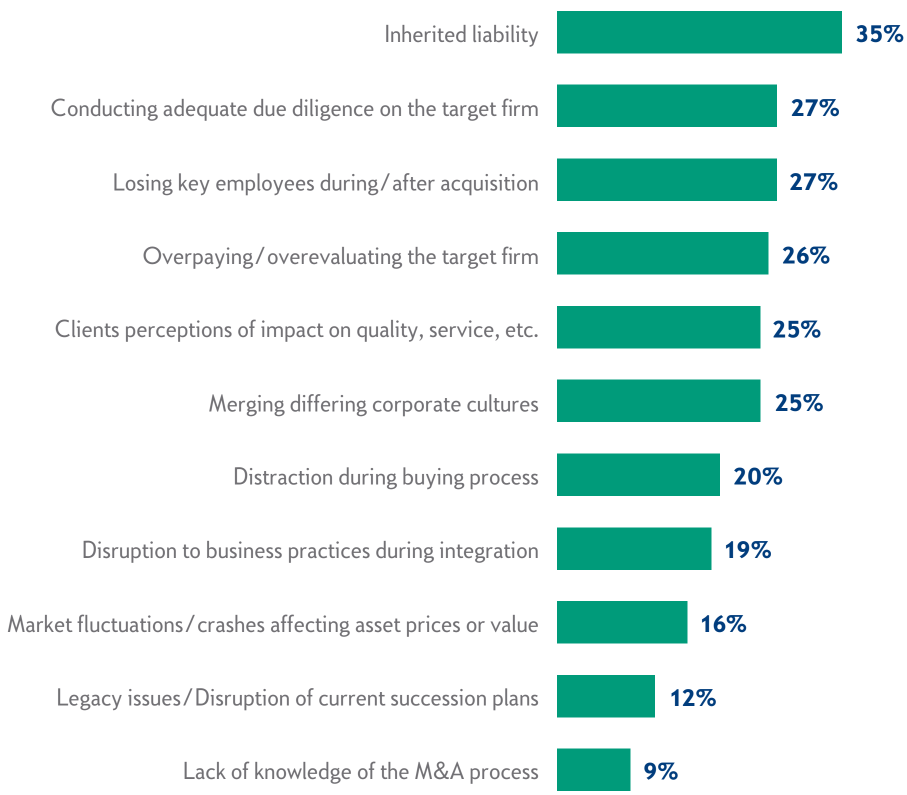
Despite mid-market firms overwhelmingly believing it is a buyer's market and even their own zeal for acquisitions, only three in ten mid-market firms actively seeking a deal are highly confident that they'll actually complete an acquisition in the upcoming year. Tempering their enthusiasm is a number of factors that current and potential buyers would do well to take heed of.

Chief among the concerns cited by all current or potential buyers is the prospect of inheriting liabilities (35%) and/or failing to conduct adequate due-diligence (27%) (*Figure 5*). With ample buying power in the form of surplus cash and easy liquidity, many companies may be driven to pursue deals simply to put their money to work. But these firms should be careful not to get so excited about closing a deal that they exaggerate the benefits and understate the risks. Prudent due-diligence is the best defense from serious buyer's remorse.

FIGURE 5

CONCERNS RELATED TO ACQUIRING

(Top 3 Box, 11-Point Scale)
Base = Current and Potential Buyers (n=258)



For many firms, due-diligence goes far beyond understanding a target firm's balance sheets – it involves an intimate understanding of the industry and reputation of the firm in question; how the firm treats its employees and positions itself to its customers; what tax guidelines and regulations apply to the business and how well that firm has complied in the past; and, of course, how well it fits within the acquiring firm's overall value structure and revenue strategy. No executive wants to buy a firm that doesn't realize its expected revenue, or worse yet, a firm that turns out to be laden with liabilities.

For the president and CEO of a $5MM – $10MM IT services firm and regular purchaser of firms, due-diligence means asking every question possible:
"I find [due-diligence] a very paranoid period, because it's almost like everything is out there, and you don't know what you haven't asked or what rock you haven't turned over during the due diligence, but you've got that gnawing feeling in your stomach. The one thing you didn't ask about is the one thing that will be a disaster. So they're all important, and we try to have a long list of the things we go through. The financials are by no means the whole picture. They're pretty much a rearview shot you know, a moment in time."

An SVP of a $25MM – $50MM nationwide satellite television service provider and another regular purchaser of firms, recounts an experience with a seller who skewed the truth:
"We take a good hard look to make sure everything is compatible. Some time back we had an acquisition where basically they kind of misrepresented their customer base and the attitude of the customers and frankly we didn't do a good job in checking them out. So we had a lot of let's say repair work within the customer base to get them. But shame on us for not doing our due diligence."

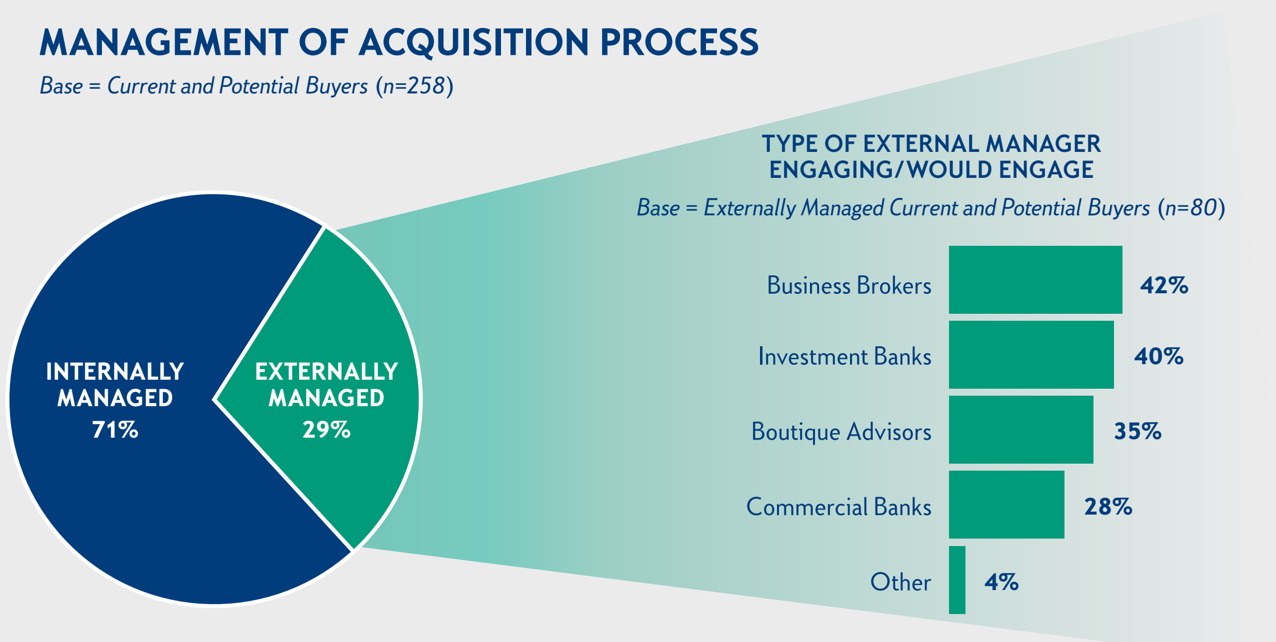
Pennywise and Pound-foolish?

Finally, mid-market firms intending to make acquisitions this year should not let easy debt and market optimism obscure the potential value of experienced external support. Despite their trepidations, less than one in three mid-market firms intend to engage external advisors to help manage their acquisition process (*Figure 6*).

FIGURE 6

MANAGEMENT OF ACQUISITION PROCESS

Base = Current and Potential Buyers (n=258)



The primary reasoning for managing processes internally was largely the same no matter who was answering: "no one knows our business/needs/industry or the key players in our market like we do." While buyers are undoubtedly knowledgeable about their businesses, they may not always be schooled in the "art of the deal" and pulling together an internal team which oftentimes consists of the CEO, CFO and other key employees can oftentimes be a significant distraction impacting the forward momentum and revenues of the firm. Other reasons mentioned include external providers are too expensive, are only necessary for large acquisitions, or are not interested in small firms or our smaller purchases. One CFO of a $10MM – $20MM life sciences & medical device firm explains why he typically does not involve outside advisors in the process:

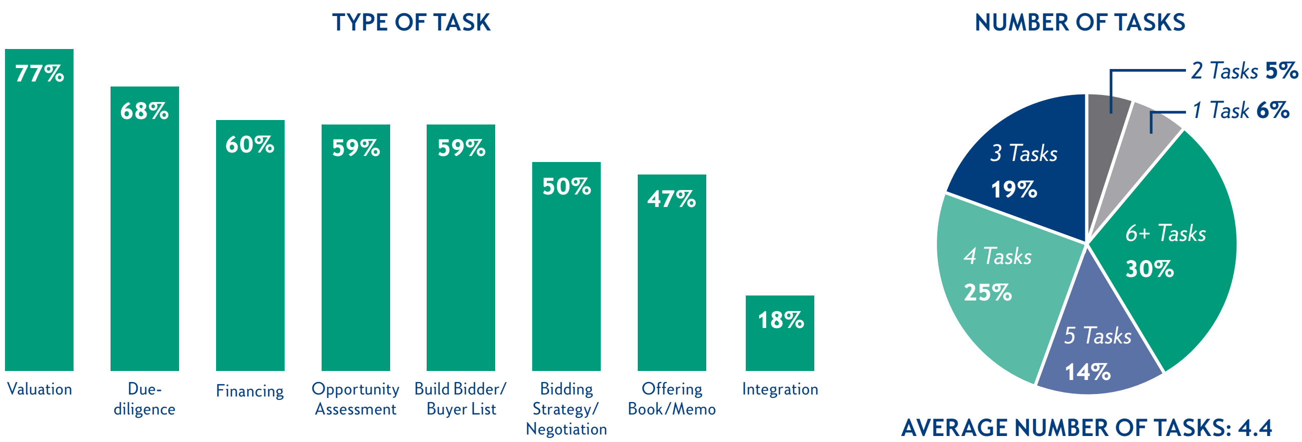
> *"[Investment and commercial banks] are not going to help me buy a two million dollar revenue firm. They're not going to offer anybody that would be better than me. I'm saying all you need is me and three other people to do this."*

Of those bringing in an outside partner, valuation is chief among the tasks sought from advisors, followed closely by due-diligence (*Figure 7*). Among buyers relying on an external advisor, there is nearly equal interest in business brokers, investment banks, and M&A boutique advisors.

FIGURE 7

ACQUISITION TASKS FOR EXTERNAL PROVIDERS

Base = Externally Managed Current and Potential Buyers (n=80)



In contrast, executives interviewed for the study that did rely on external advisors had some advice and praise to offer. Commercial banks were noted for reassuring sellers about finances, clarifying "what the debt requirements would be, and let[ting] them get a little bit creative earlier on as to ways to do the financing" (CFO and VP of a $10MM – $25MM electrostatic toner manufacturer). One interviewee found M&A specialists incredibly useful for relieving himself of the burden of searching for targets:

> *"That's what they do for a living. And that's because if I'm not getting the right opportunities through my passive network, you know, I'm still trying to run a business. I'm not about, personally, to go do 200 calls a day for two months. So I hire a business that specializes and has the staff and the business acumen to be able to interview myself, my board, get to know my business, get to know the type of business I want to procure, the type of space, the type of geography. And then once they feel they've got a good performer, they'll perform, through their resources, the smile and dial, and then they would report back to me whatever period we agreed, daily, twice a week, once a week, whatever, with the progress; how many calls were made, how many conversations were had, how many ended up in a second conversation, how many end up, you know, that they want to have a conversation with me. I mean it's almost like a traditional sales funnel. And then they'll provide whatever aspect of service I need. They can finish at that point or I can continue the engagement, have them assist in the negotiation process on my behalf. They've got contacts, that if I want to, I can involve them with my lawyer to help maybe improve the cycle for contacts. You know, they're kind of a multifaceted M&A business that I can consume as little or as much as I want within the cycle, and I quite like that."* (*President and CEO of a $5MM – $10MM IT services firm*)

Likewise, interviewees who felt that they may become increasingly active in M&A agreed with the sentiments of one likeminded executive, who would seek the assistance of a firm whose raison d'être was transactions:

> *"If we do go down this path and we continue to want to grow [through acquisitions], I think that's where we're going to need is someone whose reason in life is going out and finding and researching and serving up these opportunities."* (*CFO of a $250MM – $500MM packaged meats company*)

Regardless of who they choose to use, however, executives expect their external advisors to know their business and their industry as well as they do.

OUTLOOK ON SELLING

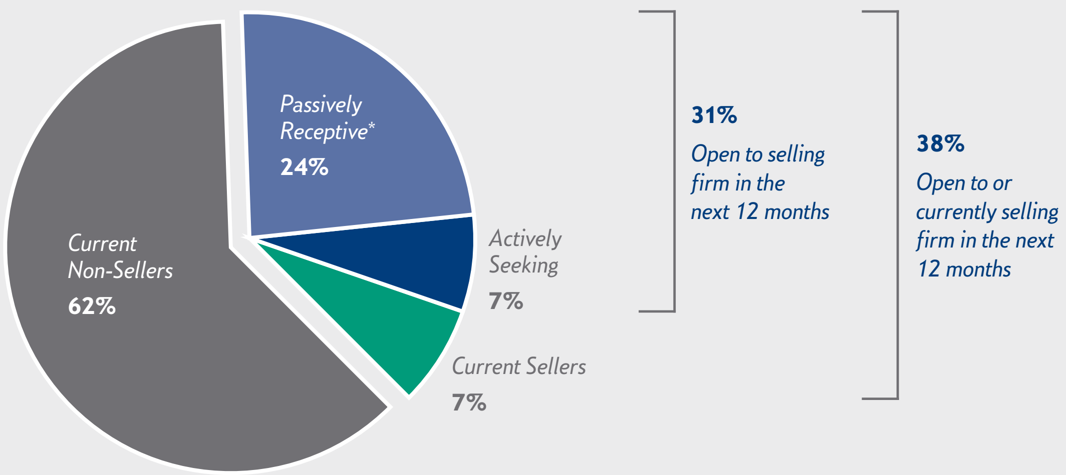
If You Insist...

Although a small portion of the mid-market are currently engaged in a deal to sell part or all of their business, nearly one in three express interest in selling at some point in 2013 (*Figure 8*). However, most firms open to a sale are only “passively receptive” to a deal (24% of all firms) – meaning they are not actively seeking a buyer, nevermind running a full M&A process, or “auction”, that would help them drive up the value of their business. Adopting this passive stance in an aggressive buyer’s market leaves potential sellers vulnerable to being undervalued or overlooking a larger, long-term strategic opportunity.

FIGURE 8

POTENTIAL SELLER OPPORTUNITY SEARCH STATUS

Base = U.S.-based Mid-Market Firms (n=330)



**Passively receptive is defined as firms “not actively pursuing buyers, but open to discussing acquisition(s) if presented with the right opportunity.”*

Ironically, being undervalued and/or underpaid is the top concern among current and potential sellers, especially among smaller firms with between $5MM and $25MM in annual revenue (*Figure 9*). Furthermore, confidence in being acquired over the next year among those actively seeking selling opportunities is relatively low, with less than one in three actively seeking sellers anticipating being bought in 2013.

FIGURE 9

TOP TEN CONCERNS RELATED TO SELLING

(Top 3 Box, 11-Point Scale)
Base = Current and Potential Sellers (n=125)

Avoiding the Pitfalls of Undervaluation

Even more than with buyers, there are key indications that many mid-market firms are unfamiliar with the M&A process and how to extract the greatest value from a sale or merger.

First, many potential sellers may be misreading the market. As mentioned earlier, nearly three-quarters of mid-market executives view conditions today as a buyer's market, and 55% believe that it will remain as such through 2013. At the same time, private equity firms are experiencing a crunch, forced to sell off assets they may have been holding onto since the last recession. But despite the fact that the current market and favorable interest rates have led to increased demand for acquisitions, concerns remain high among sellers, few of whom are focusing on strategically positioning themselves as attractive targets. While the majority of these passively receptive sellers intend to begin actively seeking opportunities in the future (83%), most say they're waiting until the market is more advantageous (52%), possibly unaware of the potential advantages in today's market (*Figure 10*).

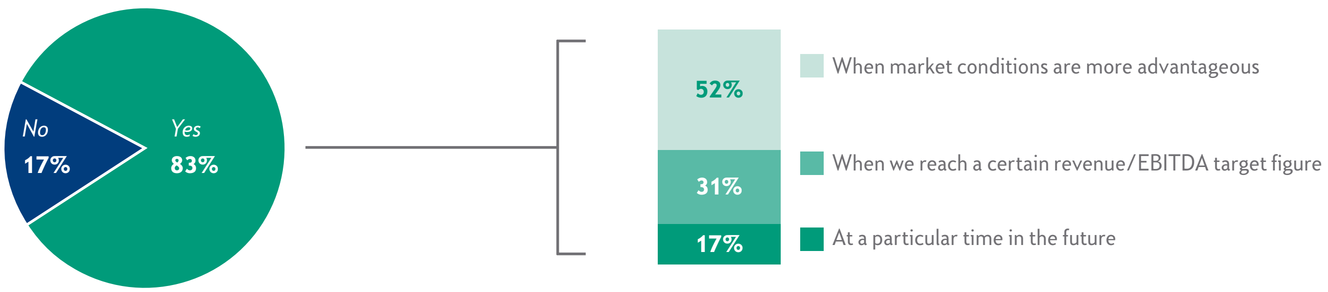
FIGURE 10

LIKELY TO ACTIVELY SEEK SELLING OPPORTUNITIES IN THE FUTURE

Base = Passively Receptive Potential Sellers (n=77)

CATALYSTS TO ACTIVELY SEEK SELLING OPPORTUNITIES

Base = Potentially Active Sellers (n=64)

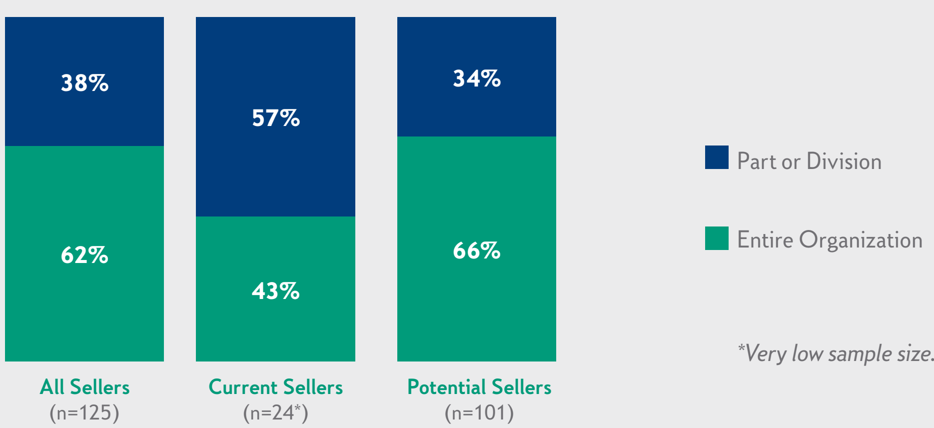


Second, many sellers may be misunderstanding the market, or at least the expectations of mid-market buyers. Most current or hopeful sellers anticipate wanting or needing to sell off their entire firm, especially potential sellers (66%) (*Figure 11*). However, the reality is that most deals in the mid-market involve only a partial sale – sales composed only specific units or discrete assets (57%). Interviews with mid-market executives support that finding: most firms are only interested in a target firm's product lines or business divisions that fit with the acquirer's core business values and offerings.

FIGURE 11

TYPE OF SALE IN PROCESS OR SOUGHT

Base = Current and Potential Sellers



**Very low sample size. Interpret with caution.*

To summarize the sentiments of the interviewed executives: buying a whole mid-market company is often the less attractive and potentially costly option, involving the purchase of products, people, and services the acquiring firm simply has no need for. For some, like this president of a $5MM – $10MM insurance agency, it's only the business and value they want from a target firm:

"I'm not looking to buy the physical assets of their company. I don't want their desks and their computers and their building. I want the business, and there's a very easy equation that we utilize to value the insurance business based on the renewal commissions. And we know straight out that when we buy it four years later we're making money. It's a tried and true process that our prior president had started probably in the late 70s on a smaller scale."

According to other interviewees, buying a whole firm can mean buying parts that simply don't fit into the values or goals of the core business – a big no-no in acquisition practices. Worse yet, there's always the risk of acquiring liabilities when you buy parts that you may not fully understand; best to stick to those assets you know: *"Usually we're just buying the assets. We're not buying the company, we're not buying the stock or anything. Just buying the assets and we aren't taking any liability with that."* (*EVP of a $25MM – $50MM brick distributor & masonry supplier*)

Simply put, firms open to positioning themselves for a partial sale may have greater success in today's market. This is especially true in cases where a firm owns a product line or division that may be more valuable in the hands of someone else; a potentially very attractive opportunity for both the seller and the buyer. Additionally, executives seeking a full sale may lack a full understanding of the various structures available to maintain a majority or partial ownership stake while also raising the funds they need or providing the liquidity they desire. Sellers should always bear in mind that their parts may be worth more than the whole, and it wouldn't hurt to prepare reliable carve-out statements that can explain exactly why to potential investors. Depending on what parts are being sold, the payoff may be a significant boon to the remainder of the firm, as was the case for one interviewee and his brick distribution business:

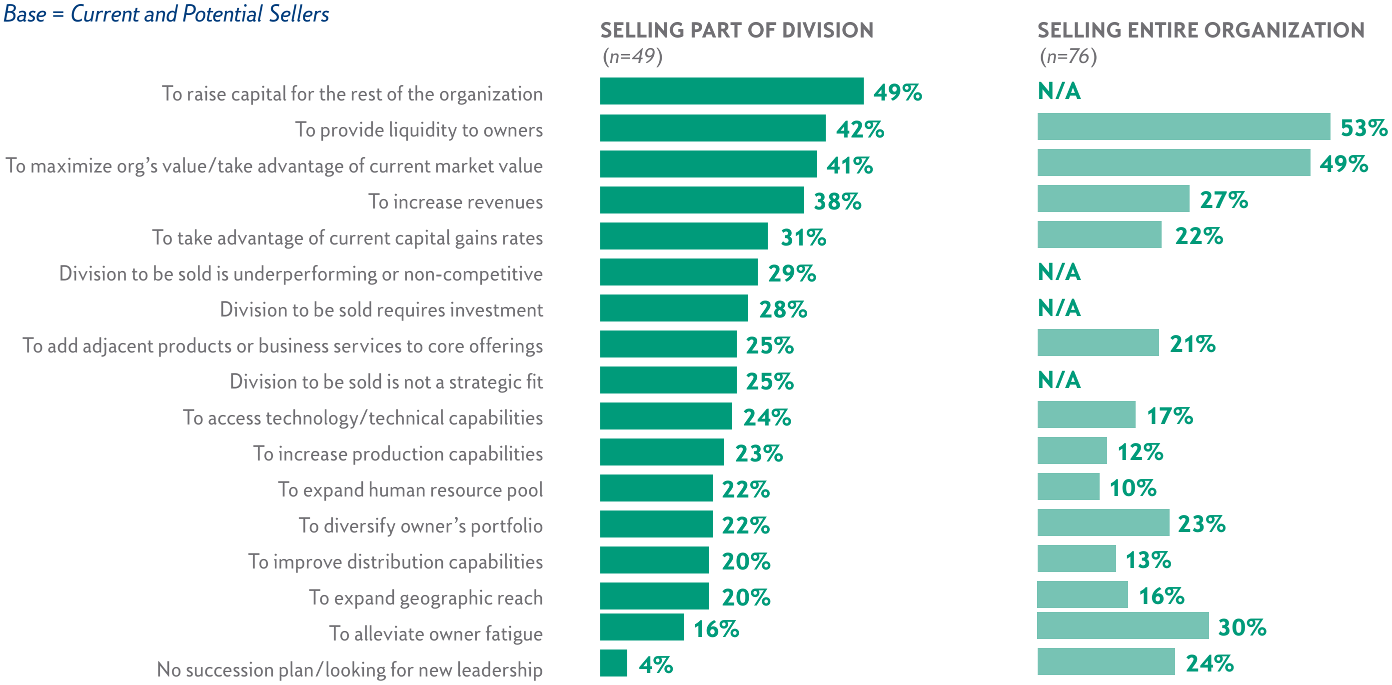
"We were a very small part of a larger construction company and back in 2008 they sold the majority of their business and only kept the brick division. So when they cashed out, we were in a very good position where we had more money than we knew what to do with. Very rare. If we had the opportunity where a deal came up where it was a good deal we could pay cash for anything we wanted to do."

Finally, sellers seeking the most value from their sale should take care not to show their hand, especially if it's a desire for liquidity or fatigue that's driving their interest in selling. Providing liquidity to owners (53%) and alleviating owner fatigue (30%) are among the top three drivers for those interested in a full sale, leaving these firms vulnerable to taking less than they are worth (*Figure 12*). This is a particular concern among firms with no formal M&A process in place. Even if fatigue is the primary driver for an owner's interest in selling, running a process, an awareness of current multiples, and due-diligence on potential buyers can lead to a better sale price, as well as greater assurance that the acquired organization will continue to grow and its employees and clients will be looked after

FIGURE 12

DRIVERS OF SELLING

Base = Current and Potential Sellers



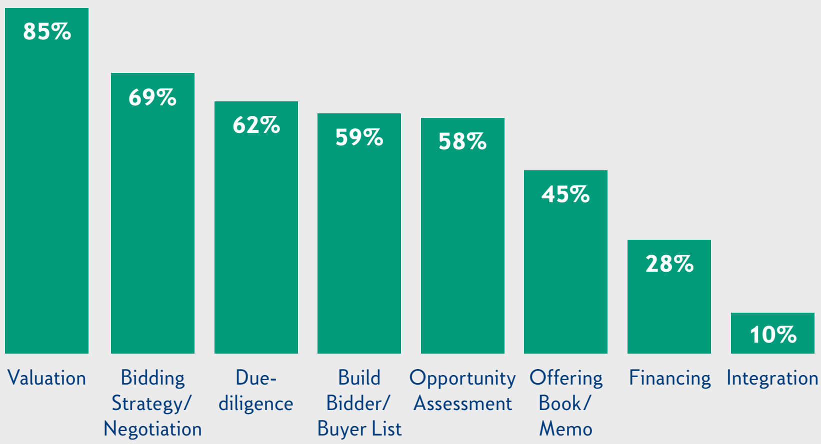
Again, despite their concerns or lack of familiarity with M&A processes, only four out of 10 current or potential sellers have or would consider having an external provider help manage their selling process. Among the many tasks those firms would engage an outside provider to handle, valuation is by far the most mentioned (85%), though help with bidding strategies (69%) and due-diligence (62%) is also widely sought (*Figure 13*). Two-fifths of these executives are turning to investment banks and M&A boutique advisors for these kinds of assistance. Larger mid-market firms with between $100MM and $2B in annual revenues are especially likely to consult investment banks on selling issues.

FIGURE 13

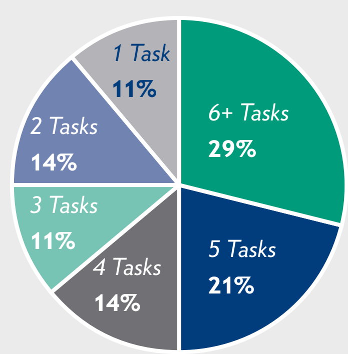
SELLING TASKS FOR EXTERNAL PROVIDERS

Base = Externally Managed Current and Potential Sellers (*n=56*)

TYPE OF TASK



NUMBER OF TASKS



AVERAGE NUMBER OF TASKS: 4.2

CONCLUDING REMARKS: ART OF THE DEAL

Words of Advice

Though news concerning the economy may try to convince you otherwise, it's an exciting time to be a mid-market business owner. With its new challenges, the market has also opened new approaches to transaction-based growth. For those executives who understand the risks of the market, who know the value of their company, and who have the tools and external support to properly identify and evaluate opportunities, there are many paths to strategic success for their businesses.

The mergers and acquisitions option may seem daunting to some. Whether looking to sell or buy, there's a lot to consider, and the commitment involves a great deal of time and money, sometimes for gains that won't be realized for years, or at all. To avoid M&A mishaps to the greatest extent possible, it's best to keep focus on the basics, such as your company's strengths and the strategic purpose of a potential purchase or sale.

For more "basics" to keep in mind, consider these words of advice from other mid-market executives who have been there before:

- **ARM YOURSELF WITH AN UNDERSTANDING OF THE M&A PROCESS; DON'T ASSUME YOU KNOW.**
  "I think the biggest thing with these acquisitions is really to try to understand what it is you're getting into. And make sure you really understand it beforehand, because you can spend a lot of time afterwards trying to fix something that maybe you should have seen in the first place."
  (*CFO of a $250MM – $500MM packaged meats company*)

- **EVERY DEAL IS UNIQUE; THERE'S NO ONE RIGHT APPROACH.**
  "Each one of these is different; in that respect they're like a child. They all have different needs. There's no one formula that you can say if you do A, B and C you're going to get D. There's no formula for what we do, there is a process but you have to tailor the process to each individual brand or company that you're acquiring. It's very, very unique and specific to the thing that you're acquiring. It's not that you can say ok this is how you do acquisitions. This is how you do the acquisition for this one; this is how you do the acquisition for this next one. You know it's very unique and I'm not sure it's like that in any other business [strategy]."
  (*DVP of a $25MM – $50MM retail and consumer products company*)

- **BUILD YOUR NETWORK, DEVELOP YOUR RELATIONSHIPS.**
  "One key for us has been the personal relationships. Over time we've developed a lot of personal relationships with other companies and organizations in our industry, and I think those are what have led to us becoming aware of or people making us aware of possibilities out there. I probably couldn't stress enough developing those individual relationships."
  (*CFO and VP of a $10MM – $25MM electrostatic toner manufacturer*)

- **BE PATIENT, BE CAUTIOUS, AND DON'T SKIMP ON THE RESEARCH.**
  "I think the biggest thing is be patient, be cautious. It doesn't matter what the product is or the type of industry there's always people out there trying to sell their company and we've known people that have jumped at an acquisition, did not properly do their research and found that they got stuck and they've spent an awful lot more money than they had planned on just to make the acquisition successful."
  (*SVP of a $25MM – $50MM nationwide satellite television service provider*)

- **PLAY FAIR IN NEGOTIATIONS.**

  "Both sides during and at the end of the negotiation have to feel that they've won more than they've given up, that there's been a two-way street, they've been listened to. Some elements they won, some they didn't, but overall both sides feel it's an equitable, not one-sided relationship, that they feel there's a critical element, and one of the most difficult things to do in the negotiation, because both sides are obviously posturing to get the best for themselves they can...I want predominately to have what I want there, but I also want to make sure that it's something that's fair on the other company. Because in most cases the ownership's going to come in with the company. They're going to be the flagship for the staff they bring over. The staff are going to look to that leadership to make sure it's okay, because they don't know the company that's just bought them."

  (*President and CEO of a $5MM – $10MM IT services firm*)

- **DON'T NEGLECT THE PEOPLE INVOLVED, BE THEY CUSTOMERS OR EMPLOYEES.**

  "My most important thing was, with any kind of merger or acquisition, is that you remember that if you're also acquiring staff, that these are people, and that you need to be honest with them. It's one thing if you buy a machine and you put the machine in a new building, or you put the machine on the other side of the country, but if you acquire people who have families, and you've given them the impression that you're here for the long run, when your real plan is just to eliminate the competition, that's crappy."

  (*CFO of a $25MM – $50MM maple manufacturer*)

- **IF YOU AREN'T SURE HOW, DON'T HESITATE TO ASK THOSE WHO KNOW.**

  "If you don't have internal resources, or they don't know the process, use good consultants. The due diligence process is the most important element in the project."

  (*Finance & tax director of a $500MM – $1B polyurethane manufacturer*)

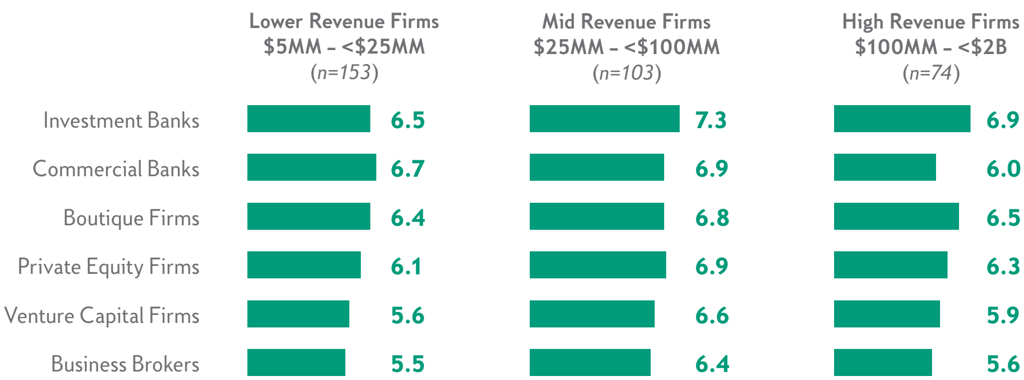
...But Who to Ask?

The good news is you have a lot of people you can rely on. Among mid-market executives actively involved in or considering multiple approaches to corporate development, banks are most highly regarded for their skill and expertise in helping businesses grow. While large mid-market firms tend to rely more on investment banks, executives at smaller mid-market firms are more likely to favor the experience and capability of commercial banks (*Figure 14*).

FIGURE 14

MEAN PERCEPTION OF EXTERNAL PROVIDERS' SKILL AND EXPERTISE IN CORPORATE DEVELOPMENT BY FIRM SIZE

(Based on 11-Point Scale, 0-11)



As it is with potential M&A targets, not all external advisors may fit your business's needs. Take care to investigate banks/firms you may not have originally considered to make sure you find the one that best understands your industry, your business, and what you're looking to achieve. The right partner should not only be able to help you with the process from start to finish, but can clarify how the trends and intricacies of the M&A markets enhance or limit your growth opportunities. With a measured understanding of the risks, and a focus on the best opportunities, you can position your firm for deals that deliver differentiating value.