

Windward Advisors, LLC

If I Had Been Contemplating Exiting My Business, What Do I Do Now Given This Economic Environment?

Business owners, who for various reasons have been considering a possible exit and sale of their businesses, are now faced with the stark reality that we are in a recession, business values and financial trends for many companies and in most industry segments are down, obtaining financing has become difficult, and it appears that an economic recovery may be slow and gradual given its root causes. Couple those items with a pending administration change that proposes increased capital gains and other taxes and levies, difficulty in budgeting and forecasting with any degree of accuracy, and the dilemma becomes obvious. For many, who had forestalled taking any action in the past several years opting to enjoy the fruits of a vibrant economic period with record earnings and business valuations, they are now embracing the reality that they may have waited too long and missed a window of opportunity to cash in when times were good and values high.

Okay, that's what the economic conditions were and where it is now, so what can you do? First, take comfort in knowing that this is not the first time we have ever gone through such cycles and economic downturns and it won't be the last. In fact, since 1948 we have experienced 10 recessions. The average duration was 10 months with a recovery commencing 5 months before the recession ended and the public markets showed an average gain of 39% returns within one year from the end of the recession lows.⁽¹⁾ Feeling better yet? Assuming you are able to maintain, or minimize the impact of this recession on operations all is not lost, only deferred. So what do you do during the interim? All too often we find that most companies are ill prepared for a transaction and fail to allocate the time needed to identify what needs to be done and to properly prepare the company for a "*Sales Process*". **There is no better time than the present to start preparing!**

As a sell-side advisory firm Windward Advisors actively works with owners to help identify and address issues and devise strategies to assist the company in preparing for a successful "*Sales Process*". Windward then represents the company in the Process to ensure that the business value obtained is maximized. In this newsletter we will review some of the influences on value, and recommend steps that should be taken to increase value in preparation of a future transaction.

Consider Your Industry

Unless you are fortunate enough to be an industry leader, you are probably not in a position to establish and affect your industry trends so it is best just to try and understand it. Although many industries have suffered a severe downturn, there are several that have been less impacted by the current economic slowdown. For instance, healthcare-related businesses remain attractive due to their necessity as well as macro trends such as an ageing population and an increased need for home

(1) Ned Davis Research and Nation Bureau of Economics Research, 2008

health services. As an example, according to a recent CDC study of the prevalence of diabetes in the United States, the percentage of the population with diabetes in adults ages 45-64 has increased from 1995 to 2005 from 6.2% to 10.2%. If you are a company providing goods or services to this space, demand is probably up regardless of what the economy is doing as a whole. Business valuations may actually be higher today than a year ago since investment capital is still very abundant and are finding it increasingly difficult to find attractive markets within which to invest. This is a basic relation between having limited supply and heavy demand.

As another example, military spending continues unabated. Between 2001 and 2007 U.S. military spending increased 59% in real terms. While military spending is an economic stimulus, there are legitimate concerns that the recent election results could significantly impact such spending and the related valuations and outlook of companies that support the military and defense industries. This could call for an action plan to diversify the products or services being provided or to focus more actively on pursuing other commercial applications for those same products.

Energy-related and infrastructure industries are experiencing unprecedented growth pressure. In response to what we recently encountered with escalating fuel, electric, and other energy source prices, and the all too apparent risks and needs for developing energy independence, many companies operating in this space stand to reap lucrative upside benefits and are in demand.

Alternatively, if you are a provider of building materials, a mortgage broker, an auto manufacturer, or a credit card services company, your expectations for a swift recovery may need to be tempered and plans altered. Conversely, certain technology sectors may continue to prosper; and industries that enable cost-reduction, such as business process outsourcing, or provide logistics management and services are enjoying continued growth. **The point here being; know your industry, its participants and its trends and factor those in to your plans.** For some, an exit in these conditions could still be an attractive alternative, while many should just wait it out and focus on operating efficiencies if conditions permit.

Capital Gains Taxes

With an administration change it is likely that we will see an increase in the capital gains tax rate from the current 15% to as high as 25%. In anticipation of this potential change, some business owners may elect to accelerate their exit plans, even at the risk of a slightly depressed valuation, to ensure that their after-tax proceeds are maximized. However, a thorough examination is recommended with input from your tax advisor prior to making this type of decision.

Valuations

According to GF Data Resource it reported average total debt leverage as a multiple of EBITDA for private equity leveraged transactions, ranging from \$10 to \$250M, was down to 3.5x during the first six months of 2008 compared to the same period last year of 4.0x, or a 12.5 % decrease. Transaction multiples in the \$100 to \$250M range rose as high as 5.2x last year whereas smaller transaction, those between \$10 and \$50M, averaged 3.95x. Most recently, in calls we conducted with private equity groups, we were told that lenders are now reluctant to finance transactions having overall debt leverage of more than 2.5x. This implies that, in order to get deals done, buyers have to put more equity into transactions and the decrease in debt leverage is putting downward pressure on business valuations. **When debt leverage multiples are high, the seller is usually the beneficiary.**

GF Data Resources also identified three trends within the second-quarter 2008 valuation data:

- Average business valuation multiples on transactions between \$10 million - \$25 million have stabilized at approximately 5.0x Enterprise Value/EBITDA, compared to 5.6x in the first six months of the same period last year for an 11% decrease.
- In the \$25 million - \$100 million valuation range average values dropped from 6.6x in the first half of 2007 to 5.8x in the second, for an 18% decrease. In 2008 to date, that figure has rebounded to 6.2x, most likely driven by a flight to quality and attractive industries dictating higher multiples.
- Market conditions continue to take their toll on \$100 million - \$250 million transactions. Average pricing in this upper tier of the GFDR universe fell to 6.0x from 7.8x for a 23% decline. New data is expected to be released in later November and we expect to further erosion in values in most categories.

Capital Availability

According to “*Buyouts*” magazine there is still over \$440B of committed private equity capital and a number of strategic acquirers have accumulated cash for the purpose of acquiring companies. When the economy and organic business growth are slow, both strategic buyers and financial buyers focus on rationalizing their companies and refining growth initiatives, which include considering acquisitions that will compliment their businesses, provide top-line growth and bottom-line synergies.

Financial buyers need to put money to work since most have rigid time deadlines in which they have access to the capital committed for making investments. To illustrate the pent-up demand for reasonable investments, ThomsonReuters recently reported that private equity firms invested only \$19B in the first half of '08, compared to \$255B invested during the first half of '07. During this same period roughly \$140B of additional capital was raised by private equity funds, most of which is still available. Now, instead of having 5 years to invest the capital, they have four. If they don't get the capital invested they lose access. Do you think these firms will start getting a bit anxious?

Bank debt terms are obviously much tighter, stringent, and costlier than they have been in recent years, driving more conservative capital structures and requiring larger equity commitment proportions. To be an attractive borrowing candidate in this environment, which is particularly important to financial buyers, a business must have sustainable cash flows and steady to growing trends. Strategic buyers, on the other hand, who are flush with cash and are performing well, will have adequate access to debt through existing relationships, even though availability levels may be tighter.

The Need to Improve What You've Got

If a company's performance is down relative to the market or industry sector, or if performance for the next 6-12 months looks weak, owners should consider waiting to exit but use the time wisely to improve business performance and thus, the value of their company for in the future. As already stated, very few companies are prepared for an exit transaction, so taking the opportunity to coordinate with a team of advisors and addressing the issues will considerably increase value and probability of success without losing valuable time when the market picks up again.

Examples of background work that Windward has helped businesses to identify and improve, in advance of the exit or recap transaction, include the following:

- Performing a SWOT analysis and providing recommendations on items identified that need to be addressed in order to improve operations and business value
- Understand and compare exit alternatives and options as they relate to the objectives of the owners
- Identify and facilitate cleaning up any financial, legal, or other issues that could detract from value
- Formalize and prepare projections and forecasts with underlying assumptions
- Facilitate the preparation and implementation of a strategic plan
- Continue to develop customer relationships that would lead to larger and more diversified sales revenues
- Restructuring and renegotiating credit lines and terms commensurate with current performance
- Develop more formalized organizational structure, job descriptions and responsibilities, establish action plans with accountabilities, and deadlines for tasks by operational areas, and ensure that a program for management development is implemented.

Of course, any time is a great time to focus energy on profitably expanding target markets, implementing a professional Board of Directors, evaluating how lean manufacturing techniques can reduce inventory levels and variable costs within your enterprise, etc. etc.

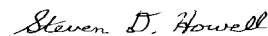
If you or someone you know is considering exit or recapitalization alternatives it is never too soon to begin developing and implementing a formal plan. In the assessment phase of planning Windward has significant experience to help business owners determine whether now is a good time to pursue an exit, or whether some additional work is warranted first, and can then represent at the appropriate time in the sale of the business. In any case, surrounding yourself with an experienced team, including appropriate counsel, accountant, and personal financial advisor, to help your decision process will pay many times over the investment required.

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