



The Increasing Relevance of Minority Investments

January 2010

Dresner Partners Overview

- Focuses exclusively on the middle market (businesses with revenues between \$25 million and \$500 million)
 - Family businesses
 - Closely-held private companies
 - Small and middle-cap public companies
 - Subsidiaries or business units of public and private companies

Mergers & Acquisitions	Private Financings
Sale of Companies Leveraged Recapitalizations Management Buyouts ESOP Structured Transactions Acquisition Advisory	Common/Preferred Equity Equity-Linked Securities Subordinated Debentures Senior Secured Loans ESOP Financings
Valuation	Restructuring
Classic Business Valuation Shareholder Value Optimization Fairness Opinions Corporate Tax Planning Estate Tax Planning SFAS 141 & 142	Operational Restructuring Strategic Cash Generation Turnaround Lender Advisory Crisis Cash Management Crisis Communications

Valesco Investment Criteria



Founded:	1990
General:	Seeking lower middle market private companies <ul style="list-style-type: none">• Strong management• Profitable• Vision for the future
Transaction Size:	\$10 mm to \$75 mm enterprise value, \$2 mm to \$15+ mm EBITDA
Investment Type:	<ul style="list-style-type: none">• Buyouts• Recapitalizations• Growth capital investments
Company Situation:	Scalable businesses that have untapped growth potential
Business Model:	<ul style="list-style-type: none">• Manufacturing• Value added distribution• Product centric service businesses
Economic Targets:	<ul style="list-style-type: none">• High profit margins EBITDA Margins =10% -15%+• Efficient working capital utilization (Inv + AR)/Sales = 35%• Low capital intensity Fixed Assets/Sales = 4X

- State of the Market
- Preparation for taking on Minority Investors
- Mechanics
 - Discounts/Premium in Comparables Analysis
 - Valuation Basics
 - Structuring to Get to a Deal
- Case Study – Minority Investor



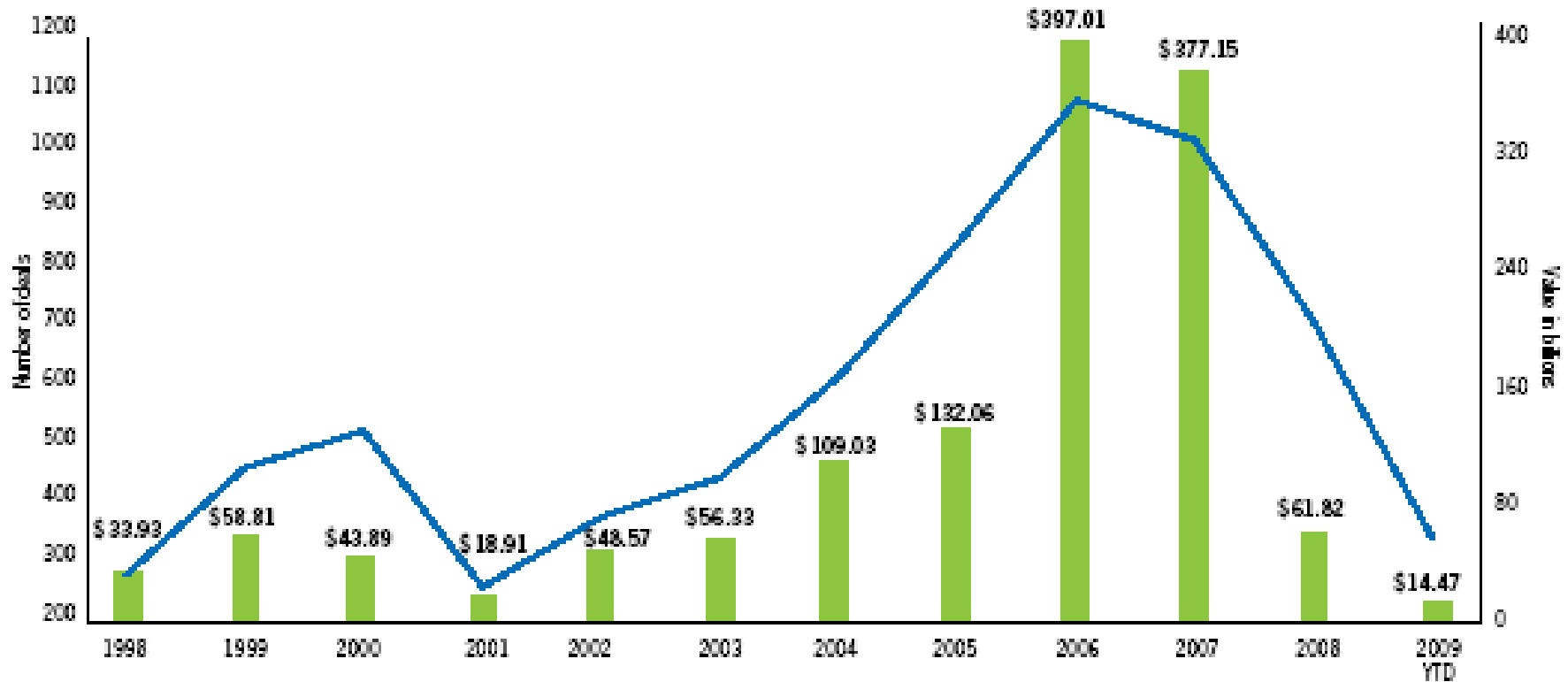
LBO & VC State of the Market

"Civilization stands at the crossroads. Down one road is despondency and despair, and down the other is total annihilation. Let us pray that we choose the right road."

- Woody Allen

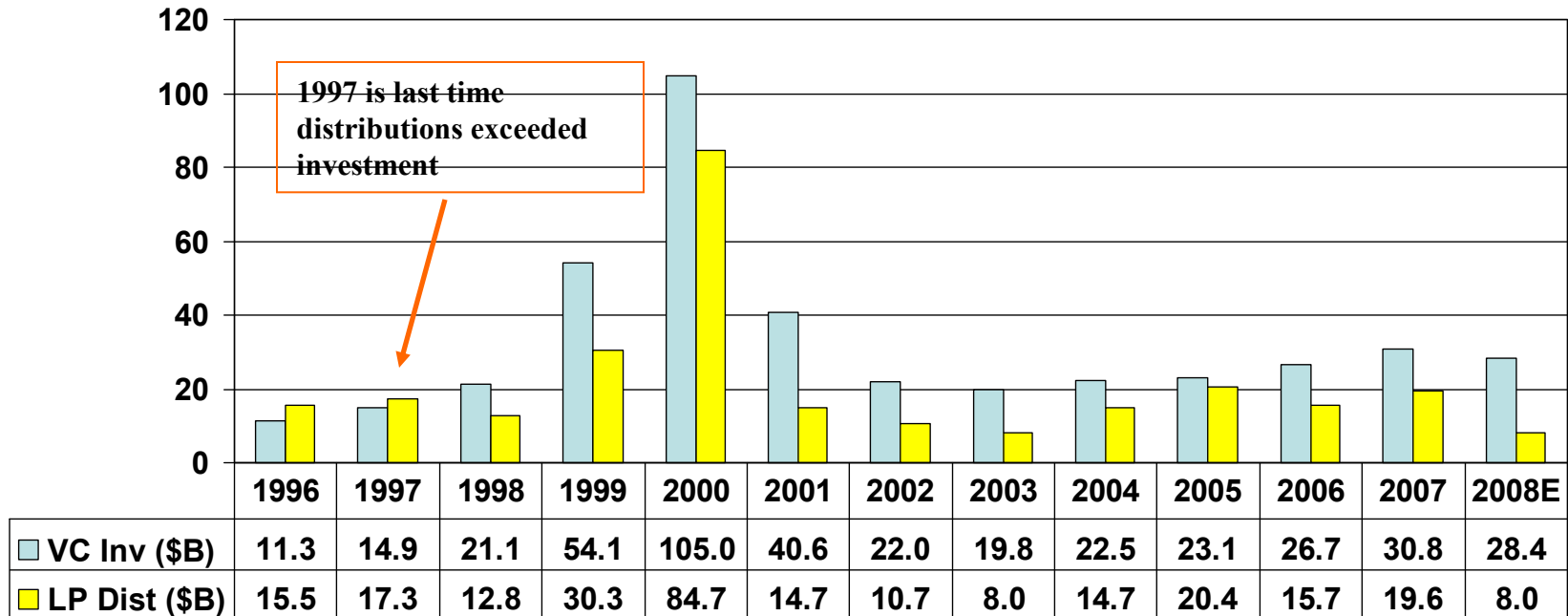
U.S. LBO Deal Value... Down 96% and # Transactions Down 80%... from '06 peak

Figure 1
Announced U.S. buyout deal volume (\$B)



Year to date: 1/09 - 9/09
Source: Dealogic

Since '97, VC Investment Exceeded LP Distributions; Much is Bottled Up in NAV



Source: Thomson Reuters/National Venture Capital Association

Private Equity - Post Boom

“Gut check” for Entrepreneurs and/or Private Equity-backed portfolio companies on exits...

Selling at the top??

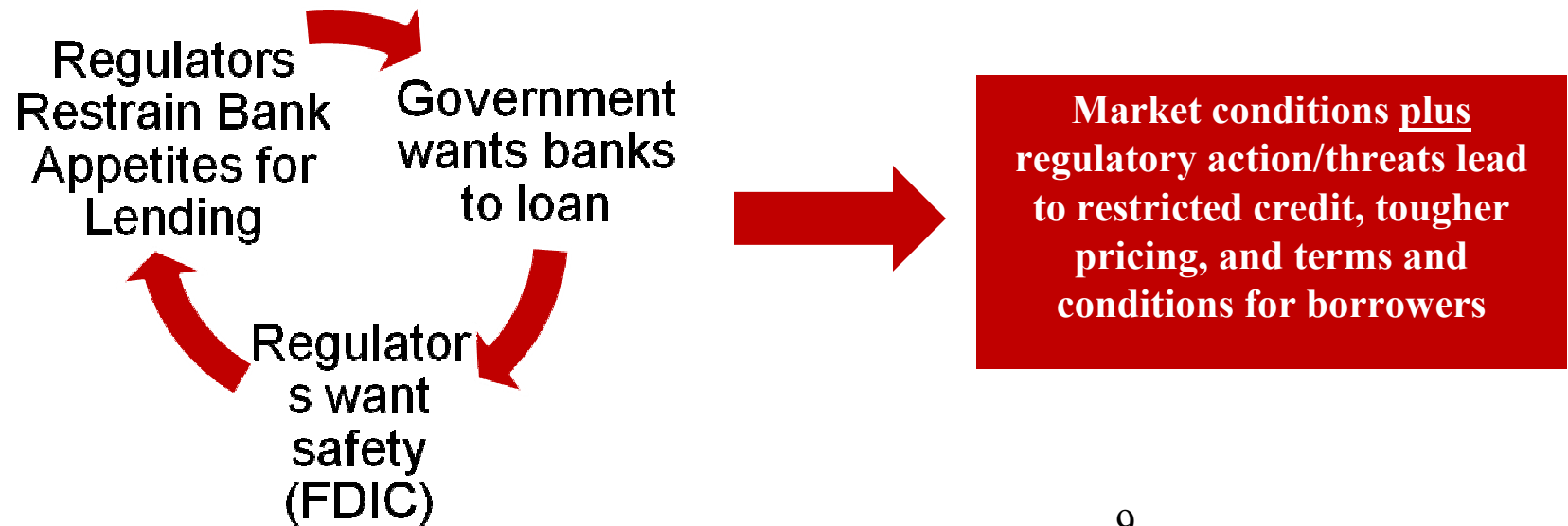
“There is going to be a flood of exits. People can’t wait for the lofty multiples of 2007. They need cash. Cash trumps multiples. ...sellers had unrealistic expectations... they learned their lesson the hard way.”

Bank Loan Pricing Umbrella Rises

“Many small businesses are complaining that they can't get access to credit, a situation that government officials believe is preventing the economy from rebounding more quickly.”

“...Bankers are getting mixed messages from the government, Congress and regulators... They are told to lend more, but on the other hand, here are existing policies and proposed policies that will inhibit lending.”

- “Obama Slams ‘Fat Cat’ Bankers” *The Wall Street Journal*. 14 Dec 2009.



Junior Capital Supply Drops

Some traditional suppliers of Junior Capital sidelined – as demand now exceeds supply

Finance Companies

- GE Capital
- CIT Group
- Madison Capital Funding
- Freeport Financial
- NewStar Financial
- Orix Financial

- CapitalSource
- FirstLight Financial
- Tygris
- GMAC
- Cratos Capital
- Textron Financial

Banks

- National City
- Wachovia
- RBS
- Fifth Third
- KeyBank
- Bank of Ireland
- DZ Bank

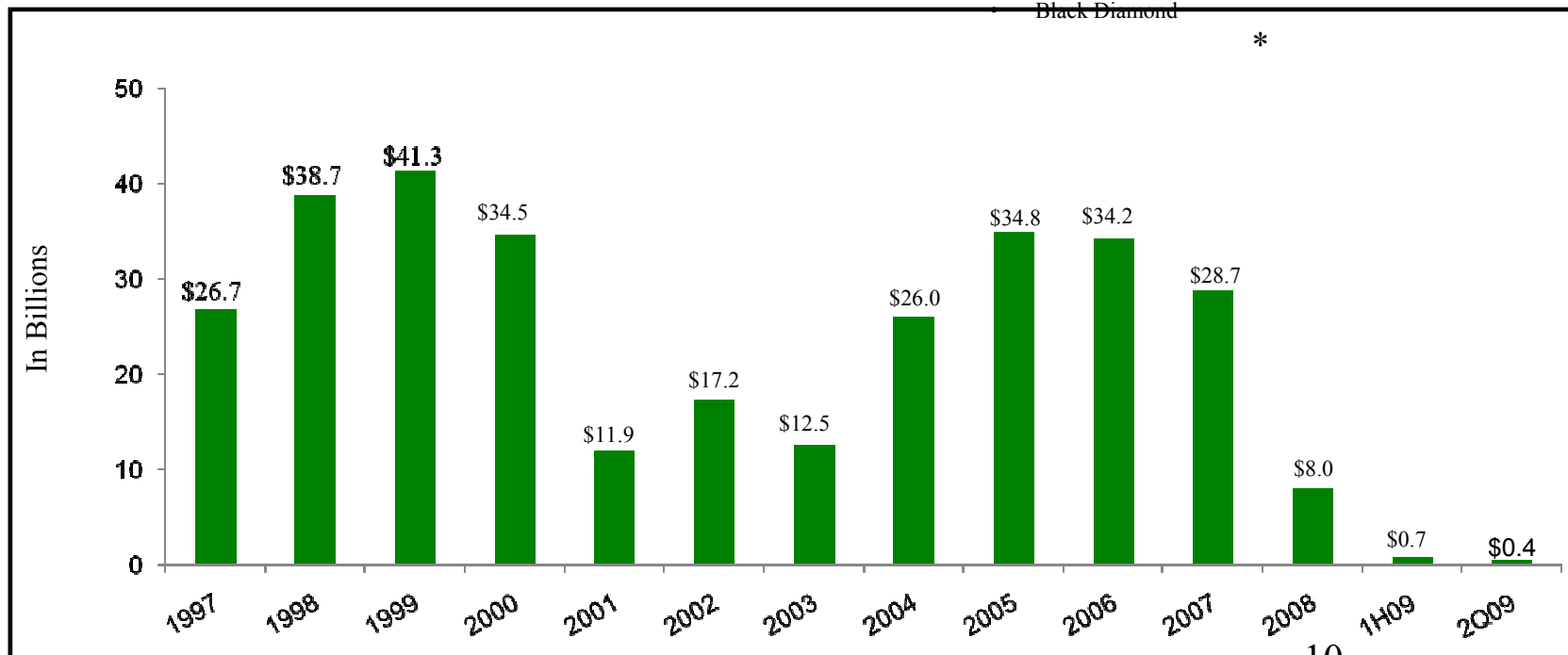
Specialty

Lenders

- Golub
- Cerberus
- Dynmas
- Fortress
- Monroe Capital
- DB Zwim

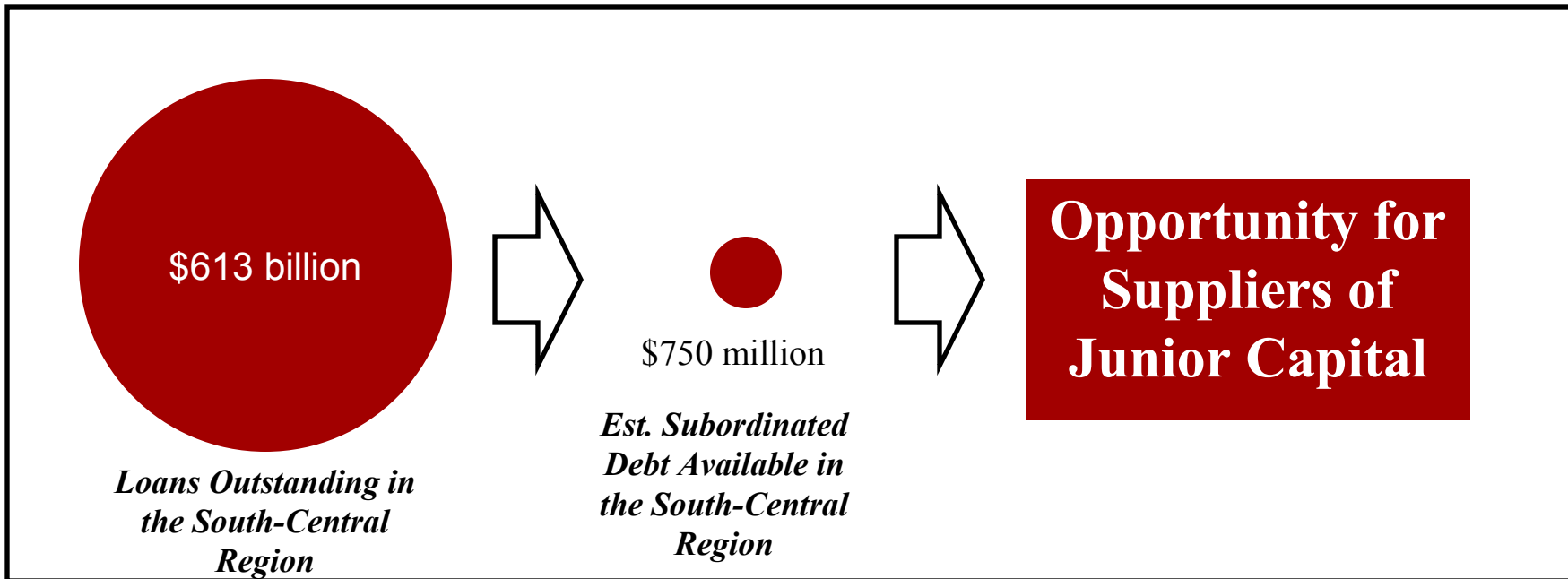
BDC's

- American Capital
- Allied Capital
- Gladstone Capital

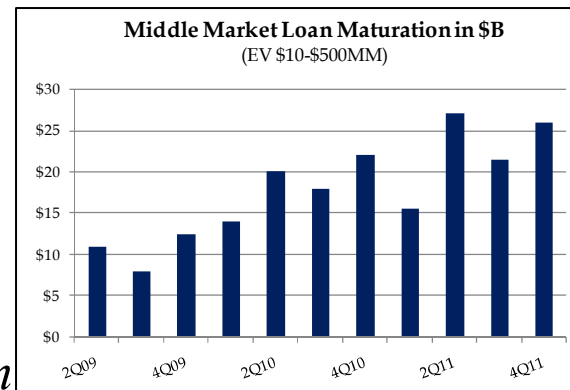


*Source: Standard & Poor's LCD March 2009.

...Hole in Middle of the Balance Sheet



- *Loan renewals down 8% nationally*
- *Lenders flight to safety*
 - *Retreat to asset based loans*
 - *Senior cash flow lending in question*



Nearly \$200 billion in middle market loans will mature in the next three years

*\$613 Billion in Loans and Leases Outstanding at FDIC Insured Depository Institutions in the South-Central U.S. as of 3/31/09. \$623

- *Insufficient sub debt resources*



Valesco State of the Market Survey: Overview*

- New transactions are proving difficult to complete given current seller expectations and U.S. market realities.
 - Fewer sellers have come to the market over the last year.
 - The biggest challenges for M&A advisors - Attracting new clients and managing those client's expectations in the face of diminished performance.
 - **Every type of capital is in demand - 43% of respondents say their client's biggest need is access to capital, both debt and equity.**
 - **Most need equity, followed by senior debt and then subordinated debt**
 - **Many have seen credit lines reduced**
-

*Results from Valesco's Survey of M&A Advisors, September 2009.

Market Dynamics

- Starting in the second half of 2008, the U.S. financial sector has been dramatically impacted by crises in the housing and credit markets as well as the broader recessionary climate
- Government action has stabilized the U.S. credit system; however, credit remains tight and availability continues to be an issue
- As a result, many companies are constrained in their ability to fund their business
 - Overlevered balance sheets
 - Difficulty funding growth (working capital, investment in PP&E, market expansion, etc.)
 - Significantly reduced flexibility to be opportunistic (i.e., acquisitions)
 - Limited ability for shareholders to pull capital out of the business and/or fund shareholder buyouts
- Concurrently, owners that had been contemplating a sale of their company to gain some liquidity became gun-shy in late 2008 and 2009 in the face of depressed cash flows and valuation levels

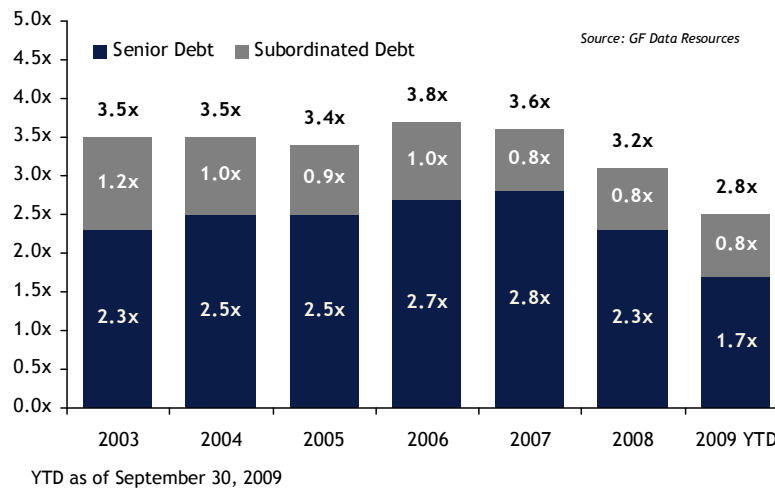
As a result, many companies have been forced to find alternative sources of capital to achieve their financial and strategic objectives

Credit Markets Tightened in 2008 and 2009

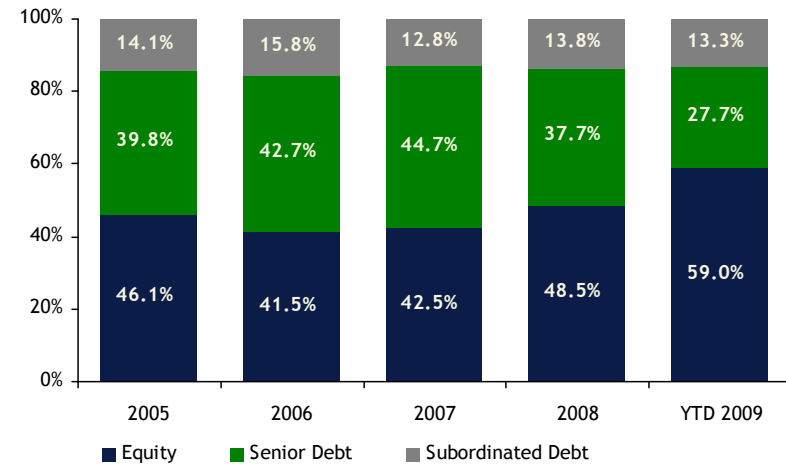
Commentary

- Average debt multiples of middle market loans have declined significantly from 2006 levels
- Equity has grown to fill in the gap in the capital structure left by senior lenders
- However, recent anecdotal evidence suggests that the credit markets are starting to thaw (albeit slowly)

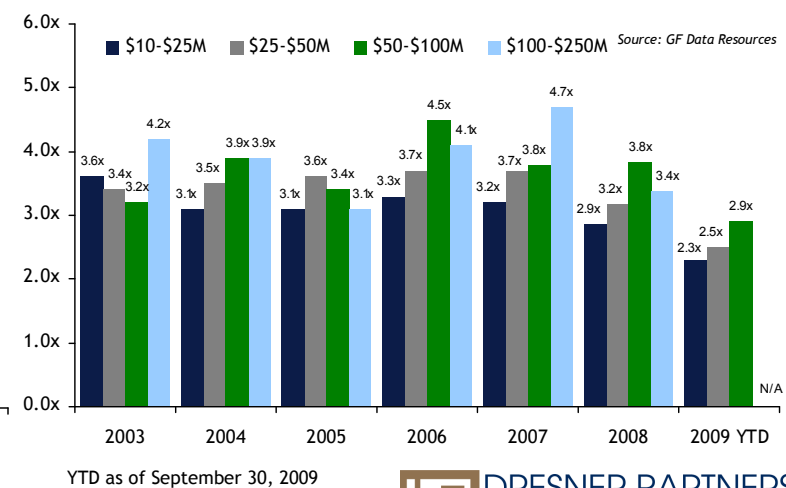
Total Debt/EBITDA (Transaction Size: \$10M-\$250M)



Middle Market Equity & Debt Contributions



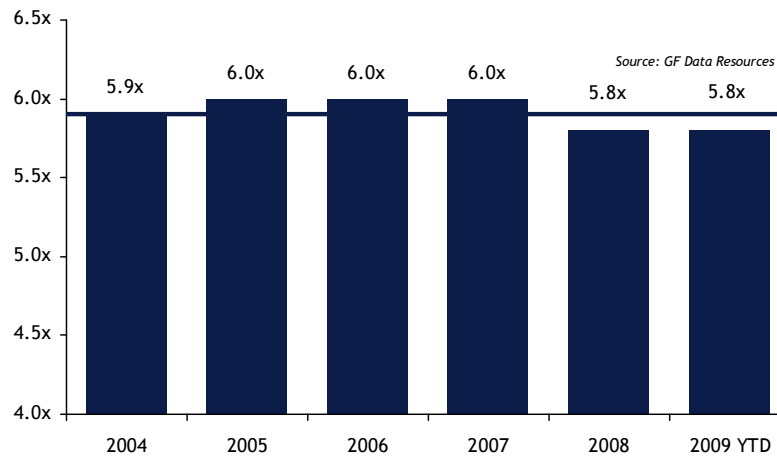
Total Debt/EBITDA By Transaction Size



Concurrently, Valuations Dropped but have Started to Rebound

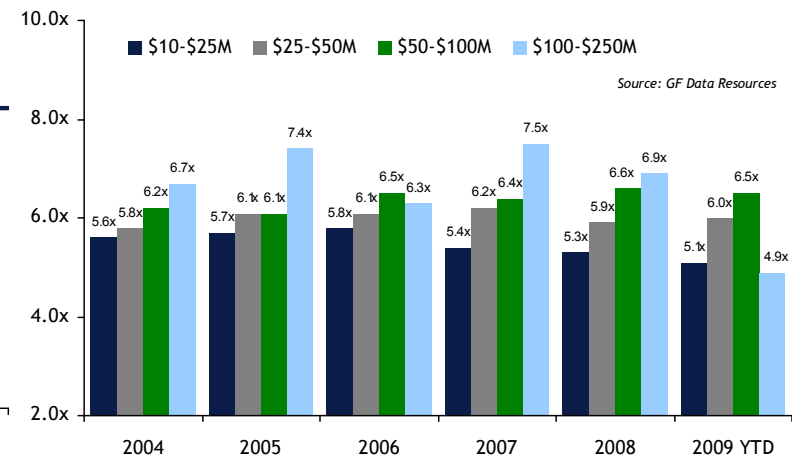
- While the middle market did not escape the impact of the financial market turmoil, its volatility was muted
- Valuation multiples dropped significantly at the end of 2008 and first half of 2009, but have since started to rebound
- There is recent evidence that healthy businesses are being valued at multiples close to pre-downturn highs

TEV/EBITDA Multiples (<\$250MM TEV)



YTD as of September 30, 2009

TEV/EBITDA By Transaction Size



YTD as of September 30, 2009

Sources of Capital

Revolver	<ul style="list-style-type: none">▪ Secured by accounts receivable and/or inventory▪ Typically floating interest rate▪ Provided by commercial banks and finance companies
Term Debt	<ul style="list-style-type: none">▪ Typically secured by non-working capital assets, such as property, plant & equipment▪ Amortizes over 3-5 years▪ Provided by commercial banks, finance companies, and leasing companies
Mezzanine Debt	<ul style="list-style-type: none">▪ A hybrid of debt and equity financing that is typically used to finance the expansion of existing companies▪ Long-term debt capital that gives the lender the rights to obtain an ownership or equity interest in the company at some point in the future, in addition to having rights as a creditor▪ Provided by private equity funds, mezzanine funds, and some commercial banks
Equity	<ul style="list-style-type: none">▪ Raising money for company activities by selling common or preferred stock (permanent capital)▪ Majority or minority option▪ Often highly structured (i.e., preferred returns, liquidation preference, etc.)▪ Provided by private equity funds and mezzanine funds

The Increasing Popularity of Minority Investments

Advantages of Partnering with Minority Equity Investors

- Enables companies seeking growth capital (or capital to survive the economic downturn) to improve financial flexibility to pursue strategic objectives
- Provides alternate option for owners seeking liquidity
 - Enables shareholders to avoid selling their business in a depressed cash flow and valuation environment
 - Provides an opportunity to diversify portfolio today while retaining a “second bite at the apple”
- Opportunity to partner with new investors who share long-term vision for the company
- Access to additional capital if needed for opportunistic purposes
- Enhances relationship with senior debt providers
- Minority investor will provide the company with additional operational and financial expertise as well as succession assistance (if needed)

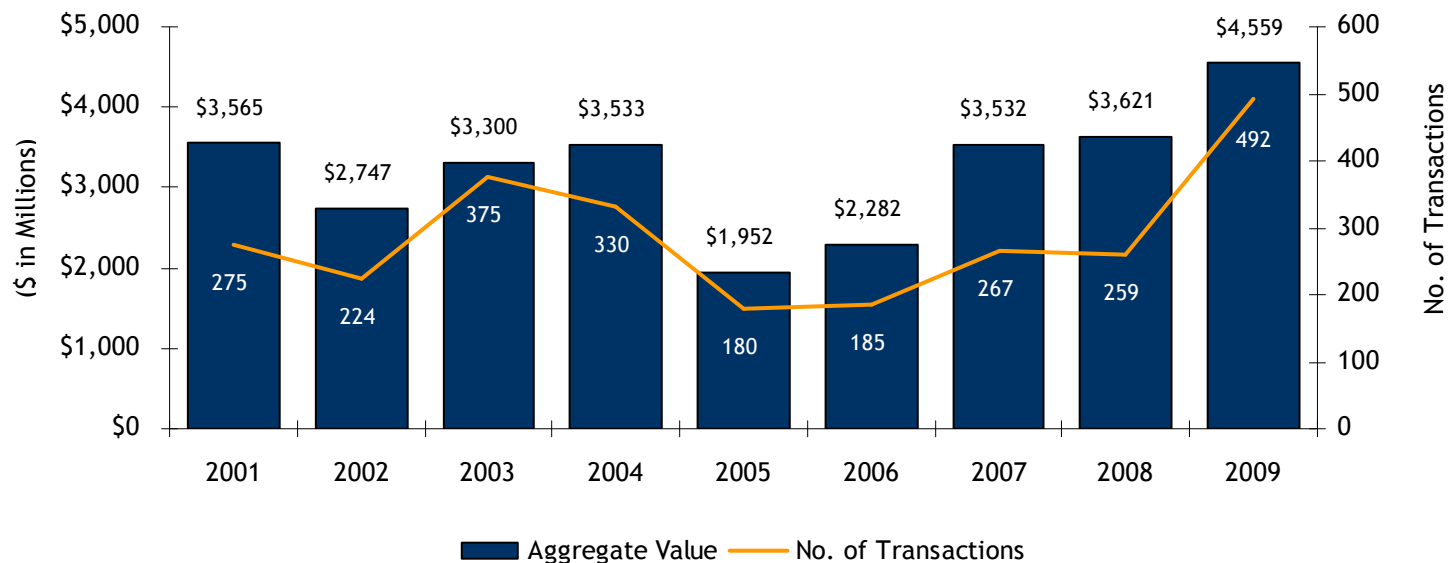
Opportunity for Private Equity Groups

- Opportunity to put capital to work given lack of high quality control deals
- Opportunity to gain exposure to companies that are not currently receptive to change-of-control transactions
- Capitalize on depressed valuation environment to drive stronger IRRs
- Gain right of first refusal in the event the majority shareholders decide to sell their stake

Minority Investment Activity

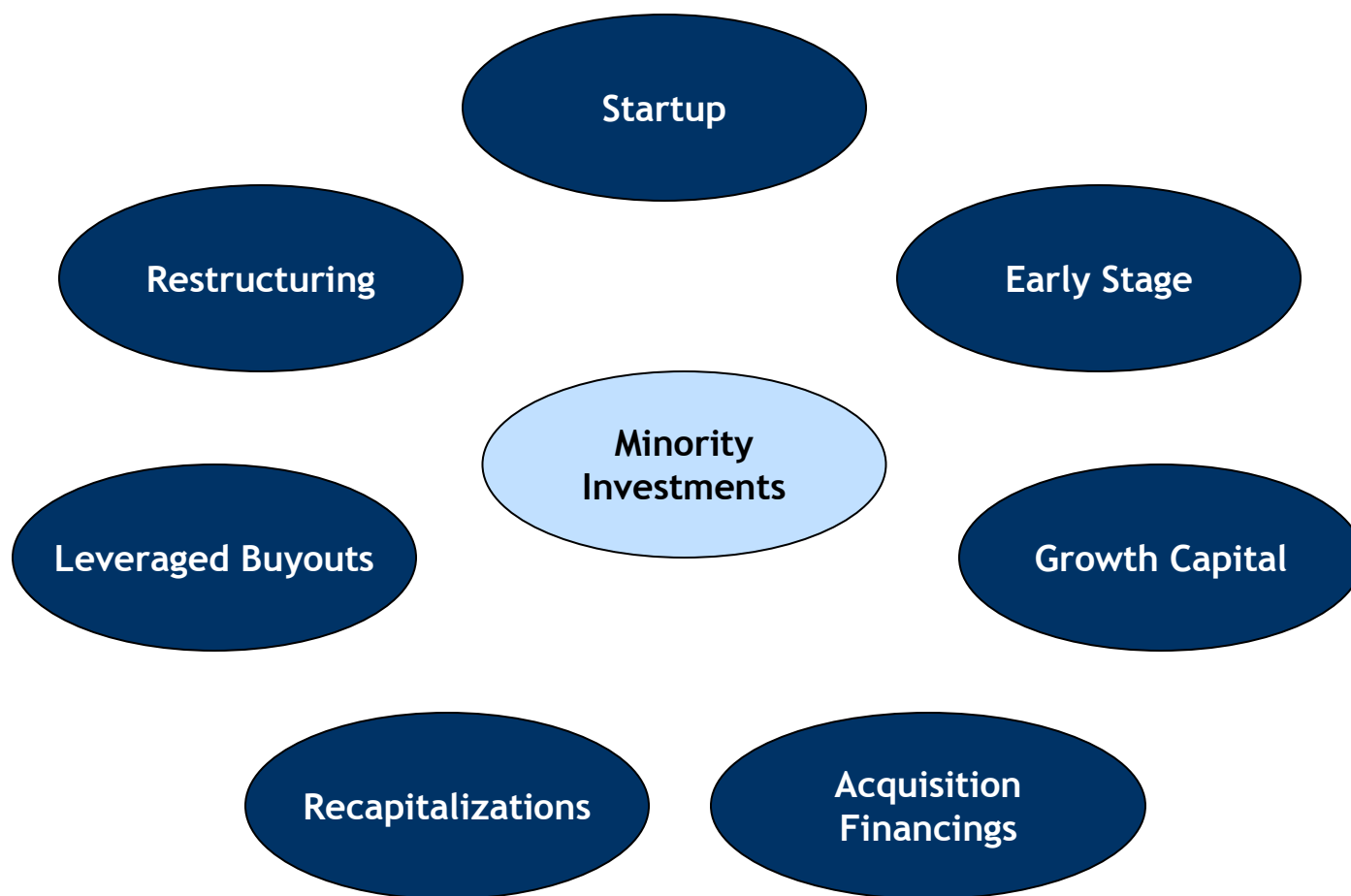
- As a result of tight credit markets and depressed valuations, there was a significant increase in minority investment activity in 2009

Minority Investments of < \$50MM in U.S. Targets



Source: Capital IQ

Minority Equity Investments Can Play an Important Role Throughout a Company's Lifecycle





How to make it “rain”...

“Adversity has the effect of eliciting talents which in prosperous circumstances would have lain dormant.” - Horace

Preparation for Minority Investor

- Updated business plan – focus on growth plans
- Comprehensive financial model with I/S, B/S and C/F statements (history and 5 year projections)
- Detailed Strengths, Weaknesses, Opportunities, Threats “SWOT”
- Realistic assessment of current value
- How much capital is needed
- Realistic estimate of time to create value and achieve liquidity for investors
- Determination: to give up control or not?

Minority Equity Investments

Minority investments fuel corporate growth while allowing owners to remain in control.

Typical Structure

- Modest Valuation
 - Discount for Minority Interest
- Management and/or Owners Retain Control
 - Little or NO Cash off the table
- Higher Cost of Capital

Considerations

- Ability to expand business
- Experienced partner (i.e. business coach) with limited control
 - Resources to take the business to the next level and enhance enterprise value
- Restrictions on activities that negatively impact minority capital
- Current ownership able to participate in future profits



Evaluating Capital Sources

Summary of factors to consider when choosing a capital source.

	Control Equity	Minority Equity	Subordinated Debt
Full Enterprise Valuation	X		
Equity to Management Team	X		
Ownership Retains Control		X	X
Cash off the table	X		
Current Ownership Participates in Future Profits	X*	X	X
Experienced Partner with Growth Resources	X	X	
Restrictions on Activities (impacting minority capital)		X	X

*On a limited basis when equity is left with exiting shareholders.

Minority Equity Investments: Issues to Consider

- Minority equity investors require a variety of legal protections relating to the general operations of the business as well as financial terms related to their securities
- Typically structured as preferred equity
 - Preferred stock often entitles the holder to a specified preferential payment upon liquidation and a share in any remaining liquidation proceeds on an as-converted-to common stock basis
 - Common stock or debt with warrants are alternative structures
- Typically obtain some degree of influence over the target through board seats, pre-emptive rights with respect to future equity issuances, and management consultation rights
- Investors generally have a five to seven year investment horizon
- The following pages highlight many of the common terms that arise in structuring minority investments
 - Note that minority investments in early stage companies often have different terms

Minority Equity Investments: Typical Transaction Terms

Governance

- Board seat(s)
- Voting rights
- Consent/veto rights on many/all material events

Dividends

- Specifies interest rate
- Cash or Payment-in-Kind (PIK)

Liquidation preference

- Typically has preference over all other equity holders (including return of capital and accrued dividends)
- Can further specify payout priority based on target IRRs for each class of security

Exit features (put rights)

- Put date: specifies a date (usually 2-5 years after initial investment) after which the fund can “force” the Company to pay back its investment plus some guaranteed rate of return
- The valuation at which the security is redeemed by the Company varies from deal to deal
- Certain events can allow the fund to cause a put early (i.e., the failure to meet certain financial performance metrics or the resignation or loss of key personnel)
- The Company may need to put itself up for sale if it’s unable to cover the put (either via cash flow or debt capacity)

Conversion

- Specifies the timing and nature of the conversion to common stock

Anti-dilution

- Protects the fund from dilution resulting from a later issuance of stock at a lower price than the fund originally paid
- Two examples: Weighted Average and Ratchet Based
- Weighted average: Adjusts the rate at which preferred stock converts into common stock based upon the magnitude of the lower-priced issuance, not just the actual valuation
- Full-Ratchet: If the Company issues new shares at a lower price, then the fund’s shares are effectively reduced to the price of the new issuance

Minority Equity Investments: Typical Transaction Terms

Right of first refusal

- The right for the fund to purchase shares should an existing shareholder wish to sell shares

Preemptive rights

- Gives the fund the right to purchase additional shares in the company should there be subsequent financings

Tag-along (co-sale) rights

- If a majority shareholder sells his or her stake, then the minority shareholder has the right to join the transaction and sell his or her minority stake in the company

Drag-along rights

- A right that enables a majority shareholder to force a minority shareholder to join in the sale of a company
- The majority owner doing the dragging must give the minority shareholder the same price, terms, and conditions as any other seller

Registration rights (also exit)

- A contractual right giving investors holding restricted stock the ability to demand that the issuing company register the shares with the SEC, effectively making the stock available for sale to the public.
- An alternative is piggy-back rights, which grant the investor the right to register his or her unregistered stock when either the Company or another investor initiates a registration (inferior to demand registration rights)

Minority Investments: Strategy & Process

- Determine marketing strategy
 - Targeted or broad universe of potential investors
 - Mezzanine and/or minority equity investors
- Investment bank due diligence
- Preparation of marketing materials
- Investment bank markets opportunity to potential investors
- Management presentations to selected potential investors
- Negotiate term sheets
- Process typically takes 4-6 months

Simple Start-up E's proposal

(Jack Levin, Kirkland & Ellis)

- | | <u>VC</u> | <u>E</u> |
|----------------|-----------|----------------|
| • Investment | \$1.0 mm | Exp. & service |
| • Stock issued | 40 shs | 60 shs |
- What is wrong with this deal?

First problem: IRC Section 83

(Jack Levin, Kirkland & Ellis)

- Rule 1: Where a service provider (“SP”) receives property “in connection with the performance of services”
- SP has Ord Inc = spread at the time of receipt

E's Section 83 OI

(Jack Levin, Kirkland & Ellis)

- | | |
|------------------------|--------------|
| • Newco FMV (000's) | \$1,000 |
| • E's % of Newco c/s | <u>X 60%</u> |
| • FMV of E's Newco c/s | \$600 |
| • Price paid by E | <u>- 0 -</u> |
| • E's "spread" = OI | \$600 |
- Tax at front end with no cash to pay tax
 - OI rather than LTCG 35% vs. 15%
 - E would owe \$210K in taxes

Solutions to E's 83 OI problem

(Jack Levin, Kirkland & Ellis)

1. E contributes “property” rather than “services”
 - E is tax-free under Section 351 on receipt of Newco stock for “property” contributed
 - Only partial solution if E's c/s has $FV > E$'s property contribution
2. Temporal differentiation – E forms Newco substantially before VC's contribution
3. Qualitative differentiation – VC receives senior securities and E participates only in future profits

2nd Problem: Premature liquidation

(Jack Levin, Kirkland & Ellis)

• Cash available (000's)	\$1,000
• VC's c/s %	<u>X 40%</u>
• VC's liq'n proceeds	\$ 400
• VC's basis	<u>(1,000)</u>
• VC's Loss on transaction	\$ (600)

Favorable Newco sale

@ 2x invest.

(Jack Levin, Kirkland & Ellis)

• Sale proceeds (000's)	\$2,000
• VC c/s%	<u>X 40%</u>
• VC's sale proceeds	\$ 800
• VC's basis	<u>(1,000)</u>
• Loss on Transaction	\$(200)

VC's proposal (Jack Levin, Kirkland & Ellis)

	<u>VC</u>		<u>E</u>
Sub debt (000's)	\$500	\$	-0-
Preferred Stock	460		-0-
Common Stock			
40% VC (40 sh)	40		-0-
60% E (60 sh)	<u>-0-</u>		<u>60</u>
Total	\$1,000		\$60

- VC senior claim \$960K plus interest and dividends
- VC residual claim on Common: 40%
- Newco interest deduction on Sub debt, good DER
- (here 1:1 and 3:1 even after Newco borrows \$1mm from bank i.e. \$1.5 Debt / \$0.5K Equity)

Case Study

Situation Overview

- Looking to raise \$10 million to fund the buyout of one shareholder
- Experienced a drop in revenue in 2009 along with deteriorated EBITDA margins
- Ended the year with leverage that is near the top of what mezzanine investors are willing to consider

Historical Financial Profile

	2006	2007	2008	2009
Revenue	\$106.3	\$113.4	\$118.3	\$100.1
<i>Growth</i>	<i>NA</i>	6.7%	4.3%	-15.4%
EBITDA	\$20.1	\$22.9	\$23.8	\$16.1
<i>Margin</i>	18.9%	20.2%	20.1%	16.1%
Total Debt	\$74.0	\$66.4	\$59.8	\$52.5
<i>Total Debt / EBITDA</i>	3.7x	2.9x	2.5x	3.3x

Case Study

	Historical				Projected					
	2006	2007	2008	2009	2010	2011	2012	2013	2014	
Financial Summary	Revenue	\$106.3	\$113.4	\$118.3	\$100.1	\$107.9	\$113.9	\$119.6	\$125.4	\$131.9
	<i>Growth</i>	NA	6.7%	4.3%	-15.4%	7.8%	5.6%	5.0%	4.8%	5.2%
	EBITDA	\$20.1	\$22.9	\$23.8	\$16.1	\$18.3	\$21.0	\$23.3	\$24.9	\$26.8
	<i>Margin</i>	18.9%	20.2%	20.1%	16.1%	17.0%	18.4%	19.5%	19.9%	20.3%
	Capital Expenditures	\$4.5	\$4.6	\$4.9	\$4.5	\$4.9	\$5.1	\$5.4	\$5.6	\$5.9
	<i>as % of Revenue</i>	4.2%	4.1%	4.1%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
	Working Capital	\$22.5	\$22.8	\$24.8	\$21.9	\$23.6	\$25.0	\$26.2	\$27.5	\$28.9
	<i>as % of Revenue</i>	21.2%	20.1%	21.0%	21.9%	21.9%	21.9%	21.9%	21.9%	21.9%
	Free Cash Flow	\$5.5	\$7.6	\$6.5	\$7.4	\$4.1	\$6.1	\$7.8	\$9.1	\$10.3
	Total Debt	\$74.0	\$66.4	\$59.8	\$52.5	\$48.4	\$42.3	\$34.5	\$25.4	\$15.0
<i>Total Debt / EBITDA</i>	3.7x	2.9x	2.5x	3.3x	2.6x	2.0x	1.5x	1.0x	0.6x	

Valuation	12/31/09	12/31/14
	EBITDA	\$16.1
Valuation Multiple	5.75x	5.75x
Enterprise Value	\$92.4	\$153.9
Net Debt	\$52.5	\$15.0
Equity Value	\$40.0	\$138.9

IRR Analysis	Minority Investment	\$10.0	NA
	Ownership	25.0%	25.0%
	Value of Equity Stake in 2014	NA	\$34.8
	Projected IRR	NA	28.3%

		IRR Sensitivity (a)				
		Exit Multiple				
Ownership		4.75x	5.25x	5.75x	6.25x	6.75x
	20.0%	17.5%	20.2%	22.7%	25.0%	27.1%
	22.5%	20.3%	23.1%	25.6%	27.9%	30.1%
	25.0%	22.9%	25.7%	28.3%	30.7%	32.9%
	27.5%	25.3%	28.1%	30.7%	33.2%	35.4%
30.0%	27.5%	30.4%	33.0%	35.5%	37.8%	

(a) Assumes \$10 million investment at 12/31/09.



Case Study

Why did Capital Southwest Invest?

- “In-house” experts
- Double “Wow Factor”
- Disruptive Technology
- Path to Management
- Patent Pending Technology

Structure Case Study: Subordinated Debt and Equity



Case study of Capital Southwest's investment in Heelys, Inc. (NASDAQ: HLYS)

- Innovative skate shoe with patent pending – need for growth and working capital
- Commitment: \$2.4 million
- **Subordinated Debenture**
 - **\$1.8 mm Contingent Subordinated Debt**
 - 10% rate, 5 year maturity, drawable at milestones, no material adverse change
 - Security: Stock pledge for 1/3rd of founders' common shares and key man life insurance payable to company
- **Dual Class Preferred Stock**
 - **\$480,000 Series A Straight Preferred Stock**
 - Non-voting, Non-redeemable, Non-dividend until 5th yr.: 8%, 2 yrs later, 12%
 - **\$120,000 Series B Convertible Preferred Stock**
 - Convertible into 43.0% of the fully diluted common shares
 - Anti-dilution, first refusal, registration, and co-sale rights, 2 BOD seats, put option

Case Study: How Minority Investor Added Value...



- Assisted in crafting strategic plans
- Recruited full management team to supplement founder/inventor
- Recruited auditors – Deloitte
- Assisted CFO in raising senior financing
 - Comerica – initial international letters of credit
 - CIT - A/R factoring and asset based loan facility
 - Bank One/JP Morgan - commercial line of credit
- Assisted in various patent application, issuance and defense matters
- Demonstrated product and sales training at trade shows, malls, street festivals, etc.
- Assisted management in acquiring a complimentary product line – Soap grind shoes
- Assessed unsolicited offers and hired bankers to conduct '05 auction (did not sell).
- Joined as an employee/officer ('06) to assist in IPO and a planned secondary offering



Structure Case Study: Financial Results



- Subordinated debt repaid early
- Series A Preferred Stock redeemed prior to first dividend due date
- Series B Convertible Preferred Stock converted into 43.0% of common stock
- Sold 8% of common stock in IPO for \$31.1 mm net (\$17,500 basis)
- Post IPO, retained 35% of common stock
- Received special dividend in 2008 - \$9.3 mm (\$1.00/share)
- Unrealized value (3/31/09) \$18.6 mm*; 9.3 mm shares at \$2.00/share; a 17% discount to cash of \$2.40/share or \$66 mm (no debt).
- From inception in 2000 through 2008, Heelys shipped over 19.0 million pairs into at least 60 countries, generating cumulative net sales of over \$550 million and net income of approximately \$50 million.

(\$ 000's)	<u>5/31/00</u>	<u>3/31/01</u>	<u>3/31/02</u>	<u>3/31/03</u>	<u>3/31/04</u>	<u>3/31/05</u>	<u>3/31/06</u>	<u>12/7/06</u>	<u>12/31/08</u>	<u>3/31/09</u>
Sub Debt Interest est.		\$90	\$180	\$180	\$180					
Dividends									\$9,317	
Sub Debt	\$(1,800)				1,800					
Srs A Pfd Stock	(480)						\$480			
Srs B Conv Pfd Stock	(120)							\$31,088		\$18,635*
Net Cash Flows	\$(2,400)	\$90	\$180	\$180	\$1,980	\$ -	\$480	\$31,088	\$9,317	\$18,635
XIRR	60.5%						<u>Cash In</u>	<u>Cash Out</u>	<u>Unrealized</u>	<u>Total</u>
Times investment \$	25.8						\$2,400	\$43,315	\$18,635	\$61,950