



## Fourth Quarter 2010

### Middle Market Transaction Update

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## M&A Volumes Climb in Q3 2010 Middle Market Continues to Surge

### Middle Market M&A Returning to Normalcy

As anticipated in the previous newsletter, middle market M&A activity continued to post significant improvements in Q3 '10. Pent up demand built during the down years of 2008 and 2009 continues to drive transaction activity. Previously cautious financial buyers who stayed on the sidelines in previous quarters have amassed historically large amounts of uninvested capital, approximately \$400 billion, and now are putting their money to work in the middle market. Additionally, corporate businesses with robust cash positions and leaner operating models have been increasingly active in the market, acquiring smaller companies to fill product line gaps, expand market presence and increase operational synergies. In Q3 '10, both aggregate deal value and volume increased 9.8% and 18.3% from Q2 '10, respectively, for disclosed middle market transactions (Enterprise Value < \$500 million and > \$10 million). In addition, transaction multiples continue to rise as buyers increasingly compete for attractive companies. Transaction multiples for Q3 '10 averaged 7.3x enterprise value to EBITDA versus 6.8x in Q2 '10 and 5.8x for all of 2009. Transaction volumes are expected to continue to increase throughout the remainder of the year as corporate and financial buyers target year-end close dates to lock in potential gains due to the relatively unknown future of capital gains taxes.

### Credit Markets Continue to Improve

The credit markets showed continued signs of easing in Q3 '10, with senior debt-to-EBITDA leverage multiples increasing to 3.6x from 3.3x in Q2 '10. Through the first three quarters of 2010, loan volume for issuers with less than \$50 million in EBITDA totaled \$7.6 billion, up 60% and 18% from the same periods in 2009 and 2008, respectively. Equity contributions also increased despite improved debt markets, signaling the challenges still faced by financial investors in the lower-middle market in acquiring senior debt financing.

### Housing Market Struggles Weigh on Inflation

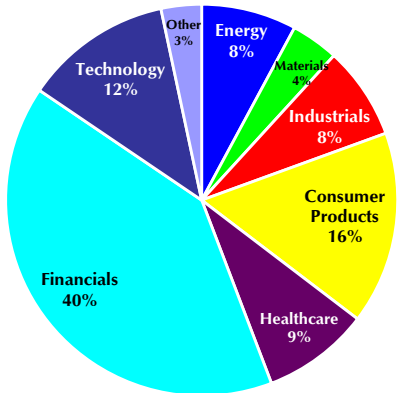
Fears of run-away inflation have been put to rest as the risk of potential price deflation enters the Federal Reserve's radar. The CPI increased 0.1% in September, with the majority of price growth stemming from increases in energy commodities such as gasoline. The less volatile core CPI (excluding food and energy), however, held flat for the second consecutive month and has increased 0.3% since March. The lingering macroeconomic effects of the housing market collapse have begun to be seen in the direct performance of the core CPI index this year via the relative performance of the shelter index. Not surprisingly, while the core CPI has experienced little to no change in the past five months, the shelter index has also remained essentially flat, and is down 0.4% over the last 12 months [the CPI shelter index, a measure of the cost of housing and rent prices, cumulatively accounts for roughly 30% of the CPI (more than food and energy combined), and 40% of the core CPI].

**TRANSACTION ENVIRONMENT**

**The Data**

**Deal Volume** – Middle market M&A activity surged in Q3 '10, continuing the momentum of Q2 '10 as investors and corporate businesses continue to increase their willingness to do deals. Middle market disclosed transactions (Enterprise Value < \$500 million and > \$10 million) rose 18.4% in Q3 '10 from Q2 '10, after increasing just 2.9% from Q1 '10 to Q2 '10. Transaction volumes in Q3 '10 were their highest since Q4 '07, spurred by the overhang of substantial cash reserves of corporate buyers and uninvested capital held by financial buyers. Year-to-date transaction volumes were 76% higher than the same period in 2009. Figure I highlights Q3 '10 middle market deal volume by industry sector based on data from Capital IQ. While transactions in the financial sector (primarily distressed) continue to account for the majority of M&A activity in the middle market (40%), the consumer products, healthcare and information technology sectors all experienced significant increases in transaction volumes in Q3 '10 from Q2 '10, increasing 17%, 10% and 29%, respectively. Transaction activity continues to be benefit from corporate buyers with strong cash positions, financial investors with large balances of uncommitted capital, and sellers' incentives to realize capital gains before the end of 2010.

**Figure I**  
3<sup>rd</sup> Quarter U.S. Middle Market Transactions by Industry<sup>(1)</sup>



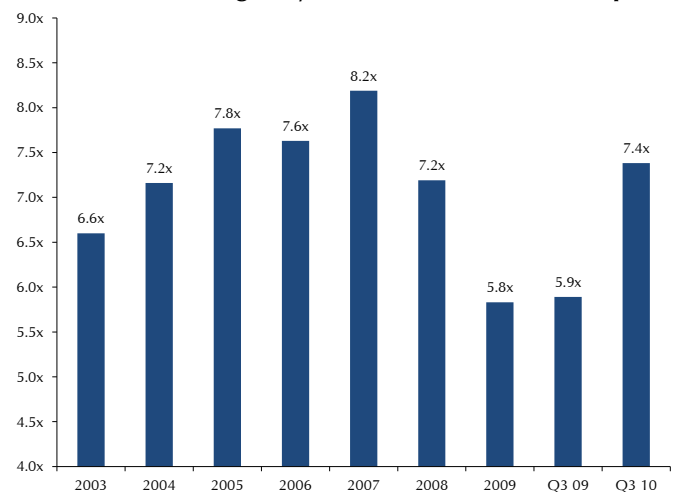
Source: Capital IQ  
(1) Middle market disclosed transactions (Enterprise Value < \$500 million and > \$10 million)

**Deal Value** – Aggregate deal value for middle market transactions increased 9.8% from Q2 '10, largely as a result of increased deal volume. Total deal value in the middle market was approximately \$40.9 billion in Q3 '10, with year-to-date total deal value increasing over 114% compared to the same period in 2009. Within the middle market, the average transaction size declined 7.2% to \$80 million in Q3 '10 compared to \$87 million for Q2 '10 and \$71 million in Q1 '10. The decrease in Q3 '10 resulted primarily from a shift in transaction size toward more lower-middle market

businesses, as deals valued between \$50 and \$100 million increased nearly 50% from Q2 '10.

**Transaction Multiples** – Middle market Enterprise Value/EBITDA transaction multiples increased in Q3 '10 to 7.3x from 6.8x in Q2 '10. The improvement in multiples is linked to an increase in demand from acquirers which has resulted in more companies being acquired at improved valuations. Transaction multiples in 2010 continue to improve compared to 2009, with multiples in Q3 '10 increasing markedly (23.3%) from a year prior in Q3 '09, when middle market transaction multiples remained depressed due to unfavorable economic conditions and investor uncertainty (see Figure II).

**Figure II**  
Middle Market Average EV/EBITDA Transaction Multiples<sup>(1)</sup>



Source: Quarton Partners Research  
(1) Transactions between \$10 and \$250 million with EV/EBITDA multiples < 15x; excludes technology, media and telecom

**MARKET DYNAMICS**

Transaction volumes and valuations are on pace for their best year since the onset of the recession as the M&A markets continue to improve. The credit markets have rebounded substantially from the lows of the recession and are increasingly active in facilitating deal flow. Additionally, the favorable transition away from distressed transactions has contributed to increase valuations as buyers seeking to fill product line gaps, expand market presence and increase operational synergies are now acquiring companies on a more selective basis, often at valuation premiums.

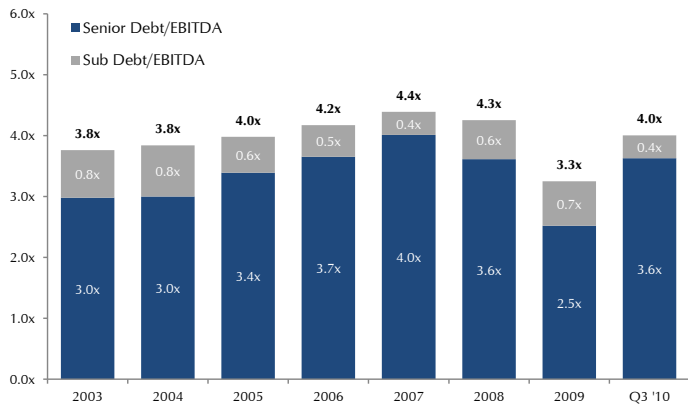
**AVAILABILITY OF CAPITAL**

**Debt Capital**

According to S&P, loan volume for issuers with less than \$50 million in EBITDA totaled \$1.7 billion in Q3 '10, down 55% from Q2 '10 but up 60% and 18% from Q3 '09 and Q3 '08, respectively. The decline from Q2 '10 was attributable to the shift in transaction size toward lower-middle market businesses where financing is less prevalent and often not required. For the first nine months of 2010, loan volumes for issuers with less than \$50 million increased 146% to \$7.6 billion, compared to \$3.1 billion in the same period a year prior. Leverage multiples continued to improve in Q3 '10 as senior-debt-to-EBITDA multiples increased for the third consecutive quarter to 3.6x from 3.3x in Q2 '10.

Subordinated debt/EBITDA leverage held flat at 0.4x in Q3 '10 from Q2 '10, compared to 0.7x in all of 2009. Throughout the remainder of 2010, senior and subordinated debt leverage multiples are expected to remain relatively unchanged.

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

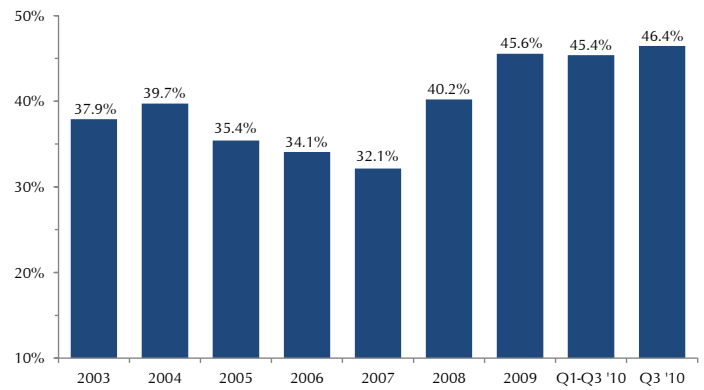


Source: S&P

**Equity Capital**

In contrast to recent historical trends, equity contributions as a percentage of the transaction capital structure increased in Q3 '10 despite improving credit markets and increased leverage ratios. S&P reported that total LBO equity contribution for deals with EBITDA of \$50 million or less averaged 46.4% of the total capital structure in Q3 '10, up from 45.8% in Q2 '10, and 45.6% for all of 2009 (see Figure IV). Equity contribution as a percentage of transaction value remains well above historic levels as lending institutions continue to take a cautious approach towards transactions involving financial buyers.

**Figure IV**  
Equity Contribution of Middle Market LBO Transactions (EBITDA \$50 mm or less)



Source: S&P

**ECONOMIC FACTORS**

The U.S. economy expanded during Q3 '10 as a result of rebounding consumer and business spending, but continues to exhibit indicators which blur the certainty of the recovery. Relative to prior periods, the labor markets appear to be rebounding, most notably in the business services sector. Fears of inflation have been tempered as recent indicators suggest deflation may present a larger issue than previously thought. Finally, the housing markets and consumer confidence data both contribute to skew the picture of the economic health of the nation as they fail to exhibit meaningful, consistent growth.

**Gross Domestic Product (GDP)** – According to the BEA's revised estimates, real gross domestic product increased at an annual rate of 2.5% during Q3 '10, compared to an increase of just 1.7% in Q2 '10, which was revised downward from a previously reported advance estimate of 2.4%. The increase in real GDP growth from Q2 '10 was driven primarily by growth of private inventory investment, personal consumption expenditures, and non-residential fixed investment. Private inventory investment by businesses continues to be a major driver of real GDP growth, increasing in Q3 '10 to contribute 1.3% to total real GDP, following a 0.8% contribution in Q2 '10. Contrary to reported consumer confidence data, personal consumption expenditures grew for the fifth consecutive quarter, increasing 2.8% from Q2 '10 and contributing nearly 2.0% to real GDP, marking the largest quarterly increase since Q4 '06. However, the trade deficit hindered real GDP growth as imports reduced the figure by 2.5% as they increased 16.8% from Q2 '10, albeit at a slower pace than Q2 '10 in which imports increased over 30%. While the revised data for Q3 '10 real GDP is certainly positive relative to preceding

quarters, lagging labor markets confirm that the current growth rate of the economy is insufficient to meaningfully alter the dynamics of unemployment and foster job creation.

**Inflation** – U.S. consumer price growth moderated in September, rising just 0.1% after increases of 0.3% in both July and August, as inflation in energy and food prices continue to account for the majority of CPI growth. Energy prices were the primary driver of price growth in September, increasing 0.7%, as gasoline and fuel oil prices were up 1.8% and 1.6%, respectively, but have decelerated in recent months. The core September CPI index (excluding food and energy) held flat for the second consecutive month, and has increased just 0.8% over the last 12 months. The cost of shelter, including rent and owner's equivalent rent ("OER"), has been largely unchanged for much of 2010. Although several sectors experienced price growth, notably the energy, food and medical care services sectors, their gains were offset by declines and lack of meaningful price growth throughout the remaining indices. While moderate CPI growth should quell concerns over deflation, additional upward price pressure must exist across other core CPI indices in order for the economy to convincingly transition out of the recession and into a sustainable recovery.

**New Housing** – Housing starts of new homes and apartments rose 0.3% in September 2010 to a seasonally adjusted annual rate of 610,000 according to the New Residential Construction Report. Housing starts of single-family homes, which account for approximately 80% of the housing market, increased 4.4% in September, but were down 10.8% compared to the same period in 2009. The number of building permits issued in September for privately-owned housing units declined 5.6% to a seasonally adjusted annual rate of 539,000, its lowest rate since May 2009 and was nearly 11% below the number of permits issued the same period a year prior. Although the increase in housing starts of single-family homes provided the market with some much needed positive data, weak construction demand continues to persist as the surplus of foreclosed properties in the market outweigh consumer demand and suggests the market will continue to struggle to recover into the foreseeable future.

**Employment** – Nonfarm payrolls rebounded in October, increasing 151,000 compared to a 41,000 decline in September, representing the second largest monthly increase since March 2007 (after April 2010). The expansion of nonfarm payrolls was driven almost entirely by job creation in the private sector, notably in the professional and business services sectors. The national unemployment rate and number of unemployed persons continue to remain

virtually unchanged at 9.6% and 14.6 million, respectively. The professional and business services sectors collectively increased 46,000 in October, of which 35,000 were temporary help services jobs. Both the August and September payroll estimate declines were upwardly revised in the October results, netting an increase of 110,000 jobs. August employment was revised from a previously reported loss of 57,000 jobs to a loss of only 1,000 jobs, and the September employment decline of 95,000 was revised to a decline of 41,000.

**Consumer Confidence** – Consumer confidence, measured by the Reuters/University of Michigan Index of Consumer Sentiment, declined to 67.7 in October from 68.2 in September, and is 4.1% lower than the same period a year prior, marking the third consecutive monthly decline. At its current level, the Sentiment Index is approximately 20 index-points below its all-time mean, and ranks barely above the bottom decile of all monthly surveys. Although positive economic growth is anticipated in the coming months, only 17% of polled participants expected a decline in unemployment. Additionally, nearly six in ten consumers thought that overall economic conditions would continue to be unfavorable, and anticipated a renewed economic downturn to occur in the next five years.

## CONCLUSION

The credit markets will play an integral role and ultimately a deciding factor in terms of the viability of a sustained recovery in the M&A markets. While transaction volumes and valuations appear to be on pace for a healthy recovery, a gradual easing in the credit markets must occur, specifically related to the access to capital for businesses in the lower-middle market. Concurrently, the ability of the Federal Reserve to control deflationary risks is imperative to the health and future growth of the economy, in order to foster and grow consumer demand to a level which facilitates meaningful job creation. While improvements in other macroeconomic areas suggest the recovery is progressing, the extent to which such improvements translate into job creation will ultimately be the deciding measure of the success of the recovery.

## RECENT TRANSACTIONS



American Mobility & Guest Services, Inc., a portfolio company of Huron Capital Partners, was acquired by Banyan Mezzanine Funds, a Florida private investment firm. Quarton Partners acted as the exclusive investment banking advisor to American Mobility on the sale.

Based in Woburn, Massachusetts, American Mobility is a leading provider of fleet management programs for strollers, electric convenience vehicles ("ECVs"), wheelchairs and other mobility products to theme and amusement parks, zoos, aquariums, casinos and other entertainment venues. American Mobility's status as a full service provider of outsourced fleet management solutions is supported by an integrated business model, patented product designs, strong corporate customer relationships and outstanding customer service. The company also operates two satellite facilities in California and Florida.

Banyan Mezzanine Funds is a private investment firm specializing in mezzanine and equity financing for growth expansion, strategic acquisition, management and leveraged buyouts, and recapitalization transactions. Banyan targets its investments towards companies operating in the lower-middle market, with an emphasis on those participating in growing industry segments.

Huron Capital Partners, founded in 1999, is a leading investor in lower-middle market companies. Huron invests in management buyouts, corporate spin-offs, and recapitalizations involving companies operating in the niche manufacturing, value-added distribution and specialty service industries.



Lexington Precision Corporation successfully emerged from Chapter 11 Bankruptcy. As part of its Plan of Reorganization, Lexington received an equity investment from Aurora Resurgence Management Partners, an affiliate of Aurora Capital Group. Quarton Partners acted as exclusive financial advisor advising the company on its plan of reorganization and arranging the equity financing to support its successful emergence from bankruptcy.

Headquartered in New York, New York, Lexington Precision Corporation is a world class manufacturer of tight tolerance, precision molded rubber components. The company has leading market share in its product categories and is a pioneer in molding rubber components using its flash-less tooling. Lexington's product offering includes insulators used in automotive ignition systems, molded rubber components used in minimally invasive surgical instruments and connector seals that are used for automotive wiring systems. The company's products are sold to companies that manufacture products for the automotive aftermarket, to manufacturers of medical devices and to customers who supply automotive original equipment manufacturers. The company operates two manufacturing facilities situated in Jasper, Georgia and Rock Hill, South Carolina.

Aurora Resurgence Management Partners is a Los Angeles-based private investment firm focused on investments in middle market companies, typically in the form of debt and equity securities. Aurora Resurgence invests in companies participating in the manufacturing, services and consumer sectors.

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