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Building Strategic Value

Survey

Pricing of Strategic vs. Financial Acquisitions

Sponsored by ExiTrak LLC

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This survey would not have been possible without the invaluable technical contribution of Page Schorer. Mr. Schorer assisted with the design and structure of the survey, as well as the statistical analysis and presentation. We are deeply grateful for his investment of time and his considerable technical expertise.

Page Schorer has over thirty years experience as a international marketing research professional and multivariate statistical analyst. (Page@LoneRiderResearch.com) He has had senior positions with such companies as Landor Associates and Young & Rubicam, and has been a partner with several small research consultancies.

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Executive Summary

Anecdotal data have long supported the notion that the strategic sale of a privately held company will garner a higher price than that of a financial sale. In fact, this is the basic idea behind the a “roll-up” or acquisition of multiple companies in an industry.

The objective of the roll-up buyer is to put together a group of companies that is much more valuable than the sum of their individual values. So, the buyer seeks to *buy low*, in a series of financial acquisitions, and *sell high* as a large, attractive strategic acquisition. The reason why a strategic acquisition is typically much more lucrative than a financial one is quite straightforward.

In a financial acquisition, the entire return on investment to the buyer derives from the after-tax profits and cash flow that the seller provides as a separate and distinct entity. For example, big company A acquires small company B and sets it up as a wholly-owned subsidiary, which operates essentially as it did before it was sold.

In a strategic acquisition, the return on investment to the buyer derives from several sources, including:

1. The after-tax profits and cash flow described above;
2. The additional after-tax profits and cash flow the seller generates as a result of the change of ownership;
3. Most importantly, the additional after-tax profits and cash flow that the buyer generates because of the acquisition. Assuming that the buyer is several times larger than the seller (the norm) these dollars can be very significant. For example, if the buyer is 10 times the size of the seller, and increases its earnings a mere 10% as a result of the acquisition, this is precisely the same dollars as if the seller had doubled its earnings. A 20% increase is the same as the seller tripling its earnings, etc. Small wonder that, in such cases, a small multiple of EBITDA is simply not justifiable.

Until 2011, however, there has been no formal study of the relative pricing of financial and strategic acquisitions. This survey, sponsored by *ExiTrak LLC* to fill this need from the perspective of professional business brokers, has yielded the following statistically supported conclusions.

1. For deals under \$5 million, it is very likely that a strategic private company sale will yield a higher price (perhaps a significantly higher one) than a financial sale.
2. The owner/manager who plans to sell the company within five years will be well advised to invest time and resources in building the company into an attractive strategic acquisition candidate.

Background and Methodology

Prior to 2011, there has been no formal study of the relative pricing of financial and strategic acquisitions. The objective of this survey was to gather statistically significant data from merger and acquisition professionals. The hypothesis was that these data would support the widely held belief that the owner of a privately held company who prepares for a strategic sale will be rewarded for his or her efforts.

The survey was sponsored by *ExiTrak LLC*. The *ExiTrak*[®] process assists the private company owner to increase strategic value to support a lucrative sale within five years.

Three groups were approached - the International Business Brokers Association (IBBA), the American Business Brokers Association (ABBA) and M&A Source. At the commencement of the survey, IBBA had approximately 1,500 members; ABBA had approximately 600. Both organizations are national in scope. IBBA had approximately 150 members outside the U.S.

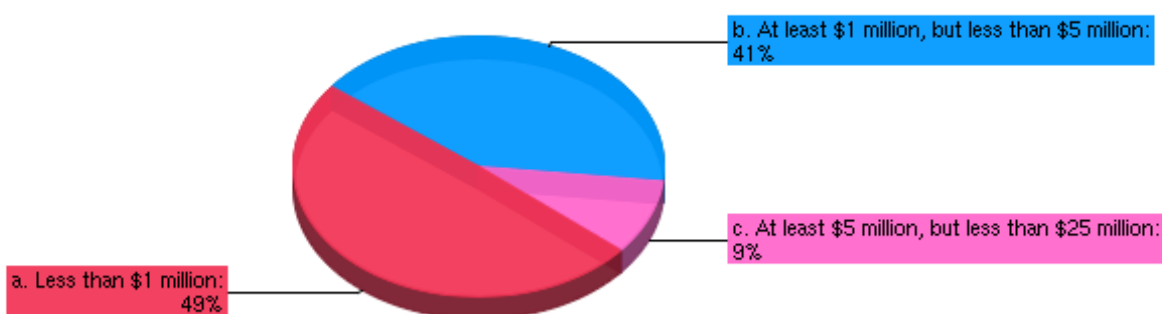
The survey was conducted on line from March 22, 2011 through June 3, 2011. There were six multiple-choice questions. Based on the response to question #6, the respondent automatically "skipped" to one of 12 follow-up questions. Thus, each respondent answered seven questions in all. (See Appendix A.)

There were 75 responses. Assuming that half of the ABBA members also belong to IBBA, and that all members of M&A Source belong to one or both organizations, the total population surveyed was approximately 1,800, yielding a response rate of approximately 4%.

Key Findings

(1) Most reported transactions constituted relatively small deals.

68 of 75 respondents (90.6%) reported that most of their completed transactions were priced at less than \$5 million.

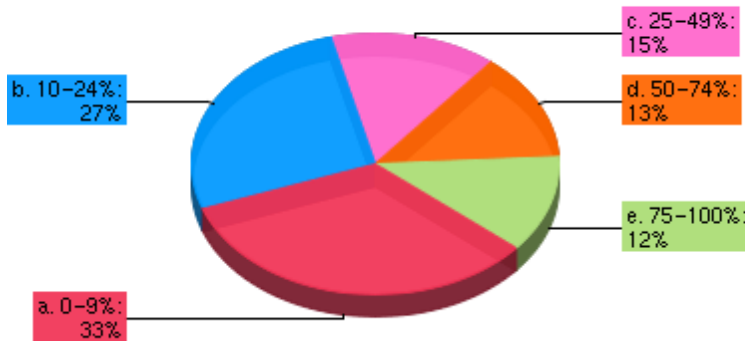


Value	Count	Percent %
a. Less than \$1 million	37	49.3%
b. At least \$1 million, but less than \$5 million	31	41.3%
c. At least \$5 million, but less than \$25 million	7	9.3%
Total Responses		75

Note: Using a sampling error test, 91% exceeds 9% at the 99.9% confidence level.

(2) Strategic sales are in the minority.

60% of respondents reported that less than 25% of their completed transactions were strategic sales.

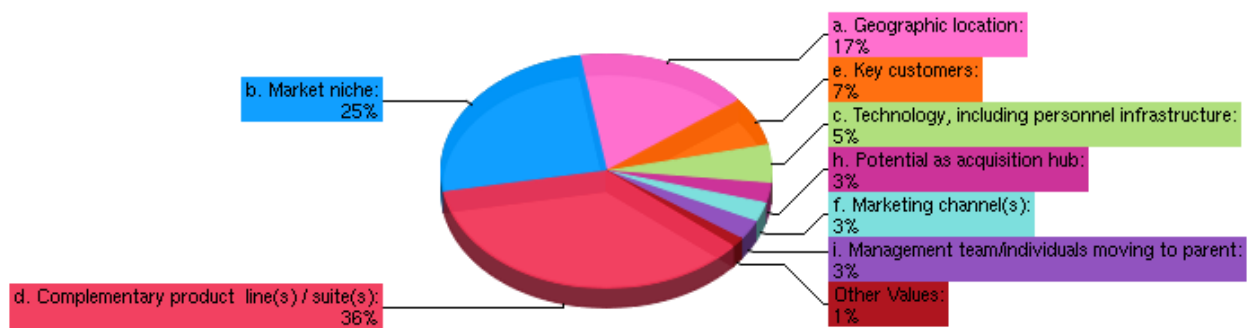


Value	Count	Percent %
a. 0-9%	25	33.3%
b. 10-24%	20	26.7%
c. 25-49%	11	14.7%
d. 50-74%	10	13.3%
e. 75-100%	9	12.0%
Total Responses		75

Note: Using a sampling error test, 60% exceeds 40% at the 99.9% confidence level.

(3) The vast majority of strategic buyers cited a strategic asset related to increasing sales as the reason it considered the seller a strategic acquisition.

A total of 85% of respondents selected: complementary product line(s) or service suite(s), market niche, geographic location or key customers.



Value	Count	Percent %
a. Geographic location	13	17.3%
b. Market niche	19	25.3%
c. Technology, including personnel infrastructure	4	5.3%
d. Complementary product line(s) or suite(s) of services	27	36.0%
e. Key customers	5	6.7%
f. Marketing channel(s)	2	2.7%
g. Strategic alliance and/or joint venture relationship(s)	1	1.3%
h. Potential as an acquisition hub; i.e. able to make acquisitions for the parent	2	2.7%
i. Management team, including capacity for individuals to move up to parent	2	2.7%

Total Responses

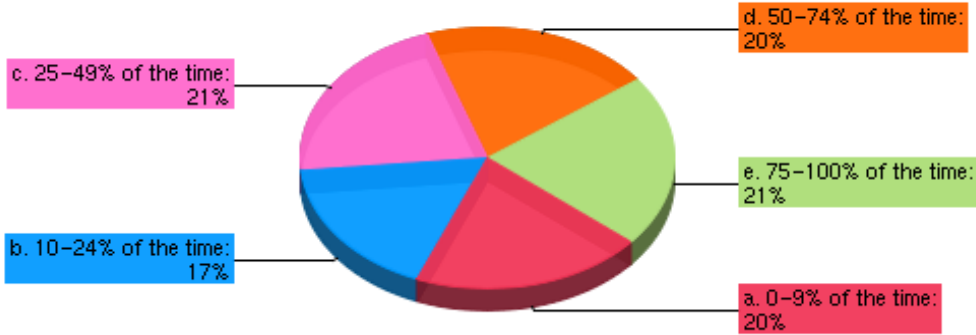
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Note: Using a sampling error test, 36% ,25% and 17% exceeds all the others at the 95.% confidence level.

(4) Strategic sales outperformed financial sales in the frequency with which the seller's target price was met or exceeded.

Primarily Financial

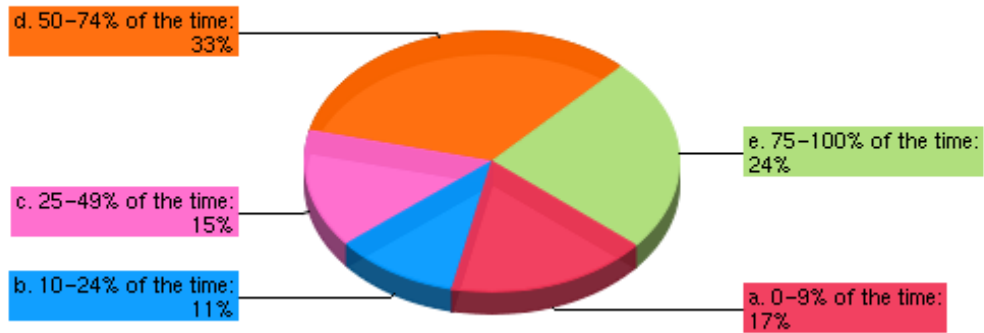
Less Than Half	58.6%
Half or More	<u>41.3</u>
Total	100.0%



	Value	Count	Percent %
a. 0-9% of the time		15	20.0%
b. 10-24% of the time		13	17.3%
c. 25-49% of the time		16	21.3%
d. 50-74% of the time		15	20.0%
e. 75-100% of the time		16	21.3%

Primarily Strategic

Less Than Half	42.7%
Half or More	<u>57.3</u>
Total	100.0%



Value	Count	Percent %
a. 0-9% of the time	13	17.3%
b. 10-24% of the time	8	10.7%
c. 25-49% of the time	11	14.7%
d. 50-74% of the time	25	33.3%
e. 75-100% of the time	18	24.0%

Total Responses	75
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Note: The Wilcoxon Signed Rank Test was conducted on the full distribution of acquisition client categories. Strategic acquisitions outperformed financial ones at the 99% confidence level.

(5) The outperformance of strategic acquisition pricing over that of financial acquisitions is even stronger when calculated from the respondents' most frequent acquisition client category. Categorical responses were particularly critical, because they reflected those types of deals in which the respondents had the most experience. (See Appendix B for the count and percentage breakdowns of the Respondents' Acquisition Client Categories.)

Strategic Sale Multiples Less Than Those in Financial Sales by at least 25%	16%
Strategic Sale Multiples About the Same as Those in Financial Sales	21
Strategic Sale Multiples Exceeded Those in Financial Sales by at least 25%	<u>53</u>
Total	100%

Note: Using a sampling error test, 53% exceeds both 16% and 21% at the 99.9% confidence level.

Significance Testing Highlights

Two methods of statistical testing were used in this research: A sampling confidence interval test and the Wilcoxon Signed Rank Test.

A sampling confidence interval at a given confidence level is a range in which the true value falls. For example at the 95% confidence level with a population of 1,800 and a sample size of 75, 25% will fall between 15.4% and 34.6% 95 times out of 100.

The Wilcoxon, considered the Rolls Royce of paired comparison tests, is a non-parametric test that is most commonly used by science and medicine for very small samples (less than 20.) Its reliability for this sample size (75) is extremely high. The Wilcoxon, and its use in this study, is discussed at some length in Appendix C.

Confidence levels in this research were at least 95% and were usually of 99%. In other words, the key findings summarized in the previous section are statistically relevant and persuasive.

Summary & Conclusions

This survey, sponsored by **ExiTrak LLC**, has provided statistically relevant and reliable data supporting the belief that privately held companies that become strategic acquisition candidates are very likely to garner a higher price than would be the case in a financial sale. These data relate primarily to deals of under \$5 million.

About 2 of 5 financial sales yielded prices at or above the seller's target. About 3 of 5 strategic sales met this standard. Responses regarding sales in industries in which the brokers had the most experience were even more compelling.

The combination of anecdotal and statistical data argue persuasively for the following:

1. For deals under \$5 million, it is very likely that a strategic private company sale will yield a higher price (perhaps a significantly higher one) than a financial sale.
2. It is worth an investment of time and resources by ownership/management to build the company into an attractive strategic acquisition candidate.

Appendix A

Survey Questions

The survey questions are listed below. Note: All "skips" from Question #6 were identical, with the exception of the industry specified, e.g. Retail or Construction. Therefore, only one sample of Question #7 (Question 7a - General Manufacturing) is included here.

1. Most completed transaction sale prices were:
 - a. Less than \$1 million
 - b. At least \$1 million, but less than \$5 million
 - c. At least \$5 million, but less than \$25 million
 - d. At least \$25 million, but less than \$50 million
 - e. \$50 million or more

2. What percentage of transactions completed in the past five years were primarily strategic sales?
 - a. 0-9%
 - b. 10-24%
 - c. 25-49%
 - d. 50-74%
 - e. 75-100%

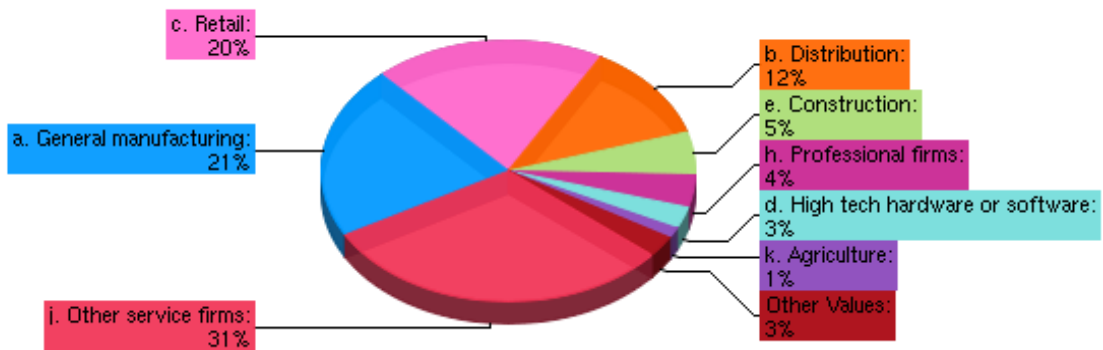
3. Of all completed strategic sales, what was the single most common reason that buyer considered seller a strategic acquisition?
 - a. Geographic location
 - b. Market niche
 - c. Technology, including personnel infrastructure
 - d. Complementary product line(s) or suite(s) of services
 - e. Key customers
 - f. Marketing channel(s)
 - g. Strategic alliance and/or joint venture relationship(s)
 - h. Potential as an acquisition hub; i.e. able to make acquisitions for the parent
 - i. Management team, including capacity for individuals to move up to parent

4. Of all completed primarily financial sales, how frequently was the seller's desired price met or exceeded?

- a. 0-9% of the time
 - b. 10-24% of the time
 - c. 25-49% of the time
 - d. 50-74% of the time
 - e. 75-100% of the time
5. Of all completed primarily strategic sales, how frequently was the seller's desired price met or exceeded?
- a. 0-9% of the time
 - b. 10-24% of the time
 - c. 25-49% of the time
 - d. 50-74% of the time
 - e. 75-100% of the time
6. Which one of the following operations categories contains the greatest number of your firm's completed transactions in the past five years?
- a. General manufacturing
 - b. Distribution
 - c. Retail
 - d. High tech hardware or software
 - e. Construction
 - f. Transportation
 - g. Utilities
 - h. Professional firms
 - i. Finance; e.g. banks, insurance companies, payroll service companies, etc.
 - j. Other service firms
 - k. Agriculture
 - l. Mining
- 7a. Among the General Manufacturing acquisitions your firm handled, how did the multiples in primarily strategic sales typically compare with those in primarily financial sales?
- a. Strategic sale multiples were less than those in financial sales by at least 50%
 - b. Strategic sale multiples were less than those in financial sales by at least 25%.
 - c. Strategic sale multiples were about the same as those in financial sales.
 - d. Strategic sale multiples exceeded those in financial sales by at least 25%.
 - e. Strategic sale multiples exceeded those in financial sales by at least 50%.
 - f. Strategic sale multiples exceeded those in financial sales by at least 100% (at least double.)

Appendix B

Respondents' Acquisition Client Categories



Value	Count	Percent %
a. General manufacturing	16	21.3%
b. Distribution	9	12%
c. Retail	15	20%
d. High tech hardware or software	2	2.7%
e. Construction	4	5.3%
g. Utilities	1	1.3%
h. Professional firms	3	4%
i. Finance; e.g. banks, insurance companies, payroll service companies, etc.	1	1.3%
j. Other service firms	23	30.7%
k. Agriculture	1	1.3%
Total Responses		75

Appendix C

Notes on Statistical Testing

With one exception, sampling confidence interval testing was used in this study. In brief, given a population size (can be infinite), a sample size, a desired confidence level and a sample proportion, there are many handy calculators on line which will provide you with a range for any proportion. For example, given a population of 1,800 and a sample of 75, at the 95% confidence level:

$$25\% \pm 9.6\% = 34.6$$

$$50\% \pm 11.1\% = 38.9$$

One simply subtracts the interval from the larger proportion and adds it to the smaller proportion. If, as above, the modified proportions do not overlap, they are different at the set confidence level.

From: <http://www.dssresearch.com/toolkit/secalc/error.asp>

There was one comparison where this test could not be used - when we compare Q. 4 “Of all completed primarily financial sales, how frequently was the seller’s desired price met or exceeded?” and Q5. “Of all completed primarily strategic sales, how frequently was the seller’s desired price met or exceeded?” This is because the two variables are correlated ($R \sim 0.6$). There is, probably, a “firm effect” here. If a firm is high on one they are probably high on the other. This is a significant correlation (99.9% level) but it does not mean that one causes the other but, more likely, that both are caused by an underlying “firm effect”.

There are T-tests and Z-tests which use the R value to modify the results to take this into account but both use arithmetic averages. These assume that the underlying scales are metric. For example, in a 5-point scale, we would assume that 2-1 = 3-4, etc. In survey research, this is quite a draconian assumption, particularly when the scales are not labeled in such a way as to strongly suggest they are equal interval.

Instead, we used a test which makes only ordinal assumptions, that $1 < 2 < 3 < 4 < 5$ and is immune to correlation effects: the Wilcoxon Signed Rank test (results below.) See: <http://faculty.vassar.edu/lowry/ch12a.html>. The worksheet for the Wilcoxon is shown below. This test is usually used in science and medicine, where both samples and number of tests are small, not in survey research, where samples are usually large (100 to 1,200) and the number of tests are many. It is just too much work and, therefore, too expensive.

ID	Financial desired price	Strategic desired price	Diff.	Diff. Sign	Absolute Diff.	Absolute Rank	Signed rank	W
10	17	4.5	-13	-	12.5	3	-3	
11	17	4.5	-13	-	12.5	3	-3	
4	87.5	62.5	-25	-	11.5	7	-7	
5	87.5	62.5	-25	-	11.5	8	-8	
6	87.5	62.5	-25	-	11.5	9	-9	
7	87.5	62.5	-25	-	11.5	10	-10	
8	87.5	62.5	-25	-	11.5	11	-11	
9	62.5	17	-46	-	45.5	30	-30	

Note: values are mid-points of the scale, but makes no difference as the test only assume ordinal relations.