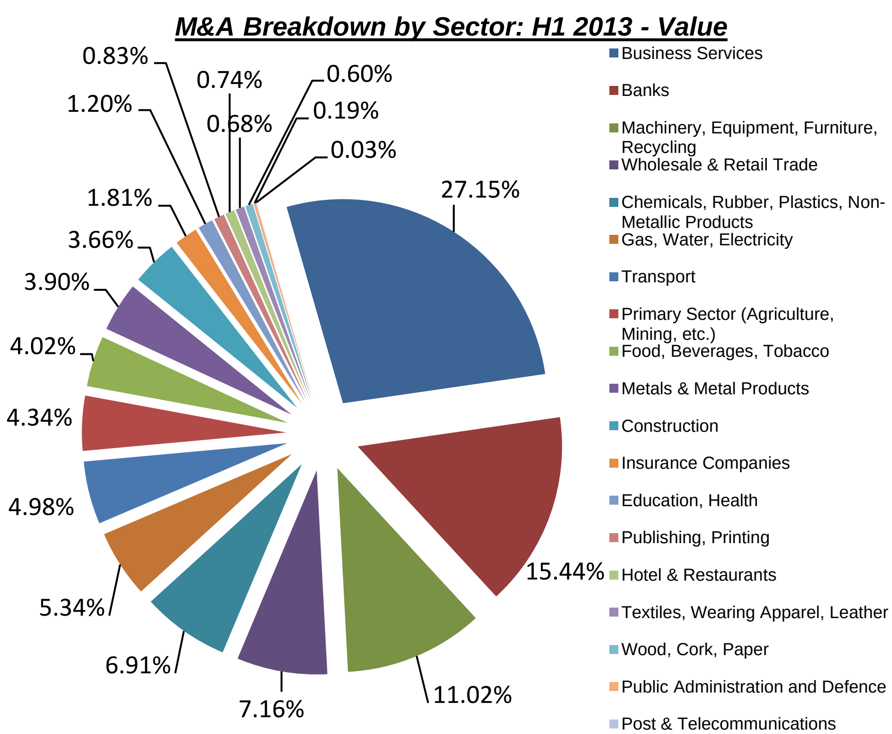
MARKET INSIGHT: M&A AND PRIVATE EQUITY REVIEW H1 2013

Increasing Value for Top Deals in M&A Marks the Close of H1 2013

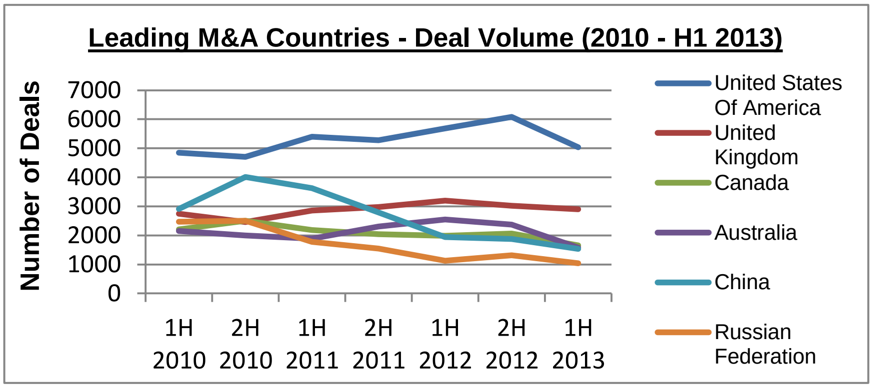
The M&A market's overall transaction volume and value decreased by 0.8% and 4.6%, respectively, from 2011 to 2012. In H1 of 2013, the M&A market's transaction volume and value declined 17.25% and 14.98%, respectively, from H2 2012. Despite these lackluster results, average value per transaction rose from $41.83m in H1 of 2012 to $50.75m in H1 of 2013. This represents a 21.32% increase in the average value per transaction during the period. With a rising average value per transaction level, it is no surprise that the M&A market has cooled slightly; however, the corporate strategics and investment funds with large cash accounts have been active in the M&A market. This trend has shifted the M&A market so that the top 20 transactions in each period now represent a higher concentration of the period's total transaction value. In H1 of 2012, the top 20 transactions represented 21.9% of the total M&A value. In H1 of 2013, the top 20 transactions accounted for 57.2% of total market value for the period.



The United States remains a hot spot of activity within the market and is seen by many investors as a haven for expansion opportunities. The size of the U.S. economy, its independent monetary policy, lower exposure to global macroeconomic uncertainty and the debt pressures in Europe are all factors that spur the M&A market in the USA. Consider this case in point: while parts of Europe remain in recession, many economists are projecting U.S. GDP growth in the 2.0% - 2.5% range for FY 2013. Optimism in the U.S. middle market has also been bolstered by an increase in consumer confidence, consistent GDP growth through the year and a reported reduction of the U.S. unemployment rate to 7.3% as of August 2013.

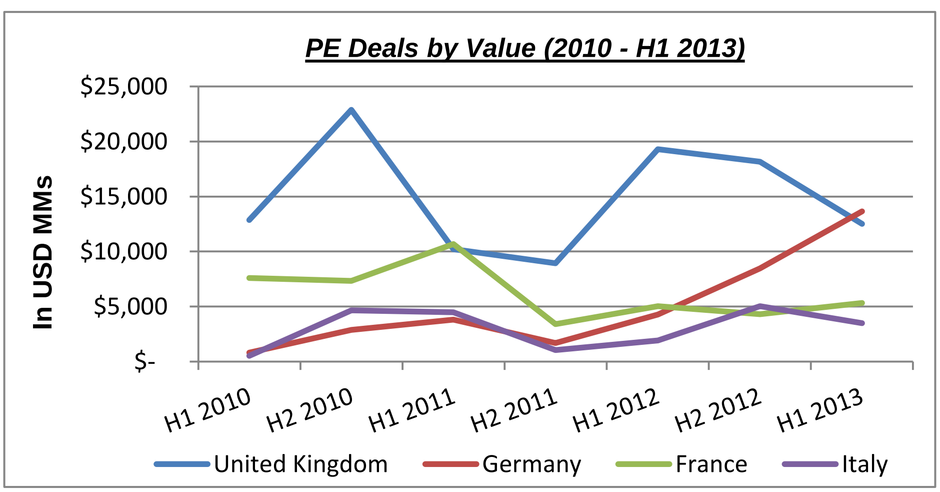
The most active sectors globally in H1 of 2013 continued to be Services ($410bn), Banks ($233bn) and Machinery & Equipment ($166bn), followed by Wholesale & Retail Trade ($108bn) and Chemical, Rubber and Plastics ($104bn). The Gas, Water and Electricity sector's transaction value grew 34.6% from H2 of 2012 to $80.7bn in H1 of 2013. This increase was led by the $10bn acquisition of NV Energy Inc. by Mid-American Energy Holdings Company, a subsidiary of Berkshire Hathaway.

Despite M&A slowdown, U.S. and Russian Federation See an Uptick in Value



With a global decline in volume and value in the M&A market of 17.25% and 14.98%, respectively, in H1 of 2013, most observers would expect that even the leading M&A countries would experience a similar decline. However, the data collected by Zephyr for its 2013 M&A review shows that the slowing M&A market has affected the leading M&A markets in some unexpected ways. The U.S. market declined by 17.32% in volume, in line with global declines, but experienced a 0.56% increase in value and a 21.62% increase in the average value per transaction. The U.K. M&A market declined by 3.97% in volume, far better than the global average, but it also suffered a severe decline in value of 28.77%, leading to a 25.83% decline in average value per transaction. M&A activity in Australia experienced the largest declines in both volume and value amongst the leading M&A countries, falling 33.53% and 43.49%, respectively, which yielded a 14.98% decrease in the average value per transaction. Canada and China struggled to maintain their market leadership positions after both had declines in volume above 18%, drops of over 30% in value and more than 19% in the average value per transaction. The most intriguing story to develop in H1 of 2013 has been the resurgence of the Russian Federation in terms of value. Despite a 20.75% decrease in volume, the market for M&A in the Russian Federation grew by 58.46% in value and achieved a 99.95% increase in average value per transaction[1].

Mixed GDP Growth in Europe Will Provide Cross Border Opportunities



The European Union offers a mixed bag of potential results for economic growth for the remainder of 2013. According to a study by PwC, the U.K., Germany and France are all expected to experience modest GDP growth of 1.7%, 0.8% and 0.4%, respectively, for FY 2013. Economic output in Southern European countries is projected to decline, with Spain, Portugal, Greece and Italy all experiencing negative real GDP growth rates between

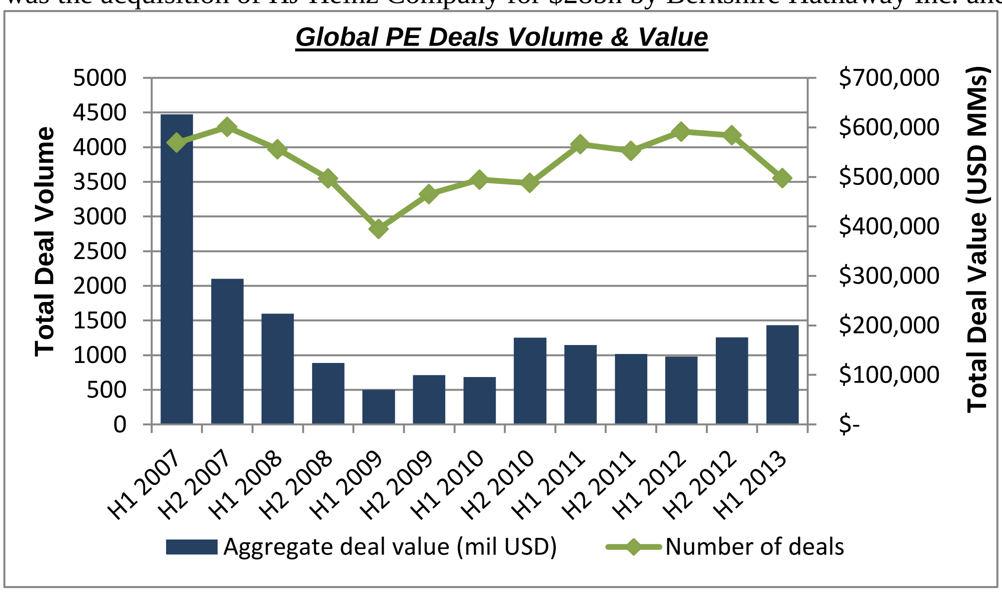
[1] Zephyr H1 2013 M&A Report

-0.9% and -4.2%.[2]

With these mixed economic conditions, it is no surprise that the performance of the PE industry in Europe was also a mix of good and bad. The U.K., one of the strongest European countries in the PE market, had a 31.13% decrease in transaction value from H2 of 2012 to H1 of 2013. Italy experienced a similar decline of 30.76% in PE transaction value. On the other hand, France and Germany experienced a 24.05% and a 61.38% lift in PE transaction values, respectively. With $13.65bn in transaction value, Germany became the top European country in terms of PE transaction value in H1 of 2013. While growth in Europe may remain subdued due to the overhang of the European debt crisis and austerity programs, opportunities are likely to increase across the EU as market participants react to these conditions. The private equity market in Europe should remain active as cash rich PE funds seek attractively priced assets. In addition, banks, industrial conglomerates and institutional investors will seek liquidity to boost capital positions or to shed non-core business units to reorganize for future growth.

Considerable Cash Raised for New Acquisitions by Private Equity Buyers

Global Private Equity value in H1 of 2013 rose 13.9% from H2 of 2012 to $200.4bn. In the same period, volume fell 14.8%. These factors led to a 33.72% increase in the average value per transaction during the period. This increase follows a 29.7% growth in the average value per transaction from H1 of 2012 to H2 of 2012. Despite the slowing activity in the Global PE market, overall value has continued to rise, leading to an average value per transaction level not seen since the H1 of 2008. In North America, PE investment volume decreased 14.2%, value increased 22.4% and average value per transaction increased 42.6%. The largest PE transaction recorded was the acquisition of HJ Heinz Company for $28bn by Berkshire Hathaway Inc. and 3G Capital Management..



Private Equity fund raising remained robust in H1 of 2013 according to Private Equity International (PEI). In H1 of 2013, PE funds raised $186.1bn, which represents a 30% increase year over year. Dan Gunner, Director of Research and Analytics at PEI, commented: "These numbers demonstrate the continuing recovering of private equity fundraising. It is likely that 2013's full-year fundraising total will outstrip any year since the crisis. However, our conversations with LPs tell us that they are increasingly exacting when committing to private equity funds. More and more, they will only collaborate with managers who can show an impressive record of accomplishment, which makes the fundraising environment as challenging as ever. Indeed, the market dominance of the largest funds to close is clear to see[3]."

We expect a continuation of active deal making within the Private Equity sector. Currently there is over $1 trillion in uncommitted capital in private equity funds worldwide, as many funds approach the close of their

[2] PwC Economic Forecasts
[3] Private Equity International

commitment periods. Private Equity firms will continue to sell older vintage assets to generate returns and move with speed to commit capital to transactions within remaining investment periods, thereby taking full advantage of the leverage offered by lower interest rate structures, to augment returns.

Impact of U.S. Fiscal & Monetary Policy

Without a clear view on taxation, regulation and the political direction of the country, many small and medium sized business owners in the U.S. remained on the sidelines of the M&A market. Large corporations also retained their cash. In December of 2012, the S&P 500 companies had over $1 trillion in cash on hand and were retaining 70% of earnings for future investment. During this time of uncertainty, privately held businesses with low tax bases came to market and significantly pushed up deal value in Q4 2012, as owners rushed to sell following the re-election of President Obama, anticipating that capital gains rates would increase further.

Now halfway through 2013, uncertainty surrounding fiscal policy is still a major concern for businesses, especially in the context of President Obama's proposed tax policies. One of the largest tax reforms on President Obama's agenda is the carried interest tax that mainly affects Private Equity firms. Under President Obama's budget proposal for 2013 and on, a general partner's share of income that results from an investment services partnership interest (ISPI) would be taxed as ordinary income after 2012[4]. According to commentary at taxpolicycenter.org, regarding President Obama's proposal, "Income that a partner earns from capital invested in the partnership and gain on the sale of an ISPI would not be recharacterized, provided that the partnership reasonably allocates income across invested capital and carried interests." The rationale is that general partners often do not invest their own capital, but rather offer investment management advice and expertise; therefore the carried interest is simply a payment for a set of services rather than profit from an appreciated asset, which should therefore be taxed as ordinary income. According to the Financial Times, President Obama's proposed changes to the carried interest tax has alarmed many PE fund managers, who are now trying to rewrite agreements with clients in order to protect themselves from the prospect of the tax hike[5].

Taxation vs. Valuation in the U.S.

While the fiscal cliff has been resolved in respect of personal income taxes, the actual fiscal policy, budget and spending levels of the U.S. government remain unresolved. This situation could lead to future tax increases, which could negatively affect the M&A market in the U.S.. Economists believe that it may be impossible to close the more than $1 trillion annual U.S. budget deficit without significant entitlement reform and / or large, broad based increases in taxation. As the U.S. government moves to close this gap, it is likely that further taxation will be imposed.

It is worthwhile to note that historically the U.S. income tax system has been set to raise tax revenue equivalent to approximately 19% - 20% of GDP. The U.S. government is currently spending 24 – 25% of GDP annually and funding this spending with annual borrowings of more than $1 trillion. It is widely expected that new tax revenues will be needed if the U.S. cannot reduce government spending, since continuing increases in the national debt are not viewed as sustainable.[6] Some economists have concluded that the only way to increase revenues for the federal government on a broad basis would be with the introduction of a value added tax (VAT) or national sales tax (NST). The introduction of a VAT or NST could be highly damaging to businesses and the resulting business valuations, since these taxes are seen as regressive, taxes that affect the already heavily burdened consumer. Opponents also fear that these tax proposals jeopardize additional economic and business growth by raising the cost of goods or services purchased. Median U.S. income has declined by 7% or $3,600 in

[4] Taxpolicycenter.org
[5] Financial Times
[6] CNN Money

real terms, over the past 16 years.[7] As such, any new consumer based tax would likely have a significant negative impact on sales, profits and the valuations of the affected business entities.

Current Low Interest Rates Favorably Impact Valuation

Ultra-low interest rates have been a significant catalyst in stimulating the volume and value of M&A transactions in the U.S. and abroad. The Federal Reserve continues to provide accommodative monetary policy to stimulate growth and job creation through the discount rate and its third round of quantitative easing. Recently, the Fed announced a target unemployment rate of 6.5%, which, when achieved, would signal the Fed to begin increasing interest rates.[8] This is an unprecedented announcement from the Fed. Given the current rate of job creation, this move indicates that low interest rates should prevail for H2 of 2013, but we do expect the FED to begin tapering its asset purchases by the beginning of 2014.

On Wednesday September 18, 2013, the Federal Reserve surprised markets by announcing it would not taper its monthly asset purchases. After the announcement, the Dollar Index dropped 1.1 per cent and the yield on the 10-year U.S. Treasuries fell 16 basis points to 2.69 per cent. In response to this, Erik Davidson, deputy chief investment officer for Wells Fargo Private Bank, said, “When money’s going to continue to be free for a while, it all plays into the valuations.” Ten-year treasury yields moved from 1.29 percent in July 2012 to a high of 3.005 percent on September 6, 2013. This large increase in rates, despite the Fed’s QE policy, shows that the market has been expecting rates to rise for some time now.

Since the Fed has decided not to taper its asset purchases, the U.S. is expected to hit its debt limit by mid-October according to Treasury Secretary Jack Lew. Unless Congress can reach an agreement to raise the debt ceiling, the U.S. government will default on its debt obligations and will be forced to shut down. The last time the U.S. defaulted on some of its T-bills was 1979. This caused interest rates to rise 60 basis points and remained elevated for many months thereafter. Although a U.S. default is unlikely, uncertainty surrounding the debt ceiling has pushed interest rates higher; hurting valuations. With record low rates behind us, a U.S. debt ceiling limit set to be reached by mid-October, and the likelihood of Fed tapering to start by the end of 2013, interest rates will continue to rise. Due to this, we think companies are likely to enter the M&A market for deals in order to lock in low interest rates before higher rates start to deteriorate deal value.

2013 – A Time of Patience in an Uncertain Environment

With a polarized and non-transparent congress and a president who seeks to alter much of the U.S. tax code, many businesses have turned their attention away from growth through acquisitions to a more organic growth centered strategy. According to a 2013 report on America’s economic engine by Deloitte, “40 percent of companies are deferring major investments as a result of the current uncertain business environment.” Due to the uncertainty arising from Capitol Hill, many businesses have taken H1 of 2013 to strengthen fundamentals and increase cash balances. According to Deloitte’s report, 34 percent of companies reported higher cash balances in 2013, which is up from 28 percent of businesses reporting higher cash balances in 2012. In reference to the uncertainty in Washington, Kevin McFarlane of Deloitte said, “The lack of progress on fiscal issues in Washington will likely continue to impact the pace of M&A.” Despite these factors, with strong balance sheets and a healthy supply of cash at their disposal, businesses are likely to increase their M&A activity once Capitol Hill clearly outlines its fiscal policies for the coming years[9].

European Outlook – A Path Set for Growth

---

[7] Bloomberg BusinessWeek
[8] Morgan Stanley
[9] Deloitte 2013 Report on America’s Economic Engine

Amidst new banking regulations, fierce austerity measures and political and social unrest in countries such as Greece, Europe has seen better days economically. Basel III guidelines have raised capital and liquidity requirements for banks considered Systematically Important Financial Institutions (SIFI), decreasing the amount of investments these banks can make. Across Europe, austerity programs are being scrutinized over their effectiveness, and in the face of these uncertainties, businesses have deferred investments in favor of hoarding cash. Despite these growing concerns, several factors in the European markets are aligning in such a way that we expect a large uptick in M&A and PE activity throughout the remainder of 2013 and into 2014.

First, According to a report by Deloitte, entitled, "Top 10 issues for Banking M&A in 2013", banks divesting non-core assets to meet liquidity and capital requirements will be, "particularly appealing to PE funds with investment management operations, which in addition to being cash-rich from an earnings perspective, are not as capital-intensive or as regulated as other lines of business." The study estimates these non-core assets held by Europe's banks to be $1.7 trillion in value.[10] Second, the UK market is experiencing resurgence in its economic health helped by a growing housing market and a declining unemployment rate. According to a CNN Money article, "the International Monetary Fund increased its forecast for UK GDP growth in 2013 to 0.9%." A strong UK will help Europe further rebound from the region's recent recession. Third, the political landscape in Europe is shifting from one based on austerity to an approach that attempts to balance austerity with growth. According to a report by CNN Money, Nicholas Spiro, Managing Director of Spiro Sovereign Strategy, stated: "The new quid pro quo in Brussels is less austerity – or at least more gradual fiscal consolidation – in exchange for more structural reform". In accordance with this shift, six countries including France, Spain and the Netherlands received one or two-year extensions to meet their respective budget deficit targets. The extensions were given in hopes that these countries will reform their product and labor markets in order to restore growth, create jobs and boost government revenues.[11] According to an article in Bloomberg News, Joachim Fels from Morgan Stanley London stated that the accumulating signs that austerity is yesterday's policy, at least in Europe, are signs of optimism about a global recovery in the second half of 2013.[12] Fourth, despite the current lull in M&A activity for many sectors in Europe, the telecom sector has been an enormous boost to activity so far in 2013. Around €60 bn in value has been announced in the telecom sector in H1 of 2013. On fiercewireless.com/Europe, Cyrus Kapadia of Banking at Lazard noted, "The European telecom markets are increasingly competitive and, with growth hard to come by, telcos need to continue to differentiate themselves and reposition their portfolios in the face of continued technology changes."[13] Currently, competitors in the telecom market are being pressured to increase earnings, as well as increase investments in 4G and LTE infrastructure. Since most companies in European telecom have been unable to keep up with both of these objectives, consolidation in this industry should continue. With an estimated $1 trillion in cash on balance sheets, record low interest rates and a European economy that is finally showing signs of growth, Europe should see an increase in M&A and PE transaction volume and value in H2 of 2013 and into 2014.

Conclusions:

Given all of the above factors, for investors and business owners seeking liquidity at good valuation, we believe that the current market offers very favorable circumstances for the execution of business development acquisitions or sale strategies. The forces of additional taxation and future potential increases in interest rates will impact valuation and could shift the market yet again. In the U.S., the prospect of increases in capital gains taxes will encourage private owners to consider sale options before further tax increases are sustained. In Europe, the implementation of deleveraging by banks and gradual implementation of Basel III will stimulate the sale of non-core or underperforming assets. We believe that Europe will continue to see a wave of distressed

[10] Deloitte Top 10 issues for Banking M&A in 2013
[11] CNN Money
[12] Bloomberg News
[13] FierceWireless.com/Europe

transactions similar to those experienced in the U.S. during the 2008 – 2009 timeframe. Investors and buyers with cash that can move swiftly and offer certainty of close will be best equipped to acquire assets for good value.

The existing policies of the U.S. Federal Reserve, The Bank of England and the European Central Bank will support prevailing low interest rates for the remainder of 2013, affording buyers with leverage for acquisitions at attractive rates. This could be short lived if global growth increases and the central banks eventually increase interest rates to stem inflation.

We also foresee greater activity among strategic acquirers who will be required to convert their cash stockpiles into shareholder value. New acquisitions that add additional value, including strategic capabilities, technologies, industry consolidations or entry into new lines of business, are likely to be more robust in H2 of 2013 than in H1 of 2013.

In closing, until fiscal policies are more clearly defined, we expect mid-market businesses will continue to hold cash and avoid high-cost acquisitions. On the other hand, with strong fundamentals, many large businesses will keep seeking additional investments despite the rising average value per transaction. Once U.S. and European fiscal policies are more clearly defined, we believe there will be a rise in both M&A volume and value in H2 of 2013 and into 2014.

* * *

Since 1986, Winchester Capital has provided bespoke research, Private Equity and M&A advisory services to our clients, which include multi-national corporations, investing institutions, private equity investors and privately held companies. Requests for strategic research, acquisition or divestment planning or transaction advisory services can be confidentially communicated to Jeremy R. De Peters, Managing Director jeremy.depeters@winchestercapital.com and Ceasar N. Anquillare, CEO ceasar.anquillare@winchestercapital.com. For further information concerning client services, please e-mail Pippa Smith, Director of Corporate Communications pippa.smith@winchestercapital.com.

This research is not offered as advice or guidance for investment purposes. The information contained herein has been compiled from publicly available sources at the time of publication and may be subject to change without notice.

Winchester Capital

Strategic Research and Advice for International Merger, Acquisitions & Strategic Alliances

Winchester House
445 Orange Street
New Haven, CT 06511-6202
Tel: 203-787-5029
Fax: 203-785-0018

33 St. James's Square
London SW1Y 4JS
United Kingdom
Tel: +44 (0)207 661 9372
Fax: +44 (0)207 661 9798