New South ESOP Conference

Acquisitions by ESOP Companies

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Why Consider an Acquisition Strategy?

- Accelerate growth rate
  - Ability to supplement organic growth
  - Speed and certainty versus Greenfield branches
- Diversification
  - Ability to broaden geographic reach
  - Ability to expand current product offering
- Improve operational performance
  - Opportunity to acquire strong operators and implement their core competencies within the base business
  - Access to management, sales and branch talent
- Efficient use of excess corporate cash

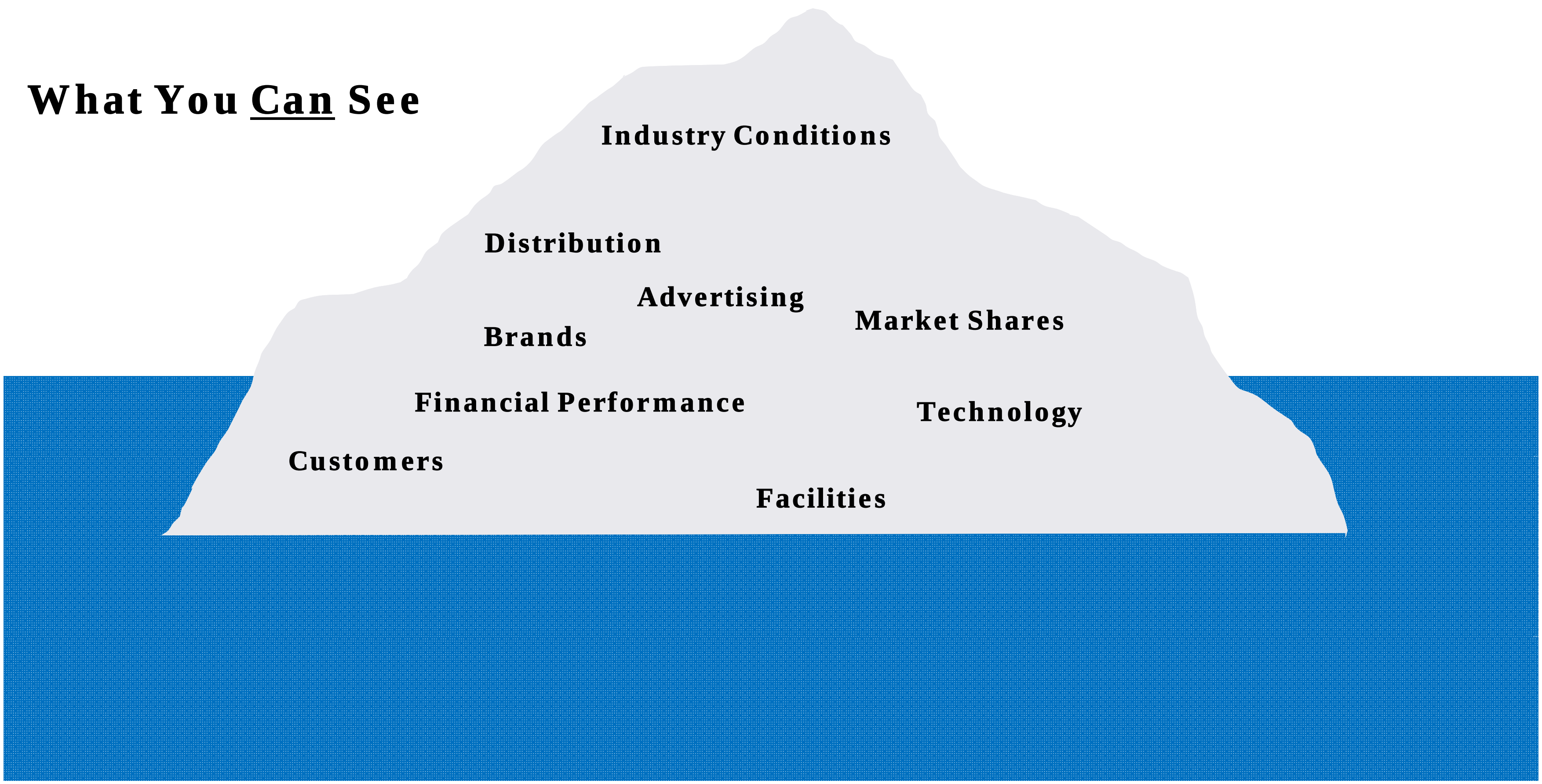
ESOP Companies Have Clear Advantages in M&A transactions

- Potential tax benefits to sellers
  - Selling shareholders of target company may be able to elect 1042 cap gains tax deferral. It is not easy but achievable
- Potential Tax benefits to the ESOP owned Acquirer
  - For a 100% S or C ESOP, ability to structure deal as either a stock or asset transaction
  - For S Corp, ESOP retains 100% of earnings vs. a non-ESOP competitor who must pay taxes on target's earnings

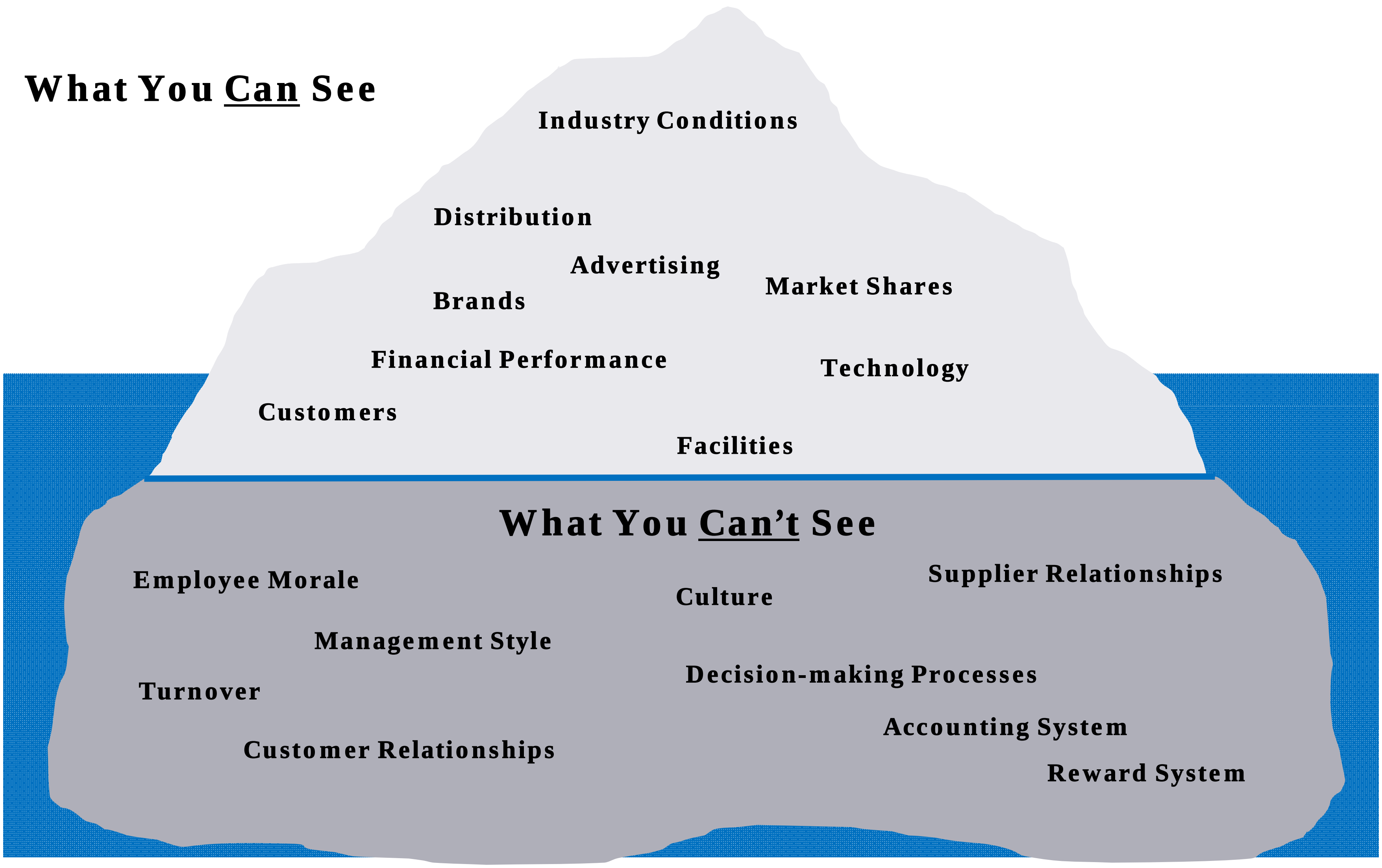
What are the Risks of Acquisitions

Acquiring a company is like buying an iceberg

What You Can See



What are the Risks of Acquisitions



Acquisition Success Factors

- Understand what you are acquiring
- Have a strategic purpose
- Focus on those with a strong core business
- Understand the competition and business environment
- Perform a realistic financial analysis
- Assess cultural differences and develop a plan for managing them
- Establish benchmarks for measuring progress and monitor continuously
- Hire an experienced team of advisors (legal, financial, accounting) to assist you in the process

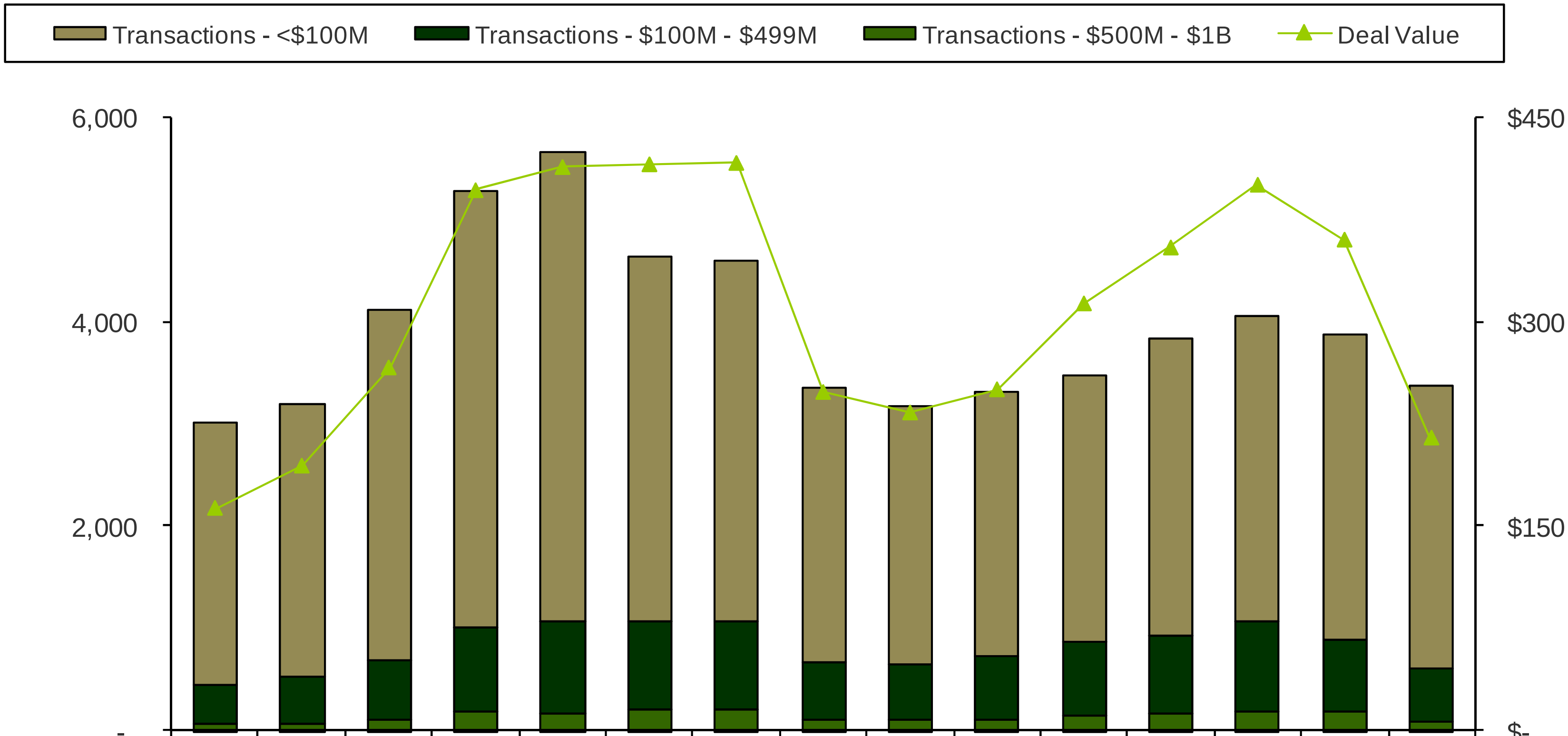
Pitfalls to Avoid

- Overpaying
- “Deal Fever” / lack of discipline
- Insufficient due diligence
- Loss of key employees post-transaction
- Cultural incompatibilities
- Poor leadership in managing the transaction/integration
- Inadequate post-transaction planning
- Overestimating synergies
- Over leveraging due to optimistic view of synergies and deal potential

Current M&A Market Trends

U.S. Middle Market Transactions

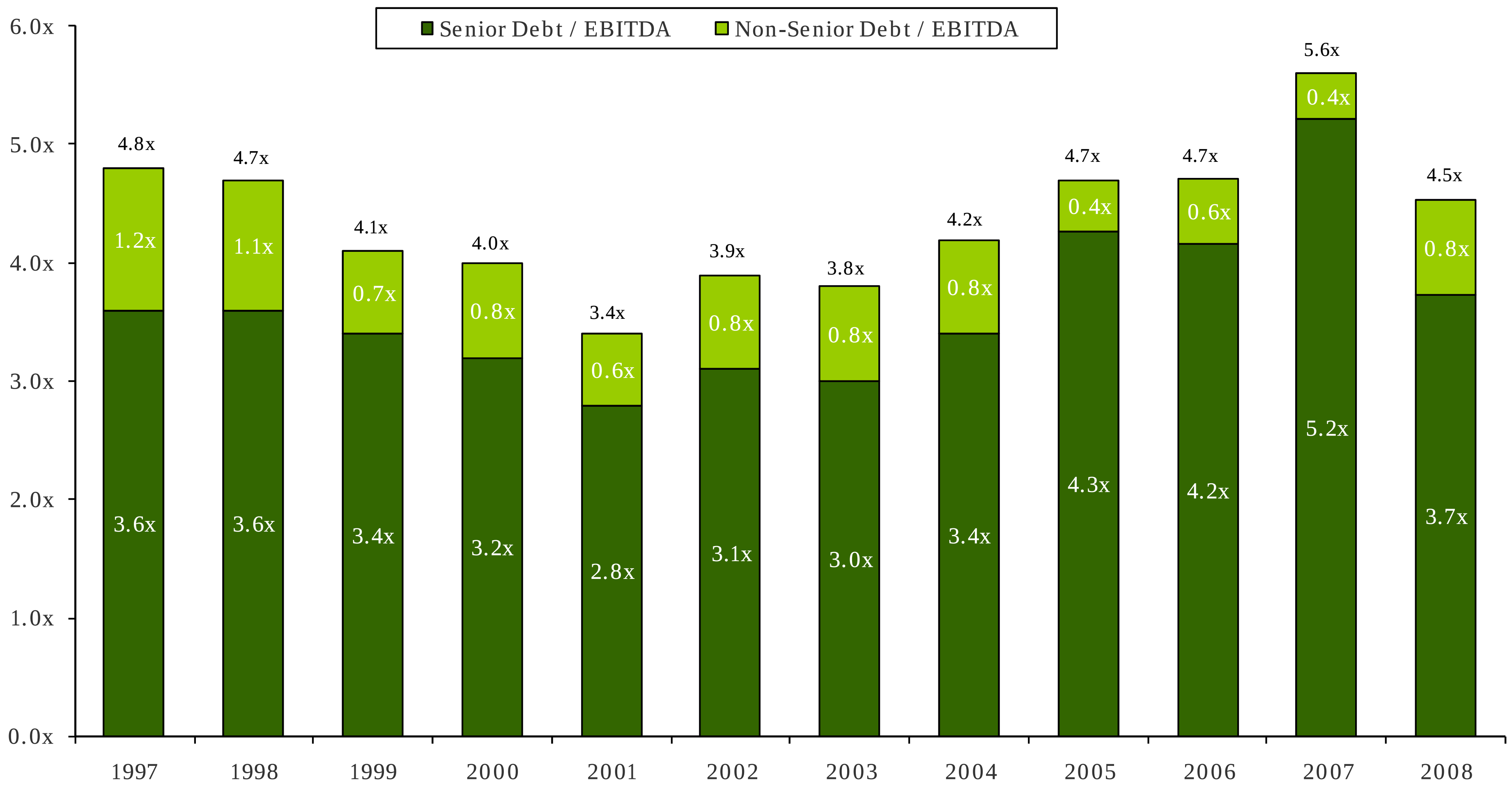
$'s in billions



	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Transactions - <$100M	2,559	2,663	3,428	4,269	4,581	3,563	3,514	2,694	2,535	2,580	2,619	2,908	2,980	2,968	2,772
Transactions - $100M - $499M	386	455	581	828	906	858	874	559	537	624	721	772	888	703	506
Transactions - $500M - $1B	53	71	103	175	162	205	197	101	97	98	135	156	176	189	87
Deal Value	$163	$194	$266	$396	$413	$415	$416	$248	$233	$250	$313	$354	$400	$360	$215

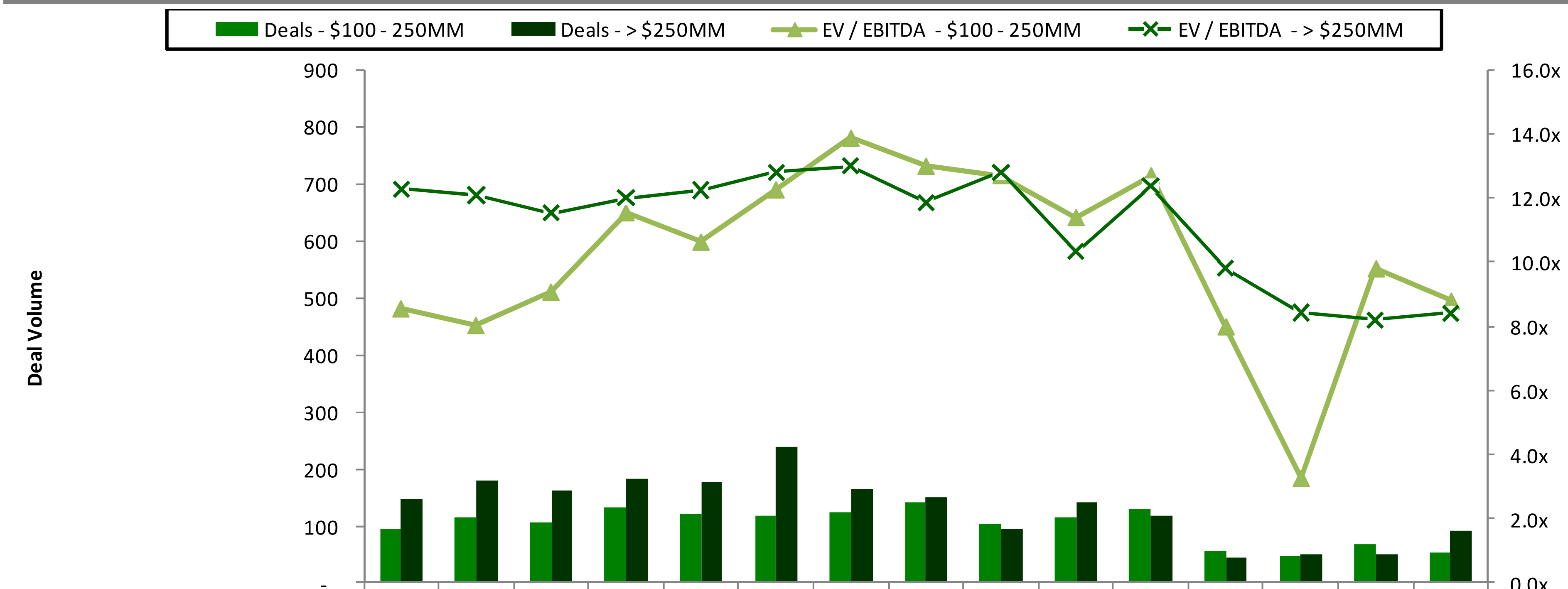
Source: CapitalIQ

Average Debt Multiples of Middle Market LBO Loans



Source: Standard & Poor's LCD

Quarterly M&A Activity (2006-Q2 2009)



	Q1 '06	Q2 '06	Q3 '06	Q4 '06	Q1 '07	Q2 '07	Q3 '07	Q4 '07	Q1 '08	Q2 '08	Q3`08	Q4 '08	Q1 '09	Q2 '09	Q3 '09
Deals - $100 - 250MM	95	114	107	131	121	119	125	140	103	116	130	55	46	67	53
Deals - > $250MM	148	180	162	182	178	238	166	150	93	140	117	45	50	51	92
EV / EBITDA - $100 - 250MM	8.6x	8.0x	9.1x	11.6x	10.6x	12.3x	13.9x	13.0x	12.7x	11.4x	12.7x	8.0x	3.3x	9.8x	8.8x
EV / EBITDA - > $250MM	12.3x	12.1x	11.5x	12.0x	12.3x	12.8x	13.0x	11.9x	12.8x	10.3x	12.4x	9.8x	8.4x	8.2x	8.4x
Deals <99.9MM	838	922	836	849	846	943	952	1,077	922	957	1,067	811	625	702	767

Credit Market Update

- Liquidity for transactions continues to be scarce
- Mortgage malaise continues
- Leveraged loan write downs by the major investment banks should be persistent throughout 2009 and 2010
- The Fed and Treasury continue to seek creative ways to stabilize the credit markets and inject liquidity
- These factors will continue to limit M&A activity among the private equity community and leveraged strategic buyers
- Cash-rich strategic buyers have begun to use their balance sheets to their advantage

The Acquisition Process

M&A Strategy

- Research is a vital first step to becoming a successful acquirer :
  - Target market characteristics and trends
  - Product and service focus areas
  - Customer focus areas
  - Vendor focus areas
  - Competitors
- Target List Creation
- Align with specific business unit and its goals and objectives
- Senior level involvement / attention is imperative
- Suggest the use of outside advisors (core competency)

M&A Strategy Tools

Strategy Frameworks

- Five Forces Analysis
- SWOT Analysis
- Value Curves
- Others

Market Intelligence

- Sales Force Surveys
- Vendor Surveys
- Customer Councils
- Competitor Public Information

Strategy Development

- Based on strategy exercises and market intelligence:
  - What are we best at/worst at?
  - How can we change?
  - Can we build it or buy it?
  - What are the $ involved?

M&A Plan Creation (Playbook)

- Develop list of priorities
- Create a target list that matches these priorities
- Allocate capital for M&A effort
- Form an M&A team
- Develop a plan of execution

Overview of the Transaction and Due Diligence Process

Phase I > Phase II > Phase III > Phase IV > Phase V

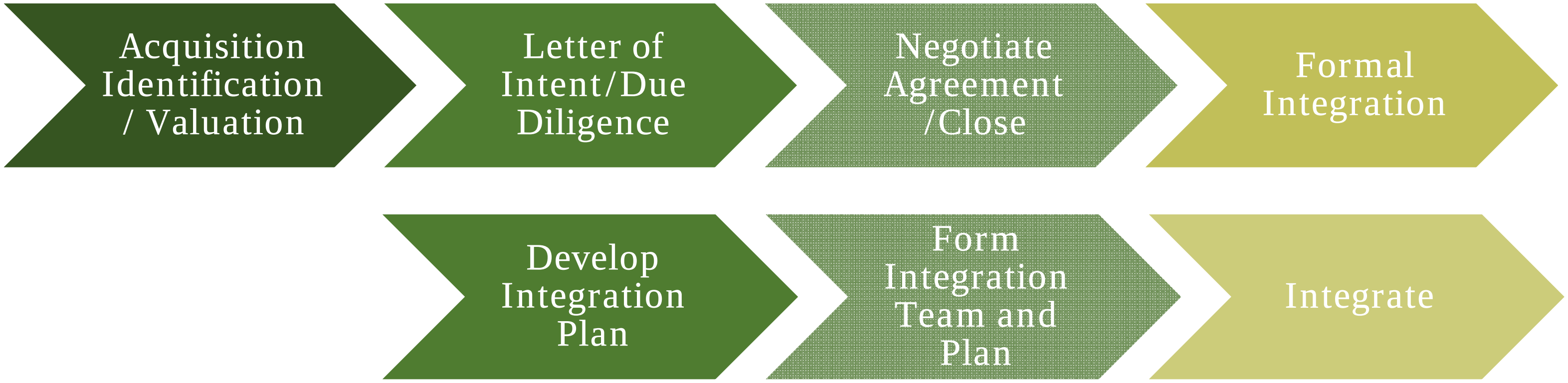
- Five phases of the process
  I. Exploratory due diligence / Valuation / IOI
  II. Transactional tasks / Formal due diligence process / Purchase agreement negotiation
  III. Approval / Sign purchase agreement / Announcement
  IV. Organizational / Integration planning / Closing
  V. Integration
- Timing
  - Phase I: 30 days
  - Phase II – IV: 45 to 90 days
  - Phase V: 90 days to completion

Formal Due Diligence

Functional Area	Summary of Key Tasks
Legal	Review and assess all corporate documents, company contracts, legal proceedings, compliance, environmental information
Financial	Review and assess all financial statements and reports, forecasts, accounting work papers, AR records, inventory records, PP&E, rebate information
Human Resources	Review and assess all organizational charts, personnel files, employee handbook, turnover statistics, compensation plans, benefit plans, employment agreements, policies/procedures
Operations	Review and assess management reports and operating metrics, order flows, purchasing, inventory management, logistics
Sales	Review and assess sales methodology (inside, outside), territories, commissions, pricing, growth
Information Technology	Review and assess all company hardware and software, IT service agreements, IT personnel
Taxes	Review and assess tax work papers, federal, state, local and foreign tax returns, sales tax, property tax, payroll taxes
Safety / Environmental	Review and assess OSHA logs, workers' comp claims, incident rates, safety & training materials, loss prevention
Insurance	Review and assess all insurance policies (general, environmental, casualty, automotive, workers comp, crime), insurance contracts, claims history, reserves

Integration

- Determines whether or not the deal will be successful
- If you wait until the transaction has closed you are too late
- Need to utilize senior level resources



Integration Common Pitfalls

- Cultural misfires
- Hastily completing tasks to “check the box”
- Not including the target company in the planning process
- Not communicating clearly and often
- Too worried about the numbers
- Diligence information not properly evaluated and handed off
- Over delegation

Transaction Considerations

Transaction Structure Considerations

Use the ESOP as part of the acquisition structure or not?

Advantages

- Tax savings to the Acquirer
  - Acquisition financing can be repaid with tax deductible contributions to the ESOP
- Shareholders of the Target company may be eligible to defer capital gains on the sale
  - Acquirer could potentially offer a lower price

Disadvantages

- Additional complexity and costs
- Increased ESOP ownership %
- Increased regulatory requirements

ESOP M&A Considerations

- How powerful is tax shield?
  - Assuming a $25 million acquisition (fully debt financed)
  - Using the ESOP, the acquirer generates $3.8 million more cash flow in first 5 years through tax and interest savings

Using ESOP

	Year 1	Year 2	Year 3	Year 4	Year 5
EBIT	4.0	4.2	4.4	4.6	4.9
ESOP Contribution	(1.7)	(1.7)	(1.7)	(1.7)	(1.7)
Interest Expense	(1.9)	(1.8)	(1.6)	(1.4)	(1.2)
Pre-Tax Income	0.4	0.8	1.2	1.6	2.0
Income Taxes	(0.2)	(0.3)	(0.5)	(0.6)	(0.8)
Net Income	0.2	0.5	0.7	0.9	1.2
Plus: ESOP Contribution	1.7	1.7	1.7	1.7	1.7
Plus: Depreciation	1.0	1.0	1.0	1.0	1.0
Less: Capex	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)
Cash Avail. for Debt Service	1.9	2.1	2.4	2.6	2.9
5-Year Cumulative	11.9				

Not Using ESOP

	Year 1	Year 2	Year 3	Year 4	Year 5
EBIT	4.0	4.2	4.4	4.6	4.9
ESOP Contribution	0.0	0.0	0.0	0.0	0.0
Interest Expense	(2.0)	(1.8)	(1.7)	(1.6)	(1.4)
Pre-Tax Income	2.0	2.4	2.7	3.0	3.4
Income Taxes	(0.8)	(0.9)	(1.1)	(1.2)	(1.4)
Net Income	1.2	1.4	1.6	1.8	2.1
Plus: ESOP Contribution	0.0	0.0	0.0	0.0	0.0
Plus: Depreciation	1.0	1.0	1.0	1.0	1.0
Less: Capex	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)
Cash Available for Debt Servi	1.2	1.4	1.6	1.8	2.1
5-Year Cumulative	8.1				

Financing Considerations

- Sources of financing include:
  - Company cash/investments on hand
  - Senior debt based on acquirer’s financial condition
  - Senior debt based on target company’s financial condition
  - Mezzanine funds (junior capital)
  - Private equity funds
  - Seller financing

ESOP Governance Considerations

- Board approval is typical
- If additional shares are required to be issued for an acquisition, shareholder approval typically required
- For material transactions, a fairness opinion is advisable
- May also consider consulting an independent trustee

ESOP Integration

- Inclusion of target employees
  - Eligibility
  - Vesting
  - Availability of stock allocations
- Changes in repurchase liability

Transaction Structures

C-Corp. or S. Corp. Acquirer – No 1042 to Seller

- Can be structured as a stock or asset purchase
- Buyer can be acquiring company itself or acquisition subsidiary
- Seller can be individual shareholders or other entity

C-Corp. or S. Corp. Acquirer – No 1042 to Seller

Transaction Steps – Using ESOP

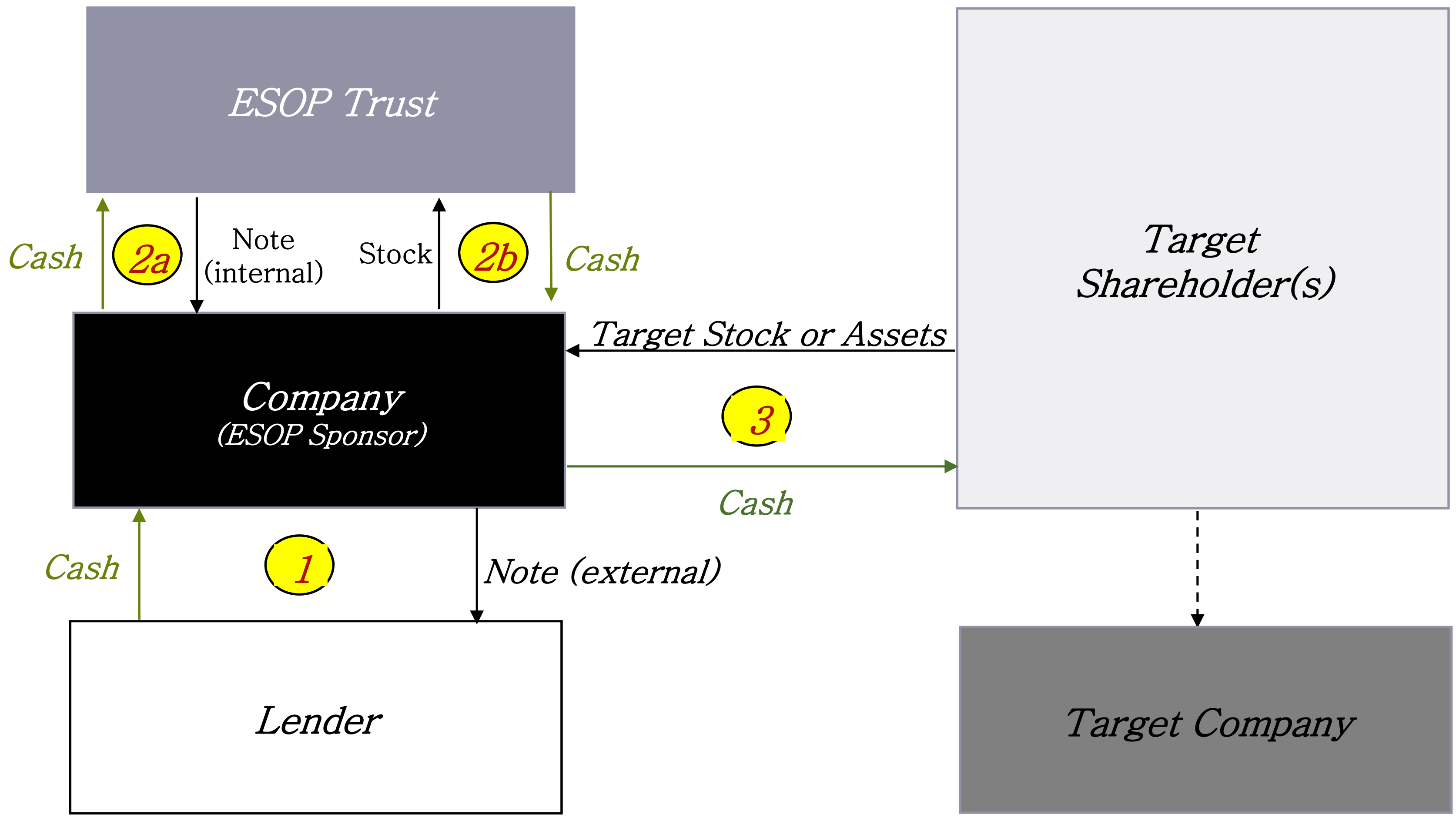
- Acquiring company borrows the funds required to purchase the target company (Step 1 on diagram) from a financial institution(s).
- Company loans the proceeds from the external loan to the ESOP who purchases newly issued shares of the acquiring company (Step 2a and 2b on diagram)
- The company then uses the proceeds from sale of new shares to the ESOP to acquire the stock or assets the target company (Step 3 on diagram)
- Going forward the acquiring company makes tax deductable contributions to the ESOP which are used to repay the external indebtedness

C-Corp. or S. Corp. Acquirer – No 1042 to Seller

Transaction Steps – Not Using ESOP

- Alternatively, the acquiring company can simply use the proceeds from the loan to acquire the stock or assets of the target company (i.e. skip step 2 in diagram)
  - no ESOP tax benefits to acquiring company realized
  - ESOP ownership % remains the same
  - If acquiring company is 100% ESOP owned S-corp., however, then the tax benefits of being 100% ESOP owned S-corp. will apply to target's earnings and there is really no need for Step 2

C-Corp. or S. Corp. Acquirer – No 1042 to Seller



C-Corporation Acquirer – 1042 to Seller

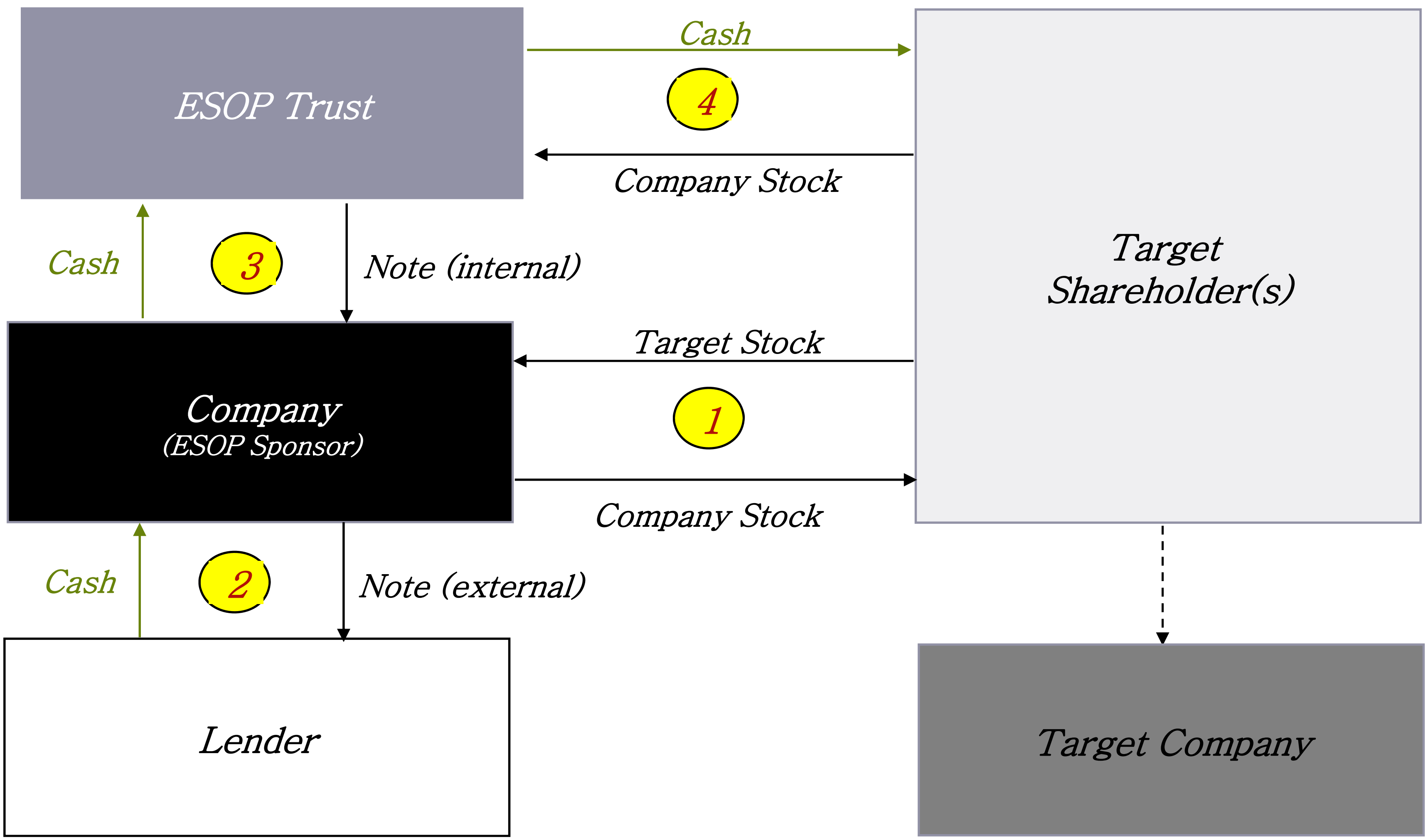
- The easy way does not work!
  - Target shareholders can’t just simply sell target company stock to acquiring company’s ESOP
  - The target shareholder needs acquiring company’s stock

C-Corporation Acquirer – 1042 to Seller

Transaction Steps

- Target Company is merged into Acquirer
  - Merger is tax-free under IRC Section 368(a)(I)(A)
- Shareholders of Target receive stock of Acquirer as merger consideration
- Shareholders of Target sell Acquirer stock to Acquirer's ESOP
  - Stock sale to ESOP can be tax-deferred under IRC Section 1042

C-Corporation Acquirer – 1042 to Seller



S-Corporation Acquirer – 1042 to Seller

- It is possible, but very complicated, for an S-Corp. acquirer to structure a transaction whereby the selling shareholders of the target company can elect 1042 capital gains deferral
- Basic concept is that target company (must be a C-Corp.) sets up an ESOP and target shareholder(s) sell to target company ESOP and then the acquiring company merges with the target company and the ESOPs are merged, as well

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