

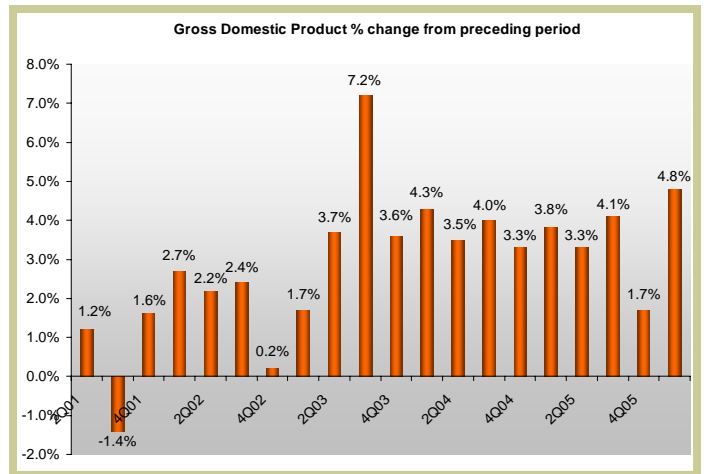
INSIDE THIS ISSUE:

National Economy: <i>Overview and Outlook</i>	1 & 2
M&A Trends: <i>January through May 2006</i>	2
Featured Article: <i>The Critical Role of M&A Auctions in Maximizing Your Business's Value</i>	1 & 3
Expert Tips: <i>Retention Strategies to Enhance Your Business's Value</i>	4
Trends to Act Upon: <i>Record Equity Capital Available</i>	4

ECONOMIC OVERVIEW & OUTLOOK Its Effect On Business Values

Overview

One of the most significant events in the first four months of 2006 centered around the implied announcement by the Federal Reserve Bank that interest rate hikes were likely to end. This signified a large divergence from previous FOMC policy statements in favor of further interest rate hikes. Another significant event was the increase in the price per barrel of oil to over \$70. As a result of these two events, the market indices sustained a strong surge, but were offset by fears about Iran's nuclear ambitions. In addition, the U.S. dollar hit a two-year high against the Euro and the Yen in the fourth quarter of 2005, after sustained weakness in 2004. However, the dollar started reversing this trend in April of 2006. The Insti-



tute for Supply Management's ("ISM") manufacturing survey indicated that the manufacturing sector grew (exceeded 50.0%) in May for the 35th consecutive month. The ISM composite index decreased 2.9% to 54.4% in May, from 57.3% in April.

Outlook

Despite the challenges in 2005, the economy in the first quarter of 2006 contin-

ued to expand. GDP growth during this period was its highest in two years. The outlook for the latter part of 2006 assumes that oil prices will drop as refineries damaged by Hurricane Katrina are expected to fully return to pre-Katrina production levels according to the EIA (as of May 9, 2006).

(article continued on page 2)

THE CRITICAL ROLE OF M&A AUCTIONS IN MAXIMIZING YOUR BUSINESS'S VALUE

By Enrique C. Brito, CFA, AVA, CM&A

The efficiency of any market is mostly based on the availability of price discovery mechanisms that enable a potential buyer to determine whether or not the price being paid for an asset represents a fair value. In the U.S., the securities markets are considered to be highly efficient because the prices are set daily by the forces of supply and demand in a process that is transparent to all participants. Indeed, whether we are buying stock in a publicly traded company or government bonds, we are always assured that the price being paid is the result of an open auction process in which buyers and sellers freely agree to transact.

In other markets, however, such as the one involving the purchase and sale of private middle market businesses, each deal stands on its own with seemingly little objective referential criteria for purchase and sale prices. But, this informal and subjective market can be quite efficient if certain rules are followed. In fact, when sellers are able to implement an effective auction process it is quite possible to craft a deal that can result in the realization of maximum value in what seems to be an inefficient market.

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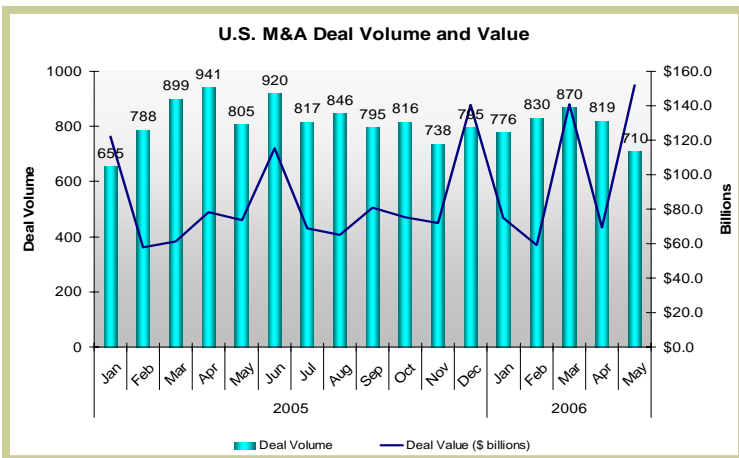
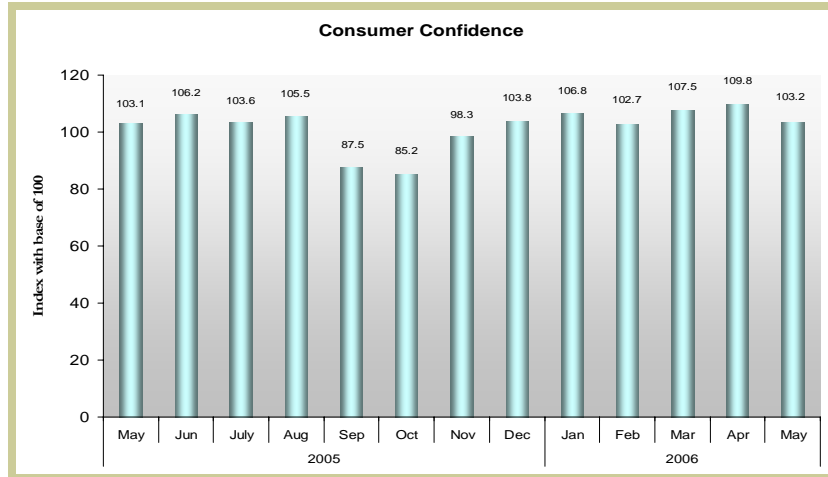
NATIONAL ECONOMIC OVERVIEW & OUTLOOK

(CONTINUED)

In addition, the Federal Reserve Board has indicated that it may soon end its current counter-inflation policies. Going forward, consumer expenditures may decrease as consumer confidence decreased approximately 2% in April (as compared to March). M&A Values and buyers abilities and willingness to do deals are directly linked to the health of the macro economy. The current trends would at least suggest sellers be alert to a possible decline in the M&A markets in the near future.

M&A TRENDS

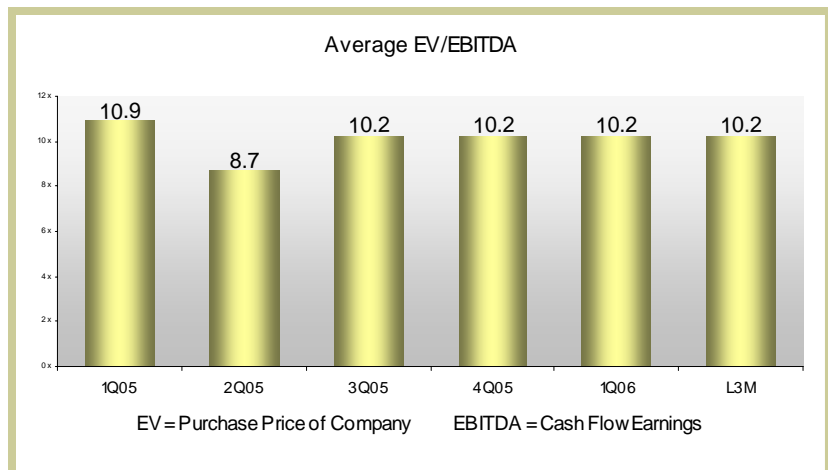
The top five industry sectors in the M&A market for the last four months have been information technology, consumer discretionary, industrials, healthcare, and financials. Within the information technology sector, computer software, supplies and services were the strongest segments in terms of announced deals. In the financials sector, brokerage, investment, and management consulting was the strongest segment in



terms of announced deals. One of the M&A deals to note in the financials sector, was the acquisition of Merrill Lynch's asset management division by Blackrock in exchange for Blackrock stock.

In the consumer discretionary sector, wholesale and distribution was the strongest segment in terms of announced deals. Average EBITDA multiples for announced deals have stayed relatively consistent with prior quarters in the last twelve months. For the past three quarters, EBITDA multiples have been averaging 10.2x. The ex-

ception was the second quarter of 2005 when the average EBITDA multiple was 8.7x. Average EBITDA multiples achieved a 12-month high of 11.0x in May. U.S. M&A deal values increased in May relative to April from \$69.5 billion to \$152 billion. In comparison to April 2005, total deal value was 106% higher for May 2006 with \$152 billion in total deal value and 710 deals versus \$73.7 billion in total.



THE CRITICAL ROLE OF M&A AUCTIONS IN MAXIMIZING YOUR BUSINESS'S VALUE

(CONTINUED)

In essence, orchestrating an effective auction in the M&A market involves getting two or more buyers simultaneously interested in a company. However, before that point is reached, a series of well-designed steps must be carefully implemented. The first step is to find actual as opposed to apparent buyers. This involves making sure that the buyers are qualified in terms of having the proper financial resources to carry out the transaction. It is not uncommon in M&A deals to find apparent buyers who are just interested in learning more about the details of the business and how it operates rather than committing themselves to the transaction. Hence, making sure that the owners are dealing with qualified buyers, who are both committed to the deal and who have the financial backing to close the transaction, is so essential.

The next step in an effective auction is to not price the business. It is inevitable that very early in the negotiation process a buyer will want to know the seller's expected price. However, the seller and its advisors are not really sure what the actual value of the company will be. The only way to find out is to test the market, as investment value from one buyer to the next will vary widely. Frequently, if the idea that the actual value is unknown is expressed openly and earnestly, a certain level of comfort and rapport may be established between the seller's advisors and the buyer. This is not to say that the seller's advisors should not prime the pump a bit when the occasion calls for it by saying something like: "We have seen deals in this sector with multiples of trailing EBITDA ranging from 6 to 12." Once a buyer is in, it is a lot easier to let the auction persuade the buyer as to the true market value of the business.

The final step in the process is for the seller and its advisors to evaluate the relative attractiveness of each of the offers received. At this stage is important for the seller to be concerned with the difference between price and actual transaction value. The broad range of consideration mixes that can be offered in a deal can easily confuse the distinction between these two factors. Hence, it is necessary for the seller to develop a framework by which to evaluate the various offers. One such framework, which can be very effective when comparing price and value, consists of considering the time value of money and the probability of collection associated with each offer. The time value of money analysis is subject to fairly objective calculations using market interest rates for each particular type of deferred obligation. The probability of collection is a somewhat subjective estimated percentage that is applied to the time value of money calculation. Although this approach is as much art as it is science, it provides sellers and their advisors with a quantitative approach to consider the total deal value associated with each offer.

Auctions have important implications for both sellers and buyers. The seller's advisors must be proficient in running the auction process so that they find the right buyer for the business and maximize transaction value. Buyers, on the other hand, must be careful not to be caught up in a bidding war that results in overpaying for the business. Many of the drivers behind the rise of auctions the increase in business values in the auction are unlikely to disappear soon and both buyers and sellers need to be aware of all the issues that they will face when entering these situation in M&A transactions.

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EXPERT TIPS

KEY EMPLOYEES – THE KEY TO SUSTAINABLE VALUE

Buyers are always concerned that key employees will leave as a result of a change in the management and ownership of the company. In addition, key employees often leave if they feel they have been overlooked or treated unfairly during the exit process, or if they are not comfortable with the new owners or managers.

The starting point in retaining key employees is identifying those who are essential to the business. The analysis should include the consideration of the impact that each employee would have on sales and profits, exposure of trade secrets, loss of employees to a competitor as well as morale and customer relations.

Once those employees who are key to the business have been identified, then a retention strategy can be designed based on one or more of the following compensation strategies:

EMPLOYEE COMPENSATION	EMPLOYEE TAXABLE INCOME	EMPLOYER TAX DEDUCTION
Salaries and Bonuses	Yes	Current
Nonqualified Deferred	Deferred	Deferred
Qualified Deferred	Deferred	Current
Qualified Fringe Benefits	No	Current
Dividends	Yes	No
Stock Bonuses	Yes	Current

TRENDS TO ACT ON

SIGNIFICANT PRIVATE EQUITY CAPITAL AVAILABILITY MEANS HIGHER BUSINESS PRICES AND MORE BUYERS

The record amounts of investment capital raised by financial buyers has increased the level of competition for high quality deals which in turn has elevated transaction multiples. In 2005, a record \$175 billion in capital was raised by private equity groups. This amount of capital raised is significant, particularly when it is compared to an average of \$30 billion per year raised from 2001 through 2004.

