



## Fourth Quarter 2011

### Middle Market Transaction Update

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- Merger & Acquisition Advisory Services
- Private Capital Raising
- Restructuring & Recapitalizations
- Financial Advisory Services

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### Middle Market M&A Activity Remains Buoyant Markets Hit a Crossroad

#### Middle Market M&A Activity is Healthy

Middle market transaction volume declined 4.5% in Q3 '11, a stark contrast to the robust quarter-over-quarter increase of 41.4% in Q2 '11. Middle market enterprise value/EBITDA transaction multiples fell to 7.3x, a 1.6% decrease from the previous quarter. The negative market sentiment regarding the U.S. economy and the sovereign debt crisis in Europe have caused the pace of M&A activity to slow as more investors choose to sit on the sidelines to see how the latest economic events play out. However, M&A volume was still healthy in Q3 '11 due to several positive factors, including the significant uninvested capital at private equity firms, strategic buyers focused on supplementing organic growth and competitive lending markets. We anticipate the M&A market to remain robust as strategic buyers flush with cash supplement stagnant organic growth by investing in quality add-on acquisitions. Strategic buyers, coupled with significant pent up demand from financial firms with record levels of "dry powder" and healthy lending markets in the U.S. should fuel strong activity in the M&A market despite the uncertainty in the economy. Our expectations are tempered due to the global economic uncertainty. We believe there is significant pent-up demand for M&A due to the record levels of cash currently on the sidelines as dealmakers wait cautiously for the economy to show signs of stabilization. The markets are at a crossroad and if the veil of economic uncertainty is lifted we anticipate M&A activity to accelerate in 2012.

#### Middle Market Lending Remains Strong

Middle market lending was down 40.3% from Q2 '11 but up 28.7% compared the same period a year ago. The composition of loan volumes changed significantly in Q3 '11 with leveraged buyouts accounting for 48.0% of total loan volumes, compared to 24.0% in Q2 '11. Loan volume associated with leveraged buyouts totaled \$4.0 billion in Q1 to Q3 '11, representing a 76.3% increase compared to Q1 to Q3 '10. Total leverage/EBITDA in middle market LBO transactions increased from 4.4x in Q2 '11 to 4.6x in Q3 '11. S&P reported that average equity contribution of middle market LBO loans was 40.1% of the total capital structure in Q3 '11, compared to less than 42.0% in Q2 '11. Due to competitive pressures in the lending market, we anticipate leverage multiples to remain attractive for companies who have demonstrated consistent financial performance.

#### Global Uncertainty Clouds Forecasts

Serious concerns regarding the stability of the U.S. and European economies have continued to cause volatility in the market. Despite slight gains in real gross domestic product, the U.S. economy remains anemic, with unemployment rates hovering at 9.0%. The consumer price index dropped in October thanks to reductions in energy costs. Consumer confidence increased slightly, but remains shaken due to a tough economic climate and a growing concern regarding the government's economic policies. On a positive note, the weak housing market may be gaining momentum, as the number of building permits issued has increased compared to a year ago. Additionally, payroll employment has increased by an average of 125,000 per month over the last twelve months.

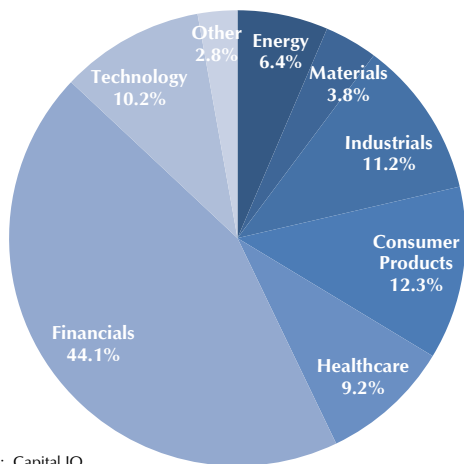
**TRANSACTION ENVIRONMENT**

**The Data**

**Deal Volume** – Q3 '11 middle market disclosed transaction volume (enterprise value < \$500 million and > \$10 million) decreased 4.5% from Q2 '11. The decrease in transaction volume can be attributed to uncertain domestic and global economic conditions that continue to deter many investors. The uncertainty in the U.S. economy, coupled with Europe's sovereign debt crisis, has pushed more buyers and sellers to the sideline causing a modest decline in M&A activity. Additionally, the time to close transactions has lengthened as investors dig deeper into sellers' backlogs and order levels to gain more insight into future performance. Despite uncertainty regarding market conditions, Q3 '11 transaction volume remained at a healthy level as both strategic buyers and private equity firms were active in the market.

Figure I highlights Q3 '11 middle market deal volume by industry sector based on data from Capital IQ. The materials industry experienced the largest quarter-over-quarter growth in transaction activity, increasing 28.6% from Q2 '11. Consumer products and energy posted the most significant decreases as transaction volumes dropped 19.3% and 22.0%, respectively, compared to Q2 '11.

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



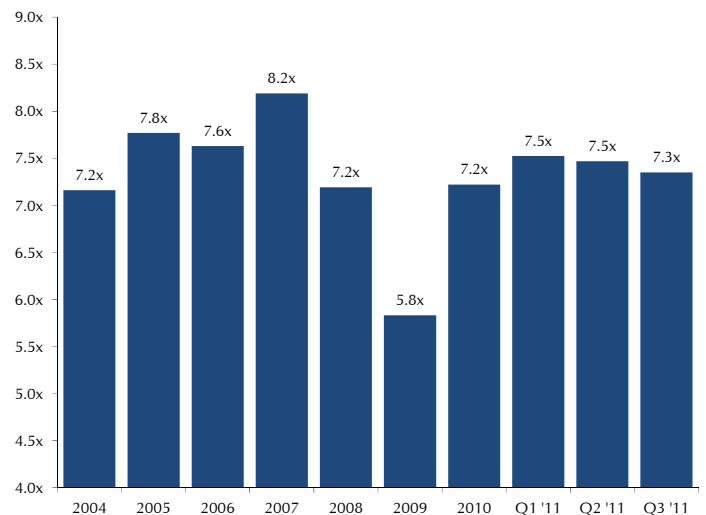
Source: Capital IQ  
(1) Middle market disclosed transaction volume (Enterprise Value < \$500 million and > \$10 million)

**Deal Value** – Aggregate deal value of middle market transactions decreased 5.0%, from \$59.9 billion in Q2 '11 to \$56.9 billion in Q3 '11, principally attributable to decline in transaction volume and lower purchase multiples. The Average middle market transaction size was \$79.4 million in Q3 '11, down from \$79.9 million in Q2 '11. This represents

the third consecutive quarter of declines in average middle market transaction size.

**Transaction Multiples** – Middle market enterprise value/EBITDA transaction multiples in Q3 '11 declined 1.6% quarter-over-quarter to 7.3x but are up 1.2% from the same period a year ago. According to S&P, enterprise value/EBITDA for middle market LBO transactions increased from 8.4x in Q2 '11 to 8.9x in Q3 '11.

**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**

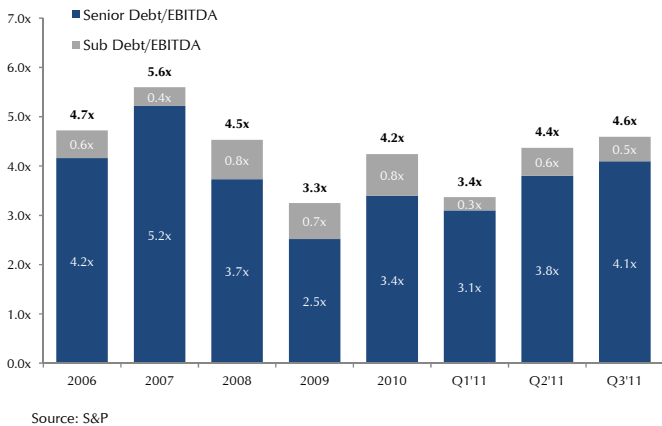
Serious concerns regarding the stability of the U.S. and European economies have continued to cause volatility in the market. U.S. lawmakers have yet to agree on a plan to cut more than \$1 trillion from the U.S. budget and passed a stopgap bill to fund the government's operations through mid-December 2011. Pressure is mounting on the European Central Bank to participate in Europe's new bailout fund to refinance bonds and cover government deficits. We expect the recent volatility of the market to continue to lead investors towards companies with defensible market positions which have shown consistent performance. We expect this "flight to quality", along with high levels of "dry powder" at private equity firms and record cash on strategic buyers' balance sheets, to continue to drive strong M&A activity and healthy purchase price multiples in the middle market.

**AVAILABILITY OF CAPITAL**

**Debt Capital**

According to S&P, loan volume for issuers with less than \$50 million in EBITDA totaled \$2.8 billion in Q3 '11, down 40.3% from Q2 '11 but up 28.7% compared the same period a year ago. This represents the second consecutive quarter of declines in loan volume. The composition of loan volumes changed significantly in Q3 '11, with leveraged buyouts accounting for 48.0% of total loan volumes, compared to 24.0% in Q2 '11. Loan volume associated with leveraged buyouts totaled \$4.0 billion from Q1 to Q3 '11, or a 76.3% increase compared to the same period a year ago. Total leverage/EBITDA in middle market LBO transactions increased from 4.4x in Q2 '11 to 4.6x in Q3 '11. During the quarter, average senior debt/EBITDA increased from 3.8x to 4.1x while subordinated debt/EBITDA decreased slightly from 0.6x to 0.5x. Due to competitive pressures in the lending market, we anticipate leverage multiples to remain attractive in the U.S.

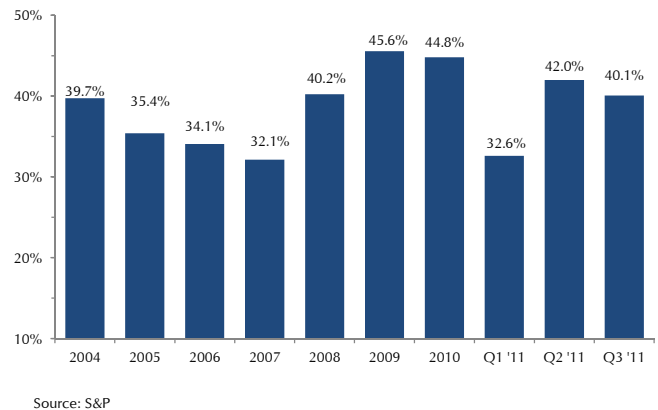
**Figure III**  
Average Credit Statistics of Middle Market LBO Transactions (EBITDA \$50 mm or less)



**Equity Capital**

S&P reported that total LBO equity contribution for deals with EBITDA of \$50 million or less averaged 40.1% of the total capital structure in Q3 '11, compared to less than 42.0% in Q2 '11. Lenders are beginning to become more flexible regarding the levels of equity contribution required as a percentage of total capital structure, because buyers are focusing on the acquisition of higher-performing companies. However, we anticipate that lenders will remain conservative, requiring meaningful participation from equity investors as the market continues to be uncertain and volatile.

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



**ECONOMIC FACTORS**

Despite slight gains in real gross domestic product, the U.S. economy remains anemic, and at this point the government cannot formulate a long-term plan to address the U.S. government's deficit. The consumer price index dropped in October thanks to reductions in energy costs, but has risen 3.5% over the last twelve months. Although the housing market remains weak, the number of building permits issued has increased compared to a year ago, which is an encouraging sign that the market may be gaining momentum. Over the last twelve months, payroll employment has increased by an average of 125,000 per month, yet unemployment still hovers at 9.0%. Consumer confidence remains shaken due to a harsh job market, a lack of confidence in government policy and volatile economic conditions.

**Gross Domestic Product (GDP)** – According to advanced estimates by the U.S. Bureau of Economic Analysis (BEA), real gross domestic product has slowly gained momentum, growing at an annual rate of 2.5% during Q3 '11, compared to a 1.3% annual growth rate in Q2 '11. Now at its fastest pace in a year, the real GDP growth rate in Q3 '11 is attributable to increases in personal consumption expenditures, nonresidential fixed investment, exports and federal government spending. These increases were partially offset by private inventory investment, state and local government spending and increases in imports. The personal consumption expenditures index regained its footing and increased 2.4% in Q3 '11, compared to an increase of only 0.7% in Q2 '11. This increase is attributable to consumers' purchases of durable goods increasing by 4.1% in Q3 '11, in contrast to a 5.3% decline in Q2 '11. Real non-residential fixed investment increased 16.3%, fueled by investments in

equipment and software, compared to a 6.2% increase in the previous quarter. Private businesses increased inventories by \$5.4 billion in Q3 '11, subtracting 1.08% from the Q3 '11 change in real GDP. Current-dollar personal income increased \$29.5 billion, or 0.9%, compared to an increase of \$145.7 billion, or 4.6%, in the prior quarter.

**Inflation** – The Consumer Price Index for October declined 0.1% on a seasonally adjusted basis, providing consumers with a price relief they had not received since June of this year. Gasoline and piped gas service costs dropped 3.1% and 3.0%, respectively, helping to reduce overall energy costs by 2.0%. The core rate (all items less food and energy) ticked slightly upward, by 0.1%, but this, along with September's equivalent rate, matches the smallest increase for the year. Prices for shelter, medical care and apparel increased over the month, while those for cars, airline fare and recreation declined.

For the last twelve months, the consumer price index has risen 3.5% (before seasonal adjustment). Over the same period, the food index has increased 4.7%, while the energy index has grown 14.2%.

**New Housing** – According to the U.S. Census Bureau, privately-owned housing starts were at a seasonally adjusted annual rate of 628,000 in October, 0.3% below September 2011, but 16.5% above the October 2010 rate of 539,000. Single-unit starts increased 3.9% to 430,000 (a three-month high), but were offset by a 13.3% decline in the number of multiple-unit starts. The number of building permits issued in October increased 10.9% from September 2011 to a seasonally adjusted annual rate of 653,000, indicating that the housing market is gaining momentum. Single-unit structure permits increased 5.1% from September 2011 and 6.6% from one year ago, while structures with five units or more saw much more dramatic increases of 29.5% from September 2011 and 62.9% from one year ago.

**Employment** – Nonfarm payroll employment continued its upward trend in October, adding 80,000 jobs and bringing the unemployment rate to 9.0%, which has remained in a narrow range from 9.0% to 9.2% since April 2011. Over the last twelve months, payroll employment has increased by an average of 125,000 per month. The number of long-term unemployed dropped by 366,000 in October to 5.9 million, which represents 42.4% of total unemployment. The number of discouraged workers declined by 252,000 compared to one year ago. Excluding the construction sector, private employment increased in all industries in the month of October, adding 104,000 jobs. Government employment,

however, continued its decline as state governments continued to struggle with deficits.

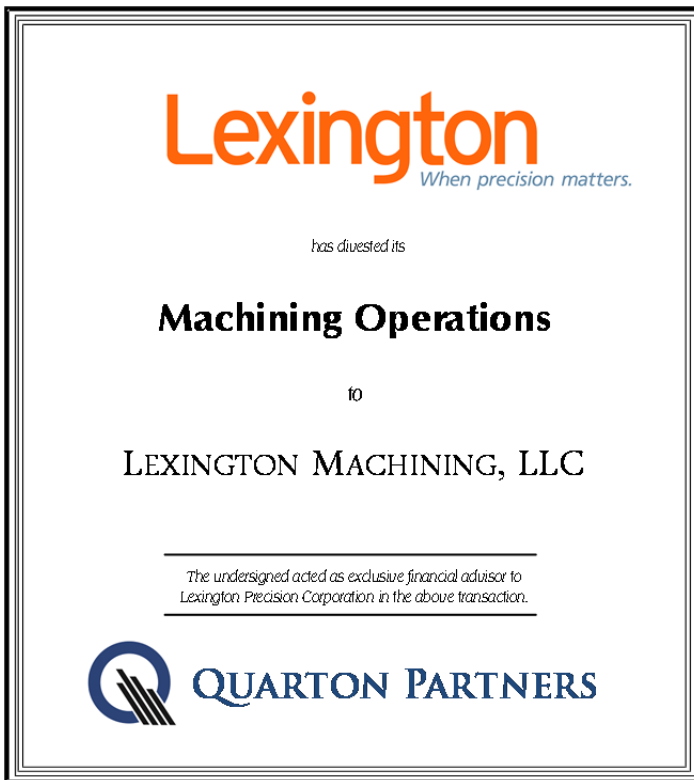
**Consumer Confidence** – Citing improved prospects for the national economy, the Thomson Reuters/University of Michigan Surveys of Consumers reported a small increase in consumer confidence in October. The index increased to a five-month high of 60.9, but still remains historically low, down 13.3 points from February 2011. Three-quarters of all consumers expected stagnating finances, with only one-in-five expect any improvement in their personal finances, in the year ahead. Additionally, a record-low 38.0% of consumers expected income increases during the year. Consumers continue to express their frustrations over the government's economic policies, with only 7.0% judging current economic policies favorably. A staggering 61.0% of Americans reported having reduced confidence in the Federal Reserve. On a positive note, consumers reported being optimistic about the national economic recovery, even if it this sentiment did not translate into their personal situations. Also, consumers noted that price discounts have helped to create favorable buying conditions. The survey's five-to-ten-year inflation outlook dropped to 2.6%, representing the lowest level since March 2009.

## CONCLUSION

The U.S. economy faces many challenges heading into the new year. Although real gross domestic product is moving in a positive direction, high unemployment and the government's economic policies have left consumers skeptical about the ensuing months. The recent turbulence in the U.S. and European markets have caused a slowed pace of M&A activity as more investors choose to sit on the sidelines. However, deal volume remained robust in Q3 '11 as both strategic buyers and private equity firms face pressure to deploy cash. In addition, the middle market M&A activity has been supported by a healthy lending environment.

The markets are at a crossroad; M&A activity could move in either direction depending on whether the European and U.S. debt crisis is handled appropriately and decision makers' concerns are eased. We believe there is significant pent-up demand for M&A due to the record levels of cash currently on the sidelines as dealmakers wait cautiously for the economy to show signs of stabilization. As a result, we anticipate M&A activity to accelerate in 2012 if the global economy stabilizes.

## RECENT TRANSACTIONS



**Lexington**  
When precision matters.


has divested its

**Machining Operations**

to

**LEXINGTON MACHINING, LLC**

The undersigned acted as exclusive financial advisor to Lexington Precision Corporation in the above transaction.



**QUARTON PARTNERS**



**ENERGY CONVERSION DEVICES**

has divested



to



The undersigned acted as exclusive financial advisor to Energy Conversion Devices, Inc. in the above transaction.



**QUARTON PARTNERS**

In August 2011, Lexington Precision Corporation divested its Machining Division (“Lexington Machining”, or the “Business”) to Lexington Machining, LLC. Quarton Partners acted as the exclusive investment banking advisor to Lexington Precision Corporation in managing the transaction.

Lexington Machining is a leading automotive supplier of high-volume, precision machined components. Through its full-service competencies in design and engineering, technical expertise and diverse manufacturing capabilities, the Business has established itself as a niche provider for critical applications, including fluid handling, powertrain and safety. The Business’ product offering includes quick connect bodies, HVAC fittings and blocks, sensor bodies, engine/transmission oil cooler fittings, solenoid components, airbag inflator components and direct inject fuel injector housings. Lexington Machining has developed strong relationships with leading Tier I automotive suppliers such as BorgWarner, Cooper Standard, Daicel, General Motors Components Holdings, Sanoh Industries and Valeo. The Business is headquartered in Rochester, New York.

Lexington Machining, LLC was formed by equity investors and members of the management team to acquire Lexington Precision Corporation’s Machining Division.

In September 2011, Ovonic Hydrogen Storage (“OHS”), a division of Energy Conversion Devices, Inc. (“ECD”), was acquired by Vodik Labs, LLC. Quarton Partners acted as the exclusive investment banking advisor to ECD in managing the sale process.

OHS is a leader in supplying safe, compact and refillable hydrogen storage systems for portable, mobile and stationary applications. OHS’ storage canisters are based upon a proprietary metal hydride storage system, which absorbs hydrogen into a solid metal alloy where it is safely stored in an inert state. OHS offers superior volumetric density and safety attributes relative to high-pressure compressed gas and cryogenic liquid alternatives.

ECD (Nasdaq: ENER) is a global leader in building-integrated and rooftop photovoltaics. The company manufactures, sells and installs thin-film solar laminates that convert sunlight to clean, renewable energy using proprietary technology. The company also designs, manufactures and installs rooftop photovoltaic systems, which enable customers to transform unused rooftop space into a value-generating asset. ECD’s Ovonic Materials Division includes the Ovonic Battery Company, the inventor and worldwide licensor of nickel-metal-hydride battery technology and the developer of proprietary advanced lithium-ion cathode materials, along with other emerging energy storage technologies. ECD’s Ovonyx joint venture is the inventor and worldwide licensor of phase change memory (PCM) technology.

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