



What Strategic Buyers Look for When Acquiring Small Businesses

PREPARED FOR

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May 8-10, 2006

DFI 
INTERNATIONAL
CORPORATE SERVICES

DFI Corporate Services is a strategic management consultancy offering solutions to clients in industries where business, government and technology intersect

Candidate Screening, Due Diligence, M&A Advisory Services: Select Activities

<p>\$110 Million</p>   <p>Strategic and financial Due Diligence of Simula Inc. Acquisition closed following DFI validation</p>	<p>\$755 Million</p>   <p>Strategic and financial Due Diligence of Stewart & Stevenson. Acquisition closed following DFI validation</p>	<p>Undisclosed</p>   <p>Due diligence of TransDigm, Inc. for Warburg Private Equity Group. Transaction closed following DFI recommendation</p>	<p>Undisclosed</p>   <p>Strategic and risk-based diligence assessment in support of bid for major regional media firm</p>
<p>\$92 Million</p>   <p>Strategic and financial Due Diligence of Specialty Defense. Acquisition closed following DFI validation</p>	<p>Undisclosed</p>   <p>Lead advisor and co-investor in 2004 acquisition of Formtek from Lockheed Martin</p>	<p>No Go Decision</p>   <p>Exploratory Diligence on Kistler for large aerospace Prime. Advised against acquisition due to revenue and contractual risk</p>	<p>\$240 Million</p>   <p>Exploratory Due Diligence of ILC Technologies. Resulted in lower valuation based on DFI review</p>



Agenda

2005 Defense Sector M&A Activity

Prime M&A Strategies

Prime Candidate Screening Processes

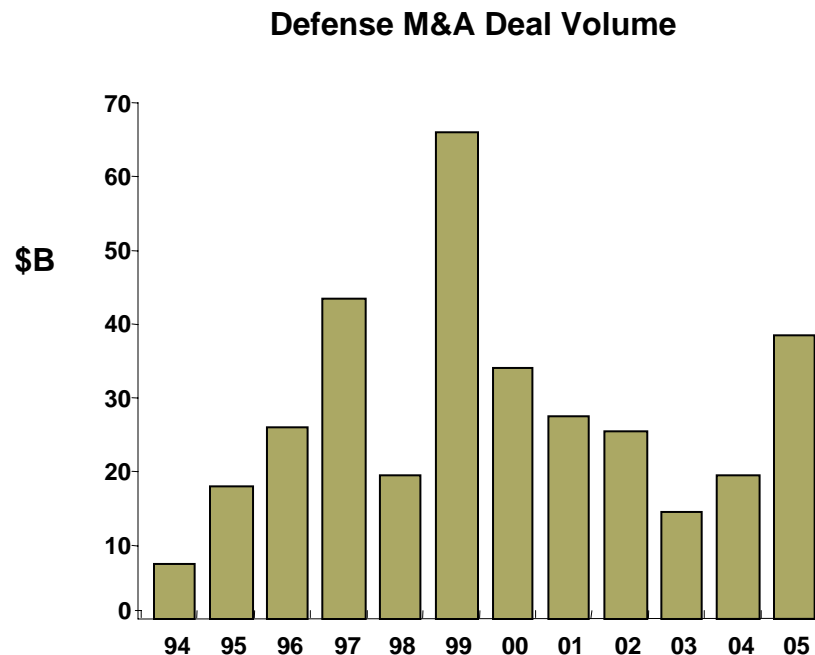
Due Diligence

Valuations

Trends for 2006 and Beyond

2005 was another extraordinarily active M&A year in the Defense and Homeland Security sectors, dominated by acquisitions of IT and intelligence companies

2005 Defense Sector M&A Activity



- **\$38B in defense-related deals in 2005**
 - Largest volume since \$65B boom in 1999
 - Nearly on par with 1997 in terms of total value, despite McDonnell-Douglas & Boeing and Hughes & Raytheon
 - BAE's \$4.2B buy of United Defense and GD's \$2.2B bid for Anteon dominated the news in 2005
- **IT was the predominant focus**
 - Primes see IT as a hedge against budget downturn
 - Not a stretch from defense systems; translatable between customer sets
- **Small firms with strong IC relationships or data mining technology were also hot targets in 2006**
 - ManTech's \$100M acquisition of Gray Hawk Systems
 - Choicepoint's \$90M purchase of i2
 - L3/Titan's \$42M buy of Intelligence Data Systems
 - Raytheon's purchase of UTD Inc.

Five factors generally drive a Prime's high-level M&A strategy

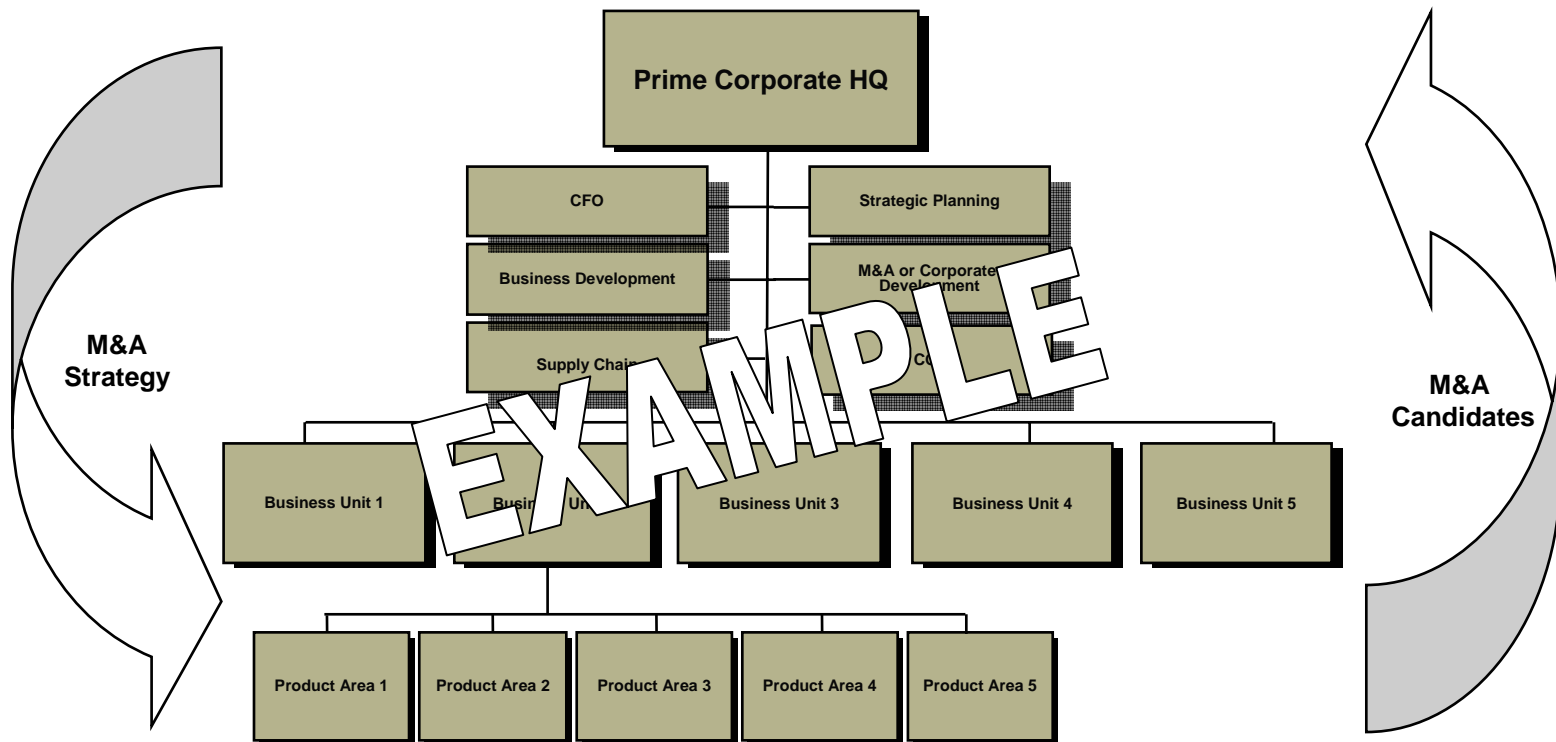
Prime M&A Strategies



Example M&A strategy: *Aggressive entry into Chem/Bio detection through fold-in acquisitions of leading CBRNE R&D firms in the \$50-\$100M revenue range*

The M&A strategy tends to flow down to operating units, who try to execute the strategy and identify acquisition candidates

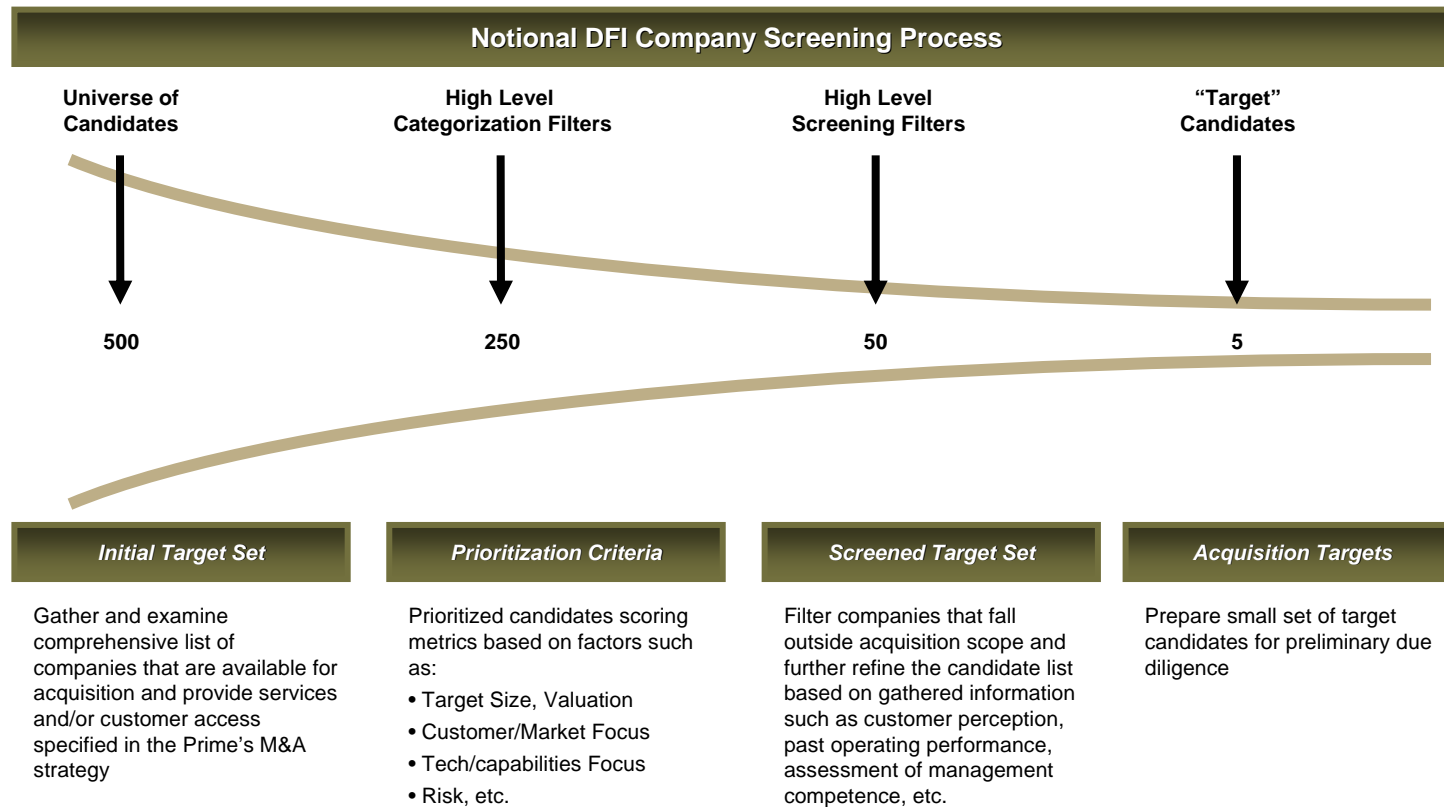
Prime M&A Strategies



Primes (both corporate and business units) will also engage banks or consulting firms to find and screen potential acquisitions

Primes will often take a tiered and systematic approach to selecting companies for further scrutiny from the large universe of acquisition candidates

M&A Candidate Screening



Primes will also find candidates through teaming, subcontracting, competitions or personal relationships ... these candidates usually bypass the screening

Primes will deep dive on select candidates by mining information obtained through the press, subscription databases, trade journals and industry contacts

M&A Candidate Screening

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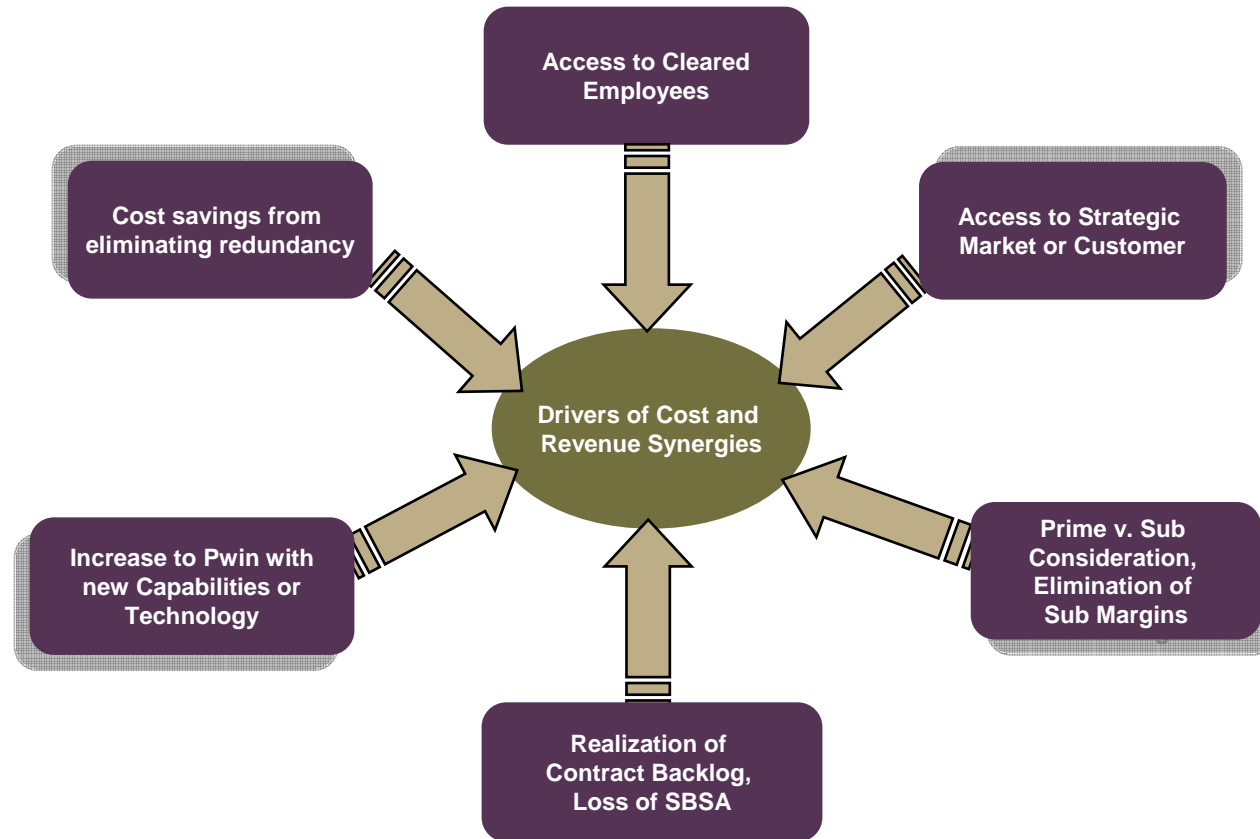
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Primes will use the data they can gather to estimate what they cannot; they will notify Seller or Seller's bank of Intent when ready to enter into Due Diligence

In Exploratory Diligence, Primes will use consultants and in-house expertise to verify Information Memorandum data and focus on strategic/financial synergies

Exploratory Due Diligence



Primes typically draw up an “Investment Thesis” that focuses on strategic fit and value and is used for executive level and/or Board level decision-making

In Formal Diligence, Primes follow a relatively standard process and/or checklist to verify financial, organizational, legal and customer assumptions

Formal Due Diligence

A. Organization and Good Standing

- The Company's Articles of Incorporation, and all amendments thereto.
- The Company's Bylaws, and all amendments thereto.
- The Company's minute book, including all minutes and resolutions of shareholders, directors, executive committees, other governing groups.
- The Company's organizational chart.
- The Company's list of shareholders and number of shares held by each.
- Copies of agreements relating to options, voting trusts, warrants, puts, calls, subscription convertible securities.
- A Certificate of Good Standing from the Secretary of State of the state where the Company is incorporated.
- Copies of active status reports in the state of incorporation for the past three years.
- A list of all states where the Company is authorized to do business and annual reports for the past three years.

B. Financial Information

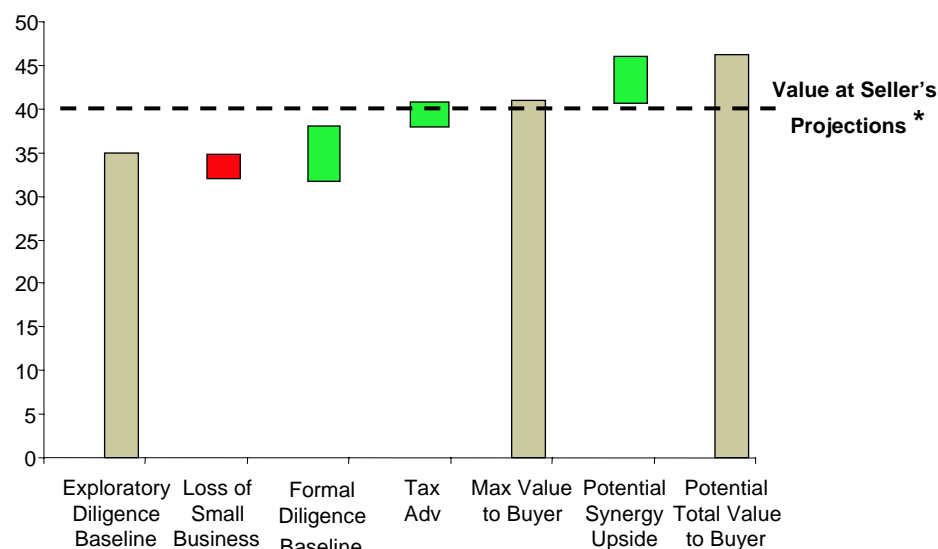
- Audited financial statements for three years together with the Company's Reports.
- The most recent unaudited statements with comparable statements to the prior year.
- The Company's credit report, if available.
- Any projections, capital budgets and strategic plans.
- A schedule of all indebtedness and contingent liabilities.
- A schedule of inventory.
- A schedule of accounts receivable.
- Etc.

Primes will send in a team of “Functional Captains” to explore and report on their respective sections of the Due Diligence checklist

Primes use standard valuation tools to reach their final price range, but vary in how they treat sensitivity analyses

Valuations

Hypothetical Prime Valuation Scenario *



* Based on ranges set by Market Trading multiples, Comparable Transaction multiples, complex NPV analyses

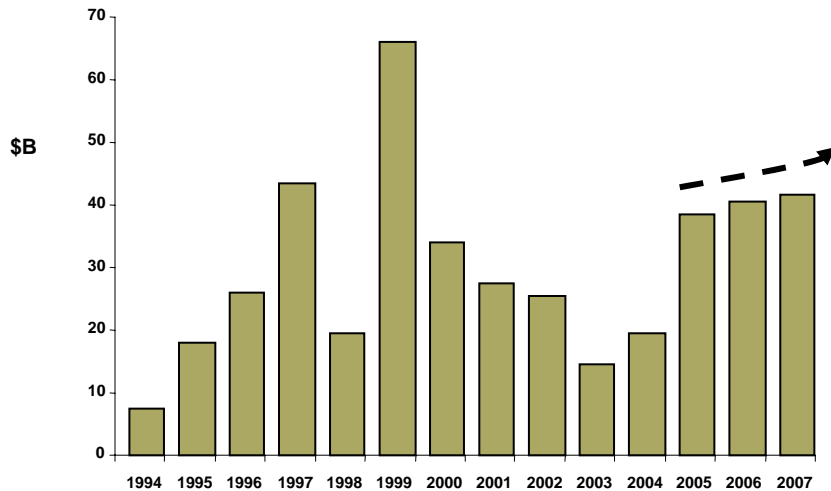
- Exploratory diligence may have resulted in “haircut” of seller’s projections, which are often overly optimistic
- Deep dives into contracts/opportunities drive baseline revenue projections; Primes run contract/backlog scenario analyses
- Research into redundant cost elements (or tax advantages) also drives valuation
- Extensive analysis and quantification of synergies ... Buyers try not to factor synergies into offer price
- Competition in M&A has driven Buyers to make offers closer to top end of identified Total Value (i.e. pricing in the synergies)

The final price is a combination of a number of factors: target baseline value, synergy value, intensity of competition, what a target is willing to accept, etc.

All indications point toward continued growth in M&A activity

Trends to Expect in 2006

Defense M&A Deal Volume



- Premiums for intelligence companies will continue to climb; IT premiums may drop
- Logistics and high-end product support companies will become sought after in FY07
- Foreign firms will continue to acquire, either directly or via newly acquired U.S. platforms
- Industry Primes will respond to a downturn in one of two ways:
 1. Consolidate (like LM, RTN, NG in mid-90s)
 2. Divest and shrink (like GD in mid-90s)
- **Either response means increased deal volume**

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Back Up

Quick Comments on Negotiations

Negotiations

- **Most consultants and managers step out of the process at this point**
- **Price, Deal Structure and Organizational Structure are the most common points of negotiation**
- **Primes will often structure “earn outs” so as to keep key leadership on board for 2 to 3 years**
- **The industry has been trending toward more Wholly Owned Subsidiary legal structures ... these allow autonomy *and* synergy realization ... usually best for small business owners who want to continue running their businesses even after the transaction**

Quick Comments on Post-Merger Integration

Post-Merger Integration (PMI)

- **It is critical to link PMI strategy to the strategic intent of the acquisition**
- **A good Buyer will begin building the Integration team even before the ink has dried, assigning a manager who has been in on the deal from the Exploratory Diligence phase**
- **Communications is key ... Buyer and Seller need to have a formalized and approved Communications plan (internal and external) ready to implement on Day One of acquisition**
- **Preserving the culture of a high growth acquisition is often overlooked and – in the case of a company acquired because of strong customer relationships – is the fundamental most important driver of value**