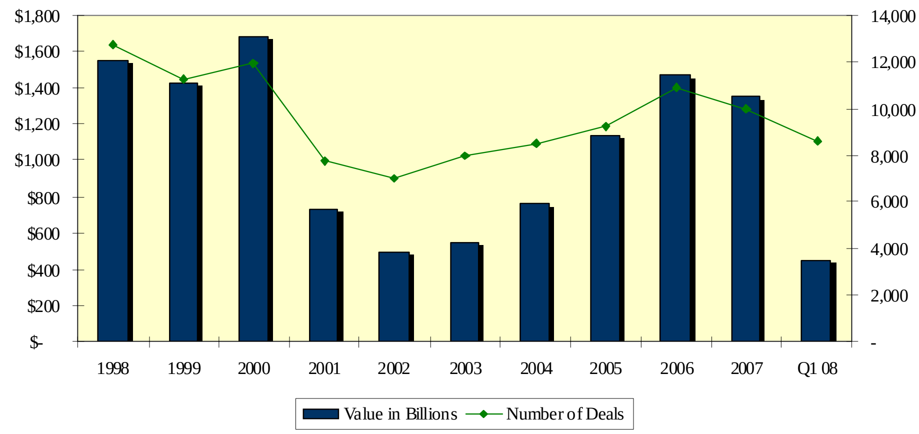
Exvere, Inc.
Market Update Newsletter – June 2008

A cyclical peak in volume and value of M&A transactions in the U.S. was reached in 2006. Spurred by a record amount of private equity and relaxed lending standards, the total dollar amount and number of completed transactions nearly matched the high of the "Dot Com Boom."

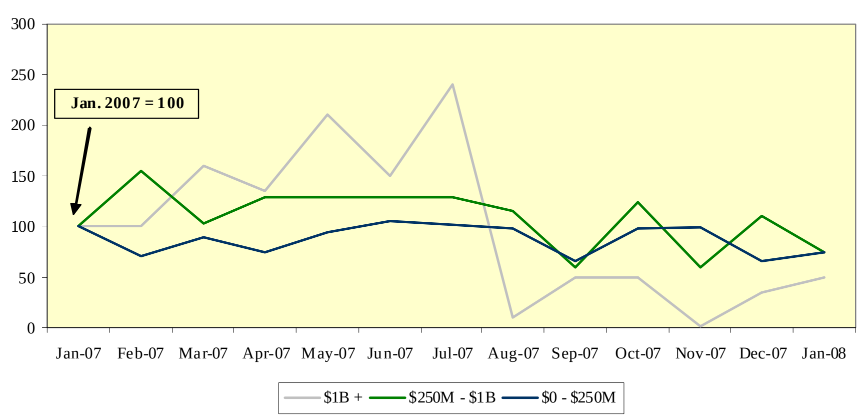
Total Number and Value of Transactions - United States



Source: Dealogic & CapitalIQ

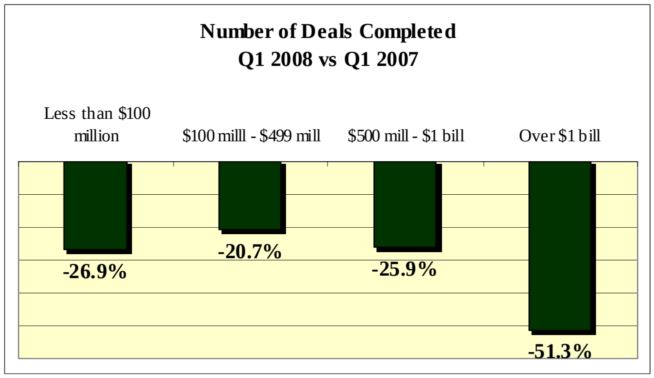
Last year, however, large, multi-billion dollar deals became scarce, especially from financial sponsors, as the debt market lost its appetite for "mega" deals. In fact, banks are now offloading loans (in some cases for $0.85 on the dollar) as they look to de-lever after reaction from public markets and the negative impact of subprime loans. Taking a deeper look, however, middle-market deals, and more specifically deals below $250 million have shown resiliency during this period. As the graph below illustrates, private equity deals in excess of $1 billion slowed dramatically, while deals under $1 billion maintained the same level of activity in 2007.

Index of US Private Equity Deals



Source: CapitalIQ

During the first quarter of 2008, all transactions regardless of size, reflected a drop-off when compared to Q1 2007. However, as noted previously, transactions over $1 billion were most affected as financing continues to remain in short supply, equating to very little "mega-deal" private equity activity. Some sectors, such as medical, aerospace and energy remain strong while cyclicals have slowed dramatically.



Source: Thomas Reuters & Robert W. Baird & Co.

Key factors contributing to the relative strength of the lower-middle market for M&A include:

❖ <u>Baby Boomer Demographics</u>

The "Baby Boomer" generation still owns and operates the majority of small and medium sized businesses. Currently there are approximately 78 million "Baby Boomers" in America, with the leading edge now in their 60s. Roughly 8,000 Americans turn age 60 each day and it is estimated that a total of 3 million will turn 60 in 2008 alone. The lack of a second boom coming on the heels of this generation has created a significant family succession gap; 45 million "Generation X" are replacing 78 million Baby Boomers.

The backbone of the U.S. economy is the approximately 22.6 million small businesses. The Federal Reserve has estimated that almost 500,000 of these will change hands in 2008, and by 2009 nearly 750,000 business owners will be seeking a sale. Because of these disparities, the likelihood of a "buyers market" in the coming decade is increasing, as too many willing sellers are chasing a scarcity of capable buyers.

❖ <u>Foreign Capital</u>

The decline of the dollar has led to a significant increase in cross-border transactions. Of the $1.5 trillion of U.S. M&A transactions in 2007, approximately $444 billion (29.1% of the total value) involved foreign acquirers. This is an increase from $229 billion in 2005, which represented 17.3% of the total value of U.S. transactions. Despite the current lending environment, the U.S. economy offers a large market with healthy growth in certain sectors, excellent infrastructure and flexible labor markets. This has led to international companies viewing midsized deals as solid, low-risk, high-returns investments.

❖ <u>Private Equity/Capital</u>

During 2007, a record amount of investment capital was raised for private equity, as total assets under management for registered private equity funds surpassed $1 trillion.

This trend is projected to gradually recede over the next few years, since lower returns are expected due to decreased leverage. Private equity is increasingly looked upon favorably when compared to other asset classes such as real estate and public equity markets. In fact, recently both CALPERS and the Washington State Investment Board announced they will be allocating more funds for private equity. New figures from London based firm Private Equity Intelligence, Ltd. show that executives at nearly 1,500 funds are now seeking a total of $844 billion in new commitments. Since January 2007, the number of private equity funds has jumped 61% and assets under management have doubled.

One noticeable trend is decreased overall valuations for private businesses. Though not as impacted as the multi-billion dollar deals, lending for middle-market deals has nonetheless tightened. This has led to lower multiples being paid in some cases, and (more commonly) an increase in the amount of seller financing. Sellers of private businesses should expect to carry anywhere from 10% - 30% of the total deal value to compensate for the tightening credit markets. On a national average for private equity transactions, equity contribution has risen from 33% in 2007 to nearly 42% in 2008, according to a recent survey from Standard & Poor's. This reflects many private equity firms employing more equity, waiting for valuations to decline, and anticipating the return of debt markets.

❖ Tax Environment

It's no secret that early indications are that a Democratic White House will have a negative impact on the capital gains tax rate. Presumptive Democratic nominee Obama has initially indicated a hike in the capital gains rate to 28%. Additionally, individual tax rates may be increased, making the sale of C-corporations on an asset basis particularly onerous. This could have an enormous impact on the sale of private businesses. To demonstrate, see the chart below:

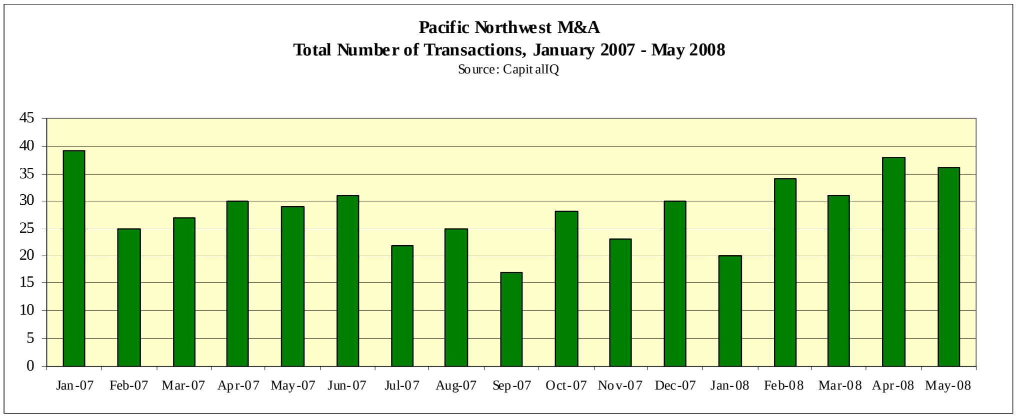
ABC Company
S-Corp - Asset Sale

	2008	2010
Sales	$ 50,000,000	$ 50,000,000
EBITDA (12%)	7,500,000	7,500,000
EBITDA mult	5X	5X
Gross transaction value	**$ 37,500,000**	**$ 37,500,000**
Asset basis		
A/R	4,261,364	4,261,364
Inv	4,375,000	4,375,000
PP&E	2,000,000	2,000,000
Total basis	10,636,364	10,636,364
Goodwill	26,863,636	26,863,636
Capital Gains tax %	15.0%	28.0%
Capital gains tax	(4,029,545)	(7,521,818)
Net proceeds after tax	33,470,455	29,978,182
Difference	(3,492,273)	

In this very simple example, the owner of this company would end up paying nearly $3.5 million more in taxes if he sold the company for the same gross transaction value ($37.5 million) in 2010 vs 2008. Said another way, in order to achieve the same after-tax proceeds 2008, the 2010 number Gross Transaction Value would need to be nearly $42 million, a 12% increase. This has major implications for private business owners debating whether to sell now or wait for another 2-3 years.

Summary

Locally, transaction volume has remained consistent, if not improving, over the past 17 months (see graph below). Exvere believes that, based on the market forces described above, lower middle market transactions will remain relatively resilient despite negative news and a tighter lending environment.



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