

M&A Basics for the Industrial Electronics and Communications Industry

ABSTRACT: The Electronic and Communications Industries are very familiar with the traditional financing model for companies of venture capital startup and then a public offering to fund growth. An increasing trend in the entire technical sector is to use Private Equity funding to transition from venture capital to growth funding. Understanding Private Equity funding basics can provide an alternative to companies as they decide strategic direction.

Professionals in high technology industries are mostly focused on the technical aspects of their products and services with often a limited understanding of the ways companies are financed. We all are familiar with the model of how companies come into being via Venture Capital or private Angel investors. Products or services are then developed and sold to customers generating initial growth and profits. A strategy of either “going public” or selling the company to a customer or competitor after a few years is a normal way for founders to cash out and/or provide the company with funds to take growth and products to the next level.

Although this model is valid and proven to be a reliable way to get companies started, there may be economic times when going to the stock market for an initial or capital infusion public offering may be problematic or nearly impossible. A growing trend over the past 15 years in the financial industry is the rise of the Private Equity Groups (PEGS) becoming an alternative to the stock market in providing funding for companies to grow through acquisition. PEGS are engaged in active restructuring of many industries, including Industrial Electronics and Communications. Understanding the basics of this alternative source of funding is an important element for company management when they are evaluating strategies for their company.

Historical Perspective

Looking back over the last 15 years, (Figure 1) you can see Private Equity transactions within the United States and with United States companies has increased nearly fivefold.

After the “Dot Com” bust of 2000 the transaction activity was reduced but running at high historical levels. In 2006 and 2007 both the number and value of transactions was at or exceeding the previous peak of 2000. Activity in 2008 may be lower but is expected to be still historically high.

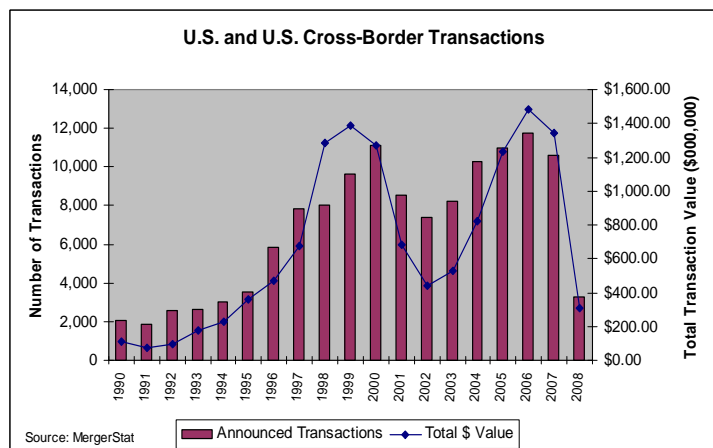


Figure 1

A listing of the Private Equity transactions for all industries show that Industrial Electronics and Communications is well represented in both number and values of transactions.

<u>Rank</u>	<u>Classification</u>	<u>Transactions</u>	<u>Value (\$B)</u>
1	Computer Software Supplies and Services	1637	97,223.2
12	Communications	250	56,535.5
14	Electrical Equipment	219	45,631.7
17	Electronics	196	12,303.0
18	Industrial and Farm Equipment & Machinery	194	16,320.5
20	Instruments & Photographic Equipment	164	27,279.5

As you may have gathered from the data, the amount of money being raised and invested by PEGS is very large and growing. Loren Lancaster, Managing Director of the Electronics and Semiconductor Group of Core Capital Group, stated “ The significant change in private Equity in the past couple of years has not been based on firms becoming more familiar with technology sectors but on the sheer increase in money available for investment. There is now more than \$1 trillion in capital from Private Equity Groups.” In the years prior to 1995, PEGS viewed Electronics and other high tech industries as being too cyclical and difficult to understand. Now PEGS are actively participating in many high tech markets and driving consolidation in many sectors.

One may ask the question. What is driving the the PEGS? The answer is quite simple – Return on Investment. If you look at the historical one month Certificate of Deposit rate for the last 15 years it has averaged less than 5%. Similarly the stock market is struggling to get above the level in 1998. With the exception of short term market fluctuations, no long term investment is making much money in the stock market. This lack of return makes historical investments in financial instruments or stocks unattractive to investors. PEGS have shown they can achieve up to 30% return on their investments through leveraging debt and acquisitions to increase valuation multiples of companies they invest in and reaping these returns when they sell their stake in companies. As a result, money is pouring into PEGS and therefore available for investments in companies.

Basics of Private Equity Transactions

Just as any technical specialty has its own language and acronyms, so does Private Equity transactions:

- Revenue – The amount of products and services sold to customers
- COGS – Cost of products and services to generate revenue
- G&A – General and Administrative costs to support the business
- Net Profit – Revenue minus COGS and G&A expenses
- EBIT – Earnings Before Interest and Taxes
- EBITDA – Earnings Before Interest, Taxes, Depreciation and Amortization

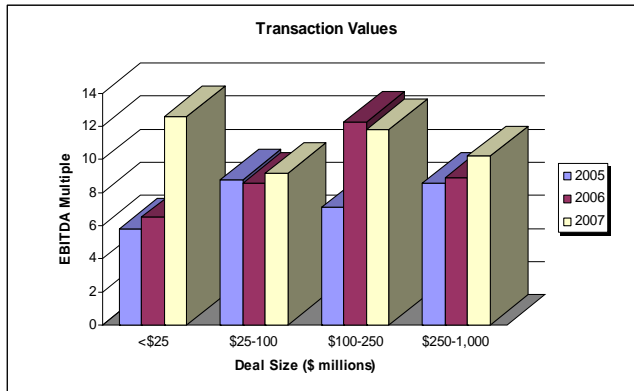


Figure 2

The most important of these terms to PEG investors is EBITDA because it is the best overall measure of the ability of the company to finance debt. They will use multiples of this measure to generate valuations of a company. These valuations are used to determine the potential return on investments for the transaction. Shown below is a chart (Figure 2) of transaction values based on multiples of EBITDA for various size transactions over time.

As you can see, transaction multiples vary by transaction size and over time. Typically, PEGS look at the past 2-3 years of EBITDA and use the appropriate transaction size multiple to determine the company's Enterprise Valuation for either a sale or purchase. There are additional ways to determine company valuation, but they will not be discussed here.

The multiples remain historically high and are driven by:

- Low cost of Capital (Low interest rates for debt)
- High availability of capital
- Strong profitability in technology corporations
- Favorable Stock Market conditions (low rate of return)
- Growing influence of Private Equity Groups

The PEGS have a relatively simple business model on the surface; 1) buy a company at a fair market valuation using a combination of equity investment and debt financing; 2) grow the company rapidly through good management and acquisition of additional companies, and; 3) sell the companies in 5-10 years or take it public at an appropriate time. This is why the EBITDA value is so important to PEGS; it drives the Enterprise Valuation for both purchase and sale. .

How to Participate

The decision to participate in this process is driven first by making a strategic decision for your company to either be part of the selling acquisition transaction. PEGS operate with both sides of the transactions so there is opportunity for a company that desires to sell all or a portion of the company or enter into a new product or market by acquiring a company. Once you make the decision, you need to position the company to be attractive to PEGS as well as develop a relationship with an investment banker, such as Core Capital Group to represent you in the details of the transaction.

Often large companies, such as Intel, Microsoft, or Qualcomm have in-house teams that drive transactions. Small to medium size companies need the expertise and contacts of investment bankers to be the broker of the transaction, bringing buyer and seller together to reach a deal. Finding a good investment banker with the experience and knowledge of your industry and technology is crucial to accurate valuation of the transaction and a good experience. Sufficient time and effort in this due diligence is an effort well spent saving time and effort once the transaction process begins.

A second aspect of a transaction strategy is to position your company for the transaction. Just as in real estate, preparing your home for sale by cleaning up those areas you know need to be fixed will increase your value to potential buyers. Similarly PEG investors have some criteria they judge the valuation of businesses on for acquisition, growth and return on investment.

Transaction Criteria

Transaction Stumbling Blocks

- EBITDA outside the 10-20 percent range
- Recent loss years
- Quickly exiting management
- No or slow revenue growth (<10% per year)
- Too many competitors (Low gross margin)
- High customer concentration (Few customers)
- Lack of solid transaction experience (Investment banker selection)

Transaction Supporters

- Strong brand recognition/reputation
- Few direct competitors
- Consistent and positive EBITDA and Revenue growth
- Revenue greater than \$10M per year
- Realistic and growth oriented business plan
- Dynamic management team interested in leading and executing
- Well differentiated Intellectual property
- Experienced transaction team
 - Investment Banker
 - Accountant
 - Lawyer

In summary to participate in Private Equity Transactions a company's management must decide on a strategic direction to either prepare the company for a sale or to grow the company through acquisition. You must understand the basics of what PEGS look for in criteria and have an experienced investment banker to help guide you through the process to have a successful outcome.

We are in a highly active transaction era driven by an abundance of low cost capital and a global economy. You and your competitors are being affected by the industry consolidation driven by PEGS and strategic investors. Larger companies are enjoying higher Enterprise valuations and strategic benefits of market share and new product growth through acquisitions. It is time to participate in the process before the music stops for your company.

Chris Baumann

Strategic Business Advisor

Chris Baumann has extensive experience in Strategic Business Planning and Market Development. He performs in-depth strategic diagnostics and plan development for electronics and semiconductor firms in transition. Mr. Baumann brings to ESG a sharp ability to review and develop business transition strategies in the context of the markets constraints and global competition.



Experience

Prior to his joining Core Capital's ESG in 2008, Mr. Baumann held various Strategic and Operational business positions with Atmel Corporation, Texas Instruments and Honeywell Corporation. He managed and grew several Business P&L and Product Engineering Groups focusing on non-volatile memories, ASICS, Analog and RF Semiconductor products.

Mr. Baumann's style is best reflected in his support of cross-functional teams to solve complex problems and desire to bring customer input into the product development process. Mr. Baumann also firmly believes that all personal and business relationships start with trust and develop into full partnerships through understanding and consistent effort.

Mr. Baumann received his B.S. E.E, in 1975 from the University of Notre Dame and his M.S.E.E. degree from the University of Notre Dame in 1977. He has completed over 50 hours of MBA courses at Texas Tech University and the University of Colorado at Colorado Springs through 1985. Mr. Baumann has been awarded a patent for advanced RF packaging in 2002.