Exit Strategy Trends and Ways to Create Value

A case study showing current trends and recurring themes in government contracting M&A transactions

The McLean Group
INVESTMENT BANKING

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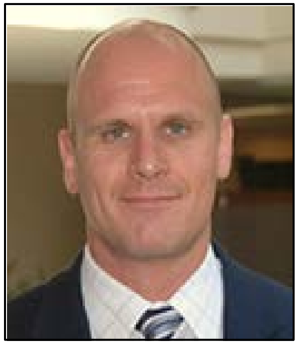
About the Presenters

Mitch Martin



- Partner and co-head of The McLean Group's M&A Practice specializing in Aerospace, Defense & Government Services transactions.
- Select transactions include the leveraged ESOP of Linxx Global Solutions, the sale of 3Phoenix to Ultra electronics, the sale of Twisted Pair Solutions to Motorola, the divestiture of RedBlack Communications from Ultralife, Inc, SMSi's sale to Boeing, and Signature Government Solutions' sale to Sotera.
- Mr. Martin is an Honors Graduate of the United States Military Academy at West Point. He received his M.B.A. from MIT and his M.P.A. from Harvard University.

Dean Nordlinger

- Partner with PilieroMazza and heads the Business and Corporate Law Group.
- 16 years of experience representing small and medium-sized privately held companies, closely-held businesses, private equity firms and entrepreneurs across varied industries, including government contracting, media and communications, information technology and manufacturing.
- Regularly represents clients on business and corporate matters in all phases of their business life cycle from start-up to sale of the company.

SECTION 1

Current Market Trends We Are Seeing

Our Top 10 Market Trends

1) M&A activity has returned to a steady-state – albeit a “new normal”
2) The primes are back in the market, creating activity across all sectors
3) Continued scrutiny on set-aside contracts
4) “Alternative Strategies” such as ESOPs appear to be gaining momentum
5) A buyer “focus on focus” within customer and capability segments
6) Consolidation and divestiture activity
7) Active capital markets
8) Structured transactions more common
9) Tax considerations continue to drive deal structure
10) Dynamic SBA regulations

SECTION 2

Representative Case Study

Introduction to Case Study

- These are the fundamental issues we are seeing over which deals come together or fall apart
- Case study makes it easier to illustrate how these issues get sorted
- There are ways to do “win-win” deals; transactions do not have to be a zero sum game

Setting the Stage

Sample Deal Outline

- Private Equity Portfolio Company (PEPCo) is acquiring Middle Corp in a structured transaction
- PEPCo has several hundred million in revenue
- Middle Corp is a fast growing, privately held S-Corp:
  - $50 million in LTM revenue
  - $5 million in EBITDA
  - Forecasting 15% annual revenue growth for the next three years
  - Holds attractive intellectual property (IP)
  - Has critical employees and management team
- Transaction hurdles:
  - Risk to aggressive growth forecast:
    - Key task order recompete lost during due diligence
    - One large contract award under protest and several others are delayed
    - Middle Corp not tracking to forecasted projections
  - Several small business set-aside contracts
  - Converted from C Corp to S Corp January 1, 2010; net unrealized built-in gain of $15 million at conversion
  - 30% ESOP ownership
  - Key employees must be retained for future success
  - Plaintiff in an ongoing lawsuit
  - Disputed working capital expectations
  - 338(h)(10)

Transaction Summary	
Estimated Close	September 30, 2015
Structure	IRC § 338(h)(10)
Total Consideration	$65 million
Cash at Close	$35 million
Seller Note	$10 million
Earnout	$10 million over 2 yrs
Escrow	$5 million
Rollover Equity	$5 million

Potential Transaction Hurdles

Missed Projections

- Middle Corp is a fast growing company with some attractive IP supporting an aggressive growth forecast
- However, Middle Corp is not tracking to its original revenue projections due to the loss of a key task order recompete and awarded work being put on hold due to budgetary constraints and uncertainty
- The top-line reductions have decreased LTM EBITDA margin from 10% to 8%

Seller Perspective

- There are still many growth opportunities
- Want credit for delayed revenue – owners already losing value on front end, don't want to be penalized post-sale as well
- A single task order loss should not devalue the business overall

Buyer Perspective

- Portion of anticipated revenue and EBITDA will now not be recognized
- Contract delays raise questions regarding market suitability and growth prospects
- Forecast credibility concerns and increased buyer risk

Possible Solutions

- Middle Corp accepts a larger earnout component
- PEPCo reduces overall valuation but increases cash offering
- PEPCo reduces cash at close but increases the rollover equity component and the total potential transaction value above $65 million

Potential Transaction Hurdles

Small Business Set-Aside

- Middle Corp is transitioning from the small business designation and 80% of its work is full and open
- The other 20% is small business set-aside work not scheduled to expire for another three years
- Middle Corp has a strong customer relationship and does not expect to lose the work in a transaction, but was assigned a new contract officer within the last 12 months

Seller Perspective

- Expects to recognize full value from existing set-aside contracts
- The past-performance and customer relationships have value to the seller
- Has developed a strategy to transition the work to full & open or continue work through a JV/SB prime upon recompete

Buyer Perspective

- 20% of the company's revenue is immediately at risk post-acquisition
- Already has a good relationship with the customer, limiting value
- Even if work continues post-acquisition, will not be eligible to prime when recompete comes up

Possible Solutions

- Conduct customer meetings earlier in due diligence (at a risk to seller)
- Middle Corp takes on the contract risk in the form of an earnout
- PEPCo pays a lower valuation for the set-aside work
- Middle Corp sells the small business contracts or spins off a division as a separate company

Potential Transaction Hurdles

Employee Retention Pool

- Middle Corp has several key employees associated with Middle Corp IP creation and maintenance
- The management and business development teams maintain critical customer relationships that are crucial to Middle Corp's growth expectations
- During diligence PEPCo identifies 10 employees (including seller-owner) who are "key" to the transaction

Seller Perspective

- Employees are loyal and will not need additional incentives to remain with Middle Corp
- If buyer would like a retention pool, will be at buyer's expense

Buyer Perspective

- A large part of the acquisition is the people / key employees
- It is incumbent upon the seller to deliver these people
- Any contracts with employees need to be controlled by buyer

Possible Solutions

- The retention pool is seller-funded
- The retention pool is buyer-funded
- Share the associated costs evenly
- Determine which party receives the tax benefit

Potential Transaction Hurdles

Litigation Liability

- Two years ago a teaming agreement with an industry competitor collapsed and Middle Corp retained a majority of the work
- Former partner company suspected foul play and is suing Middle Corp for $10 million
- Litigation is ongoing with no clear outcome

Seller Perspective	Buyer Perspective
• There is no issue/risk with the old teaming agreement	• Not responsible for prior ownership mistakes • Settle the dispute as quickly as possible • Would like to be fully indemnified by the seller

Possible Solutions

- Middle Corp settles and legal fees and settlement are paid by Middle Corp prior to closing
- Middle Corp agrees to indemnify PEPCo, payables associated with legal fees accrued pre-closing will be included in working capital calculations
- Escrow is increased to account for potential claims
- Raises the discussion for stock vs asset purchase – successor liability

Potential Transaction Hurdles

ESOP Buyout

- Middle Corp sold 30% of its outstanding shares to an ESOP five years ago
- An independent trustee, valuation firm, and attorney have been assigned to represent the ESOP in the transaction
- PEPCo, Middle Corp and the transaction trustee all prefer to shutdown the ESOP at close; however, Middle Corp and the trustee must negotiate a buyout of the escrow, earnout, note and rollover equity

Seller Perspective

- Reduce future expense by closing ESOP
- There is risk in the contingent payments, therefore the buyout of contingent payments should be discounted
- The ESOP should participate in indemnification

Buyer Perspective

- Buyer wants employees who participate in the ESOP to be happy
- Buyer does not want any risk associated with ESOP post transaction

Possible Solutions

- Negotiate a buyout of contingent payments at a risk adjusted discounted present value
- Keep the ESOP open and indemnify the buyer

Potential Transaction Hurdles

Working Capital Requirement

- Middle Corp has a trailing 12-month average non-cash working capital of $5 million
- At closing non-cash working capital is anticipated to be $8 million
- PEPCo claims that, given the Company's growth prospects, the closing working capital levels are more indicative of the Company's ongoing working capital needs rather than the trailing 12-month average

Seller Perspective

- Working capital spike is a one-time occurrence
- Target working capital of $5 million accurately represents the future short-term capital needs of the business
- "I have run this business for X years, I know exactly what NWC is required"
- Two way purchase price adjustment

Buyer Perspective

- Given the Company's growth prospects, trailing analysis is not a true reflection of the future working capital needs of the business
- Concern regarding bad debt expense of excess payables
- Wants to avoid paying a large amount at closing for excess working capital
- No adjustment if threshold is exceeded

Possible Solutions

- Provide clear terms at the LOI negotiations stating the target amount of working capital required
- Clear agreement in Letter of Intent on definitions and mechanisms for NWC adjustment
- Forecast forward monthly balance sheets to show normalized levels of working capital

Other Hurdles

Tax Issues

- 338(h)10 Election
- Cash to Accrual Conversion
- Built In Gain (BIG) Tax
- Others....

Summary Takeaways

- Think early and often about how decisions today may impact a potential sale
- It is never too early to take steps to best position a company for sale
- Anticipate problems and establish contingency plans
- Be prepared to share risks and costs
- There are no perfect transactions
- Everything is negotiable; deals do not need to be zero sum; it is possible to structure them so that they are “win-win” for all parties

The McLean Group INVESTMENT BANKING

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APPENDIX

Presenter Firm Service Offerings

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- Government Contracts Law
- Small Business Administration Programs
- Labor & Employment Law
- Government Relations Services
- Business & Corporate Law
- Litigation
- Intellectual Property Law
- Trade Association Law
- Native American Law

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Business & Corporate Law Group

We represent clients on business and corporate matters in all phases of their business life cycle, from start-up to sale of the company. We advise clients on entity formation and structure, draft documents that serve as the backbone for clients' companies as they grow, and assist with all aspects of an exit strategy.

Headed by Dean S. Nordlinger, Partner

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The McLean Group Overview

Leading Boutique Investment Bank

- The McLean Group is an independent, industry-focused investment bank with deep expertise in mergers and acquisitions, corporate finance, capital raises, and business valuations
  - Founded in 1997
  - Headquartered in McLean, Virginia with 20 offices nationwide
  - More than 65 dedicated professionals
  - Through our dedicated industry groups, we bring extensive domain and transactional expertise to every client engagement
  - Largest valuation practice in the mid-Atlantic area, outside the Big 4 accounting firms

Deep Industry Expertise
Aerospace, Defense & Government (ADG)
Diversified Industrials
Technology & Telecommunications
Agriculture & Food Processing
Energy & Clean Technologies
Transportation & Logistics
Business Services
Healthcare Services
Travel & Hospitality

Core Capabilities

Investment Banking

- Mergers & Acquisition (Private Company Sale, Public M&A Advisory, Buy-side Advisory, etc.)
- Corporate Divestitures
- Private Equity Investments
- Strategic Alternatives Analysis

Business Valuation Services

- Financial Reporting (Purchase price allocation, goodwill impairment, stock option expense)
- Equity Incentive Plans and Tax
- Litigation Support
- Transaction Advisory (Fairness Opinion, Due Diligence)

Recent ADG Advisory Experience

LINXX
ESOP buyout financed by
MOSAIC CAPITAL PARTNERS
Federal Contracting

IMPERATIS
debt refinancing by
SANDTON CAPITAL PARTNERS
Defense and Government Services

ACG
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acquired by
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MOTOROLA SOLUTIONS
Mobile Interoperability for
Mission-Critical Communications

DAI
has acquired
HTSPE
International Development Consultancy

UltiSat
received investment from
LLRpartners
Federal Contracting
Satellite-Communications Solutions

ACENTIA
has acquired
INSYSCO
Federal Contracting
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