



## *Second Quarter 2007*

### **Middle-Market Transaction Update**

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## **Global Economy Drives Healthy M&A Market *Offsets Softness in Housing & Transportation Market***

### **Reported Purchase Multiples Soften**

According to Capital IQ, the average EBITDA multiple for middle market (Enterprise Value < \$500 million) transactions during the first quarter of this year was 8.0x, down from the 2006 average of 8.7x. The number of disclosed transactions held steady relative to Q4 '06, but declined by approximately 10% when compared to Q1 '06. Total transaction value in Q1 '07 increased by 6.3% compared to Q1 '06. Further evidence of the continuing robust activity is that transactions in which value metrics are not disclosed, (predominantly smaller transactions within the middle-market), increased 21% compared to Q4 '06 and 16% compared to Q1 '06. Given the M&A market activity we are observing, we don't believe that the Q1 decline in transaction multiples represents a long-term softening trend. Rather, this decline is a function of the particular transactions during the period (e.g. industry, company specific performance, etc.).

### **Capital Availability Remains Strong**

During the first quarter of 2007, M&A-related loan volume for companies with EBITDA < \$50 million declined to \$6.4 billion, compared to \$7 billion in the first quarter of 2006. The lending community continues to surprise market participants, with total debt-to-EBITDA soaring to 5.1x in Q1 for LBOs with less than \$50 million in EBITDA, up from 4.6x in 2006. Equity contribution in leveraged deals reached 34% of the capital structure, up slightly from 33.6% in 2006.

### **Mixed Picture of U.S. Economy**

The combination of low unemployment, record stock prices, moderating consumer confidence, stable consumer prices, and slumping housing market offers a mixed picture of the economy's health. While there are some encouraging signs, one month does not make a trend. The already slow industrial core, high gas prices, and sluggish housing market have dampened consumer spending and hiring levels, suggesting that these factors are beginning to take their toll. However, the robust global economy and corresponding global liquidity, combined with the weak U.S. dollar, has created a large influx of capital that has driven a continued strong M&A market in the United States.

**TRANSACTION ENVIRONMENT**

**THE DATA**

**Deal Volume** – The strong middle-market (defined as < \$500 million in enterprise value) M&A environment continued in the first quarter of 2007. The number of disclosed transactions held steady relative to Q4 '06, but declined by approximately 10% when compared to Q1 '06. Total transaction value in Q1 '07 increased by 6.3% compared to Q1 '06. Further evidence of the continuing robust activity is that transactions in which value metrics are not disclosed, (predominantly smaller transactions within the middle-market), increased 21% compared to Q4 '06 and 16% compared to Q1 '06. The healthy M&A environment experienced in the first quarter of 2007 is consistent with everyone's predictions as private equity funds continue to invest at a record rate, debt markets remain aggressive, and strategic acquirers continue to pursue growth through acquisition. In Q1 '07, notable changes in deal volume from a sector perspective were evident in consumer discretionary, materials, and information technology, which increased 15.0%, 13.5% and 9.6%, respectively. Offsetting these increases were declines in utilities, healthcare, and telecommunications by 27.8%, 24.0%, and 20.0%, respectively.

**Deal Value** – Aggregate deal value for disclosed transactions similarly increased during the first quarter. Total deal value in the middle-market approximated \$43.9 billion in Q1 compared to \$43 billion in Q4 '06 and \$41.3 billion in Q1 '06.

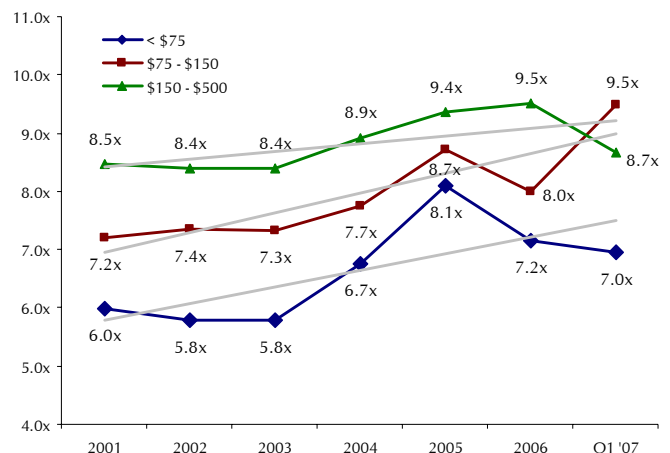
The aforementioned trends in volume and aggregate value resulted in average deal size expanding by approximately 2.9% in Q1 '07 compared to Q4 '06 and 10.0% for all of 2006. Within the middle market, the average transaction size reached \$65.9 million in Q1 '07 compared to \$60 million for all of 2006. Data continues to suggest that this increase in transaction size is driven more by the size of the transactions than an increase in transaction multiples.

**Transaction Multiples** – Middle-market transaction multiples declined in Q1 '07 relative to all of 2006 with enterprise value/EBITDA multiples averaging 8.0x for the three months ended March 31, 2007, compared to 8.7 for calendar year 2006. We don't believe that this represents any particular trend indicating a decline in transaction multiples due to the current robust M&A conditions. Rather, this decline is a

function of the particular transactions and the smaller data sample for the first quarter.

While the overall average EV/EBITDA multiples experienced a decline in Q1 '07, a more granular look at the middle-market is worth noting. As Figure I indicates, size still matters in the middle-market. Transactions with an enterprise value less than \$75 million trade at a significant discount in multiples achieved relative to their larger peers. This empirical data continues to confirm better liquidity available in the upper end of the market and the resultant impact on transaction multiples. We believe that the trend lines shown in Figure I depict a more accurate picture of the market conditions evidenced by the consistency of the smaller transactions with the larger transactions which tend to have more accurately disclosed data.

**Figure I**  
**U.S. Middle-Market Deal Statistics<sup>(1)</sup>**



Source: Capital IQ

(1) Excludes transactions with EV/EBITDA multiples > 15x

Continuing the observation we made in our last newsletter regarding margins and their impact on transaction multiples, we observed that in the first quarter of 2007 the average EBITDA margin for transactions less than \$75 million in enterprise value was 15.2% compared to 18.0% for transactions greater than \$75 million. As mentioned in the previous newsletter, while size and available liquidity for larger transactions and other exogenous factors impact the gap in transactions multiples between smaller and larger transactions, one can not ignore the impact that EBITDA margin has on transaction multiples.

### Market Dynamics

Despite the recent retreat in transaction multiples, it should be noted that multiples in general are still high when compared with historical norms. The M&A environment remains strong driven by continued strength in debt and equity financing, increased corporate profits, substantial private equity capital (approximating \$700 billion at the end of 2006), and increased liquidity from non-traditional lenders.

The mixed bag of economic indicators provides little clarity for the 2007 outlook. While there are some encouraging signs, the extent to which high gas prices and the sluggish housing market will impact consumer spending and other areas of the economy is yet unknown. However, the robust global economy and corresponding global liquidity, combined with the weak U.S. dollar, has created a large influx of capital that has driven a continued robust M&A market in the United States. Exemplifying this is China's announcement that its soon-to-be-established state investment company has agreed to invest \$3 billion in the Blackstone Group LP.

Looking ahead, middle market participants expect private equity firms to continue to actively explore the middle market for opportunities. Volume is expected to accelerate through the remainder of 2007 due to leveraged buyouts. We continue to expect the middle-market will remain active for the foreseeable future and that 2007 will be another active year.

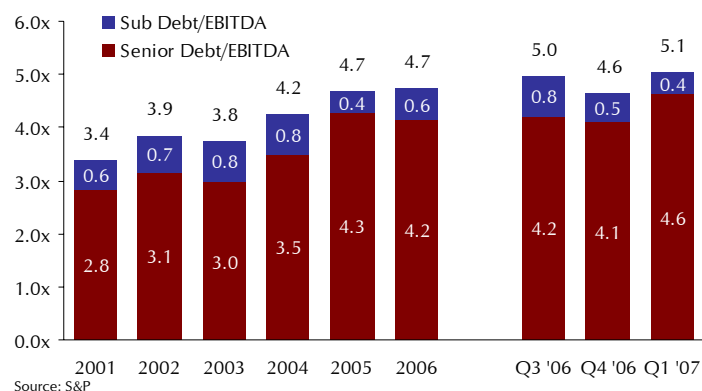
### **AVAILABILITY OF CAPITAL**

#### Debt Capital

According to S&P, loan volume for issuers with less than \$50 million in EBITDA was down slightly during the first quarter of 2007. At a 2.5 year low, the quarter ended at \$6.4 billion, down from \$7 billion in the first quarter of 2006 and \$7.5 billion in the last quarter of 2006. While market participants' explanations for the decline vary, some lenders have admitted to a noticeable slowdown either because of fizzled deals or longer-than-expected auctions.

Average credit statistics for middle-market LBOs spiked in Q1, after dipping slightly in Q4. As indicated in Figure II, total debt-to-EBITDA reached 5.1x in Q1, up from the 4.7 achieved in 2006. The increase in debt multiples has been driven by banks' relaxation of credit standards.

**Figure II**  
**Average Credit Statistics of Middle Market LBO Transactions (EBITDA \$50M or less)**



Unlike larger transactions, highly leveraged lending at the upper margin within the middle market is restrained. Whereas almost 7% of the large corporate LBOs topped a debt-to-EBITDA ratio of 7x or greater, no middle market transaction reached 7.0x. Only 7% of middle market transactions exceeded 6.0x, on par with 2005 and 2006.

#### Covenant-Lite Loans

Not only has the debt market demonstrated its willingness to provide relatively inexpensive capital at record levels, but loans are increasingly available with fewer restrictions. Relatively new to the M&A landscape are covenant-lite loans, which began to increase in popularity only two years ago. Driven by cash-rich private equity funds chasing an increasingly small number of suitable companies and investment banks and lawyers following lucrative transaction fees, these loans have thrived. Throughout the whole M&A market, these loans skyrocketed in Q1, reaching \$48 billion, more than twice the level seen in the entire year of 2006.

Unlike a traditional syndicated loan, the covenant-lite format does not carry all the restrictive clauses typically seen in the traditional loan. Covenant-lite loans thrive in the most active markets, in which the supply-demand equation is tilted persuasively towards borrowers, which certainly describes the current market situation. During the first quarter of 2007, these loans comprised 35% of overall institutional activity, from 7.4% last year and from 1.3% in 2005. At this rate, covenant-lite loans could reach half of institutional outstandings by the end of 2007.

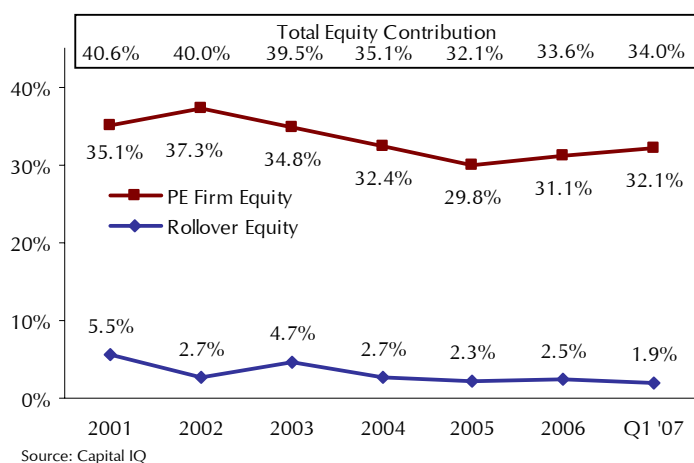
While there is much consensus that covenant-lite executions will increasingly filter down into small-cap deals, little

research is available to track the volume. Either way, by foregoing loan covenants, lenders are exchanging future pain for current gain. Low rates, combined with high leverage and essentially no maintenance conditions, drives up the prices of companies purchased by private equity firms and may hurt future investment returns.

### Equity Capital

Despite higher leverage ratios, the equity contribution increased compared to the last quarter in 2006. S&P reports that the overall LBO equity contribution averaged 34% of the total capital structure during the most recent quarter, only slightly higher than 33.6% in 2006 (see Figure III). S&P also reports that the average, when stratified by deal size, ranged between 30.6% and 34.8% in Q4. This range of approximately 4 ppt is much smaller than the historical gaps which have been approximately 14 ppt.

**Figure III**  
**Average LBO Equity Contribution**



Rollover equity, or the amount that sellers contribute post-sale, is often a key factor in enticing financial buyer interest. In Q1, rollover equity declined to 1.9%, increasing the financial sponsor portion of the equity commitment (total equity less rollover equity) to 32.1%.

### ECONOMIC FACTORS

The combination of low unemployment, moderating consumer confidence, stable consumer prices, and slumping housing market offers a mixed picture of the economy's health.

- Gross Domestic Product (GDP)** – Real gross domestic product rose at a 1.3% annual rate during Q1. The increase in real GDP in the first quarter primarily reflected positive contributions from personal consumption expenditures (PCE) and state and local government spending. These gains were partly offset by negative contributions from residential fixed investment, private inventory investment, and federal government spending. Imports, which are a subtraction in the calculation of GDP, increased. Compared to prior quarters, growth in GDP during Q1 decelerated, due primarily from a downturn in exports, an upturn in imports, a deceleration in PCE for nondurable goods, and a downturn in federal government spending. On a more positive note, residential fixed investment, among other categories, posted smaller decreases than prior periods.
- Inflation** – U.S. consumer prices increased 0.4% in April, due to a continued rise in energy and food prices. Yet, muted price gains in other categories indicate somewhat stable inflation. The core rate, which excludes volatile food and energy categories, increased 0.2% in April as expected. Year over year, the CPI gained 2.3%, the smallest in a year, which has enabled the Federal Reserve to keep the federal funds interest rate unchanged since June 2006. For the first four months of 2007, food and energy prices have risen at an annual rate of 6.7% and 25.3%, respectively.
- New Housing** – In April, construction of new homes reached the fastest pace since December 2006, albeit down versus a year ago, signaling that the nation's housing industry slump may not be turning the corner as quickly as hoped. Construction of new homes reached a seasonally adjusted annual rate of 1.528 million units in April, 2.5% higher than the forecast in March, but 16.1% lower than the revised April 2006 figure of 1.821 million units. Additionally, builders cut their requests for new construction permits by 8.9% in April, the sharpest drop since February 1990, when the nation's housing market was going through a significant downturn.
- Employment** – The April 2007 unemployment rate remained essentially unchanged from March 2007 at 4.5%. Since 2003, unemployment has steadily declined from its high of more than 6%. Unemployment, which averaged 4.7% during the first half of 2006, fell to 4.4% - a four year low - in October 2006. It has remained low,

hovering between 4.4% and 4.6% during Q1 2007. Job gains continued in several service-providing industries, including health care and food services, while employment declined in retail trade and manufacturing.




- Consumer Confidence** – While consumer confidence has fallen by 10% since the beginning of 2007, the April decline was quite small as it reflected the impact of offsetting changes. Gas prices, as well as wages, were up. Home prices were down, while stock prices reached record highs. The Reuters/University of Michigan Index of Consumer Sentiment reached 87.1 in April 2007, just below the 88.4 in March. Overall, the consumer confidence data provided no indication of an impending sharp decline in spending. Rather, it indicates a slower pace of consumer spending of about 3.0% in 2007. In addition, the Index of Consumer Expectations, a closely watched component of the Index of Leading Economic Indicators, was 75.9 in April. While this indicator declined from 78.7 in March, the index is still higher than the average of 73.5 from the first three quarters of 2006.

**CONCLUSION**

While valuations have softened, transaction volumes continue to post strong gains, primarily driven by readily available debt and equity capital in the marketplace. While the jury is out on the economic outlook for 2007, the flood of capital from the global community will continue to fuel the M&A market and corresponding high transaction multiples in the United States. The trend of high multiples sustained in the previous periods should create an interesting environment in the coming years. Contrary to the heightened multiples seen in the late 1990’s and early 2000’s where the winning bidder was the firm with the most deal savvy, access to capital, and, in many cases, luck, the current market and its transparency requires firms to have an operational focus in order to achieve historical returns. While paying unprecedented multiples, investors must bring operation expertise to extract value from all disciplines of a company. We believe that those investors who are winning auctions today must also win the race for management talent in order to ensure they win the race for returns tomorrow.

**W. Y. Campbell & Company** is one the country’s leading providers of middle-market merger advice, serving both public and privately-held corporations, as well as private equity firms since 1988.

**RECENT TRANSACTIONS**

  
*has divested*  
  
*to*  
  


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*The undersigned acted as exclusive financial advisor to TriMas Corporation in the above transaction.*  


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**W. Y. CAMPBELL & COMPANY**  
 February 2007

  
*a portfolio company of*  
  
*has been acquired by*  
  


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*The undersigned acted as exclusive financial advisor to Industrial Powder Coatings, Inc. in the above transaction.*  


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**W. Y. CAMPBELL & COMPANY**  
 March 2007

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