

Small Cap Research

QUANTITATIVE ANALYSIS

Searching For Buyout Candidates

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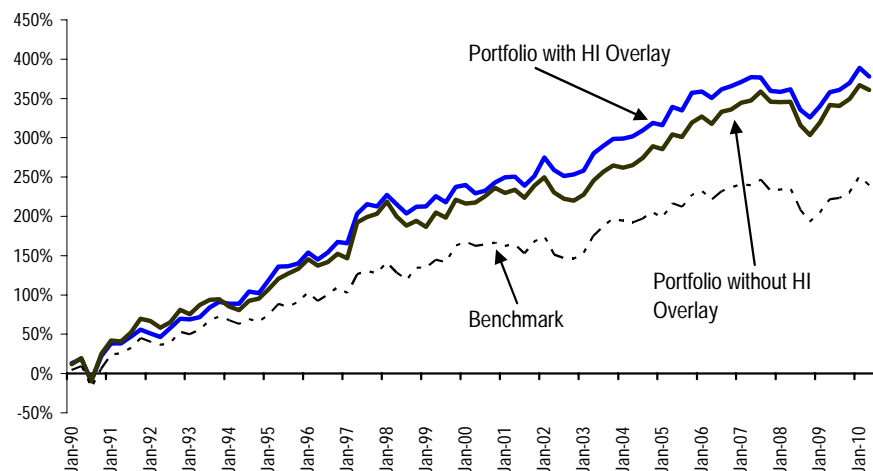
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- M&A Interest and Activity Rising:** There is currently a large amount of interest in buyout candidates as we observe rising M&A activity. We notice that cash and short term investments as a percentage of assets and market cap is at its highest level among large corporations in the past twenty years. We also find that historically as deal activity increases, acquisitions are made increasingly in the space outside of the acquirer's base industry. Our research also shows that the percentage deals done outside their current industry is related to the profit margins of the S&P 500 companies.
- Buyout Strategy:** We analyze metrics that have traditionally emphasized buyout targets and we construct a basket of 30 stocks from the Russell 2000 universe excluding financials sector. We also overlay a Herfindahl index based method for selecting concentrated industries for an enhanced strategy. This enhanced strategy historically returns an average of 4.6% quarterly compared to the core buyout strategy's return of 4.4%. Both these strategies handily beat the benchmark's average quarterly return of 2.9%.
- Current Basket:** As we noted above that a buyout based strategy outperforms during periods of high deal count. We provide a list of current buyout candidates favored by our model assuming an increase in deal activity over the remaining months in 2010.

Exhibit 1: Cumulative Returns of Buyout Strategy over Benchmark

Benchmark: Russell 2000 excluding Financials, quarterly rebalance



Source: Credit Suisse Small Cap Research

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Outlook

Recently we have observed a large amount of interest in buyout candidates. M&A activity is expected to rebound for a variety of reasons. First, we notice that cash and short term investments as a percentage of assets and market cap is at its highest level among large corporations in past twenty years. High cash levels are great for liquidity but it's a poor vehicle for future returns especially in a low interest rate environment and a rebounding economy. We anticipate that if the baseline scenario for the economic recovery plays out, large corporations will be looking to deploy their cash to buyout small to mid size companies.

We also find that historically as deal activity increases, acquisitions are made increasingly in the space outside of the acquirer's base industry. According to our thinking, an intra industry merger is likely when margins are depressed and the acquirer is looking for large synergies to improve their business structure. On the other hand, an acquisition outside the industry is likely to occur when margins are high and management is trying to bolster business even further by expanding into other areas. We observe that the percentage of external deals is related to the margin of the S&P 500 companies (Exhibit 4). Higher margins lead to higher deals external to acquiring company's industry.

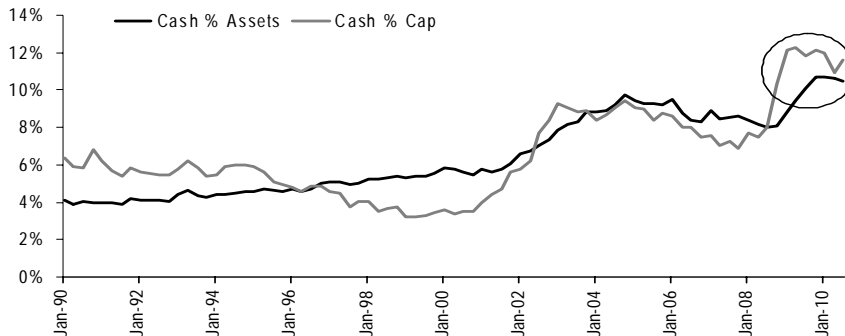
We believe that the period of easy margin expansion that is associated with the early part of a recovery is now over and the competition for additional market share is going to be high in the future. This leads us to believe we're primed for a recovery in the M&A activity in the small and mid cap space. The major risk to this scenario is a sharp decline in global economic activity. Exhibit 3 and Exhibit 4 include deals greater than \$10MM with the buyer/seller/unit in the North American region.

If the baseline scenario for the economic recovery plays out, large corporations will be looking to deploy their cash

As deal activity increases, acquisitions are made increasingly in the space outside of the acquirer's base industry

Exhibit 2: Cash as percentage of Market cap and Assets

Index: S&P 500 EX Financials

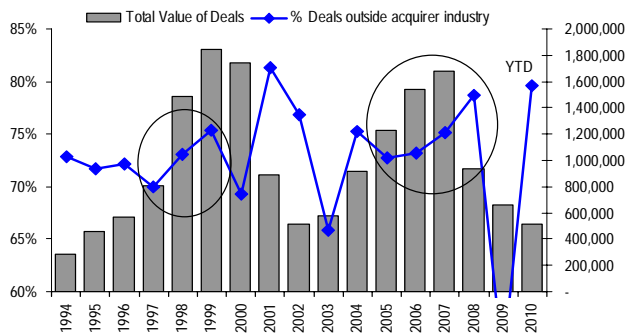


Source: Credit Suisse Small Cap Research

The percentage deals done outside their current industry is related to the profit margins of the S&P 500

Exhibit 3: % Deals outside Acquirer industry

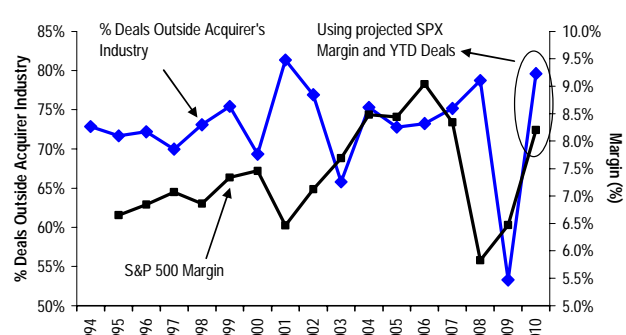
External deal are defined as target outside the acquirer 3-digit SIC



Source: Mergerstat, FactSet, CS Small Cap Research

Exhibit 4: % External Deals Vs SPX Margin

External deal are defined as target outside the acquirer 3-digit SIC



Source: Mergerstat, FactSet, CS Small Cap Research

Buyout Target Factors

Every buyout situation is unique and the characteristics of the transaction's mechanics often depend on factors such as the situation and positioning of the target company to the financing requirements required to complete the transaction. In this report, we isolate the factors that are inputs to the target identification process and seek out the most attractive publicly traded companies.

Buyout Target Candidate Criteria

- Steady & predictable cash flows post acquisition
- Value in target company (EV/EBITDA)
- Low cost of financing available for target company
- Secure market position for company and industry
- Sources of additional cash from target company
- Potential for expense reduction
- Viable exit strategy

We quantify metrics that highlight buyout target candidate criteria

We examine these factors closely in [Exhibit 5](#) and systematically quantify the metrics that highlight these factors. We use these factors in an empirical test to check for the historical performance of companies highlighted by these characteristics.

We select the Russell 2000 (excluding Financials) as our universe as it makes for a very logical space in which acquirers seek potential targets. We select the top 30 companies that score favorably on the combination of factors outlined in [Exhibit 5](#). While the typical return for buyouts is sought between 3-5 years, we reduce our investment horizon for this study – we rebalance our portfolio quarterly with holding period of one quarter. We find that this strategy works well and provides returns during the holding period which is well above the corresponding benchmark performance.

Exhibit 5: Core Buyout Target Identification Characteristics

See [Buyout factor relative weights](#) section for weights assigned to these factors

LBO Target Characteristics	Reason	Measurement
Steady & Predictable cash flows	Reduced uncertainty meeting interest obligations post buyout	Stable or upward trending Free Cash Flows with low variability
Low Enterprise Value/EBITDA	Increases probability that cash flows will cover purchase price	Low Industry relative EV/EBITDA ratio
Tangible Assets for loan collateral	Large tangible assets means low cost of financing for acquirer	Industry relative Total Assets - Intangible assets
Minimal future capital requirements	Increased chances that cash is used for debt repayment	Low industry relative CAPEX requirements
Limited current working capital requirements	Increased chances that cash is used for debt repayment	High industry current working capital
Clean balance sheet with little debt	Increased chances that cash is used for debt repayment	Low Net Debt/EBITDA ratio
Secure market position (Margin Sustainability)	Ensures stability of cash flows post acquisition	High operating margins with low standard deviation variation of margins on trend
Secure market position (Revenues)	Ensures stability of cash flows post acquisition	Stable or upward trending revenues
Divestible assets	These can be turned into a source of cash	Very company specific - not measurable
Potential for expense reduction	Reducing expenses via synergy/better management	Realizing synergies is dependent on acquirer - not measurable
Viable exit strategy	Ensures high return on equity for acquirer	Dependent on acquirer - not measurable

Source: Credit Suisse Small Cap Research

An Enhanced Buyout Strategy

We use the concept of industry concentration measured by the Herfindahl Index (HI) to add an enhancement to our previous presented core buyout strategy (Searching for Buyout Candidates, Apr 27, 2010). We ensure that the strategy now selects companies from industries that have high concentration ratios (high HI values).

A high concentration ratio in an industry indicates a higher barrier to entry in that particular industry. Our core buyout strategy had strong historical performance, when we enhance our core strategy using Herfindahl Index for an industry, we improve the strategy further. A small company in a highly concentrated industry is an ideal takeover candidate for an acquirer as it exhibits solid performance in an industry with a high barrier to entry.

We find that our enhanced strategy returns an average of 4.6% on a quarterly holding period compared to 4.4% for the previous strategy. Both of them handily beat the average return for the benchmark which is at 2.9%.

Adding a Herfindahl Index overlay improves the core buyout strategy

An enhanced strategy using a Herfindahl Index overlay returns an average of 4.6% per quarter compared to 4.4% and 2.9% for the strategy without the overlay and the benchmark, respectively

Exhibit 6: Relative Comparison of our Buyout Strategies versus the Benchmark

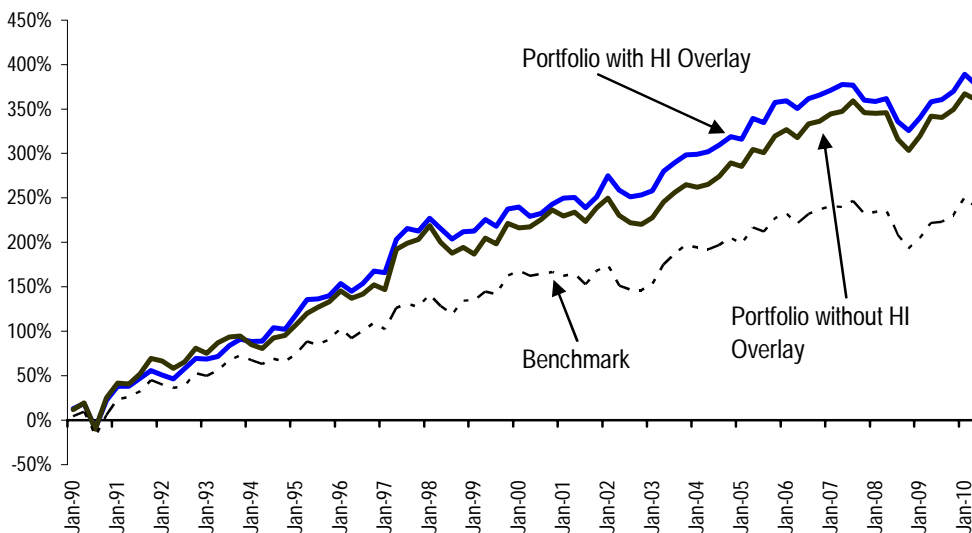
Analysis of Quarterly Returns – the benchmark is the Russell 2000 excluding Financials

Metric	Portfolio Return (with HI constraint)	Portfolio Return (without HI constraint)	Benchmark
Quarterly Return	4.61%	4.40%	2.93%
Std Deviation	11.70%	12.54%	10.76%
Hit Ratio	68.29%	64.63%	63.41%
Annualized Sharpe Ratio	0.72	0.61	0.45

Source: Credit Suisse Small Cap Research

Exhibit 7: Cumulative Returns of Buyout Strategy over Benchmark

Benchmark: Russell 2000 Ex Financials. Quarterly holding period



Source: Credit Suisse Small Cap Research

Current Stock List

Based on the factors outlined earlier for the buyout portfolio, we isolate this list of companies from the Russell 2000 universe (excluding financials). We recommend this portfolio to play a buyout based theme in the publicly traded small cap space.

Exhibit 8: Buyout Stocks Portfolio – From the enhanced model

Universe: Russell 2000 excluding Financials – as of 07/31/2010

Ticker	Name	Sector	Market Cap (\$MM)
DBRN	DRESS BARN INC	Consumer Discretionary	1,898
BKE	BUCKLE INC	Consumer Discretionary	1,220
PLCE	CHILDRENS PL RETAIL STORES INC	Consumer Discretionary	1,160
WTSLA	WET SEAL INC	Consumer Discretionary	338
TVL	LIN TV CORP	Consumer Discretionary	178
RDK	RUDDICK CORP	Consumer Staples	1,756
PSMT	PRICESMART INC	Consumer Staples	813
REV	REVLON INC	Consumer Staples	610
VLGEA	VILLAGE SUPER MKT INC	Consumer Staples	192
REX	REX AMERICAN RESOURCES CORP	Energy	158
CHE	CHEMED CORP NEW	Health Care	1,224
ODSY	ODYSSEY HEALTHCARE INC	Health Care	904
AMED	AMEDISYS INC	Health Care	762
LHCG	LHC GROUP INC	Health Care	410
PMC	PHARMERICA CORP	Health Care	390
AFAM	ALMOST FAMILY INC	Health Care	244
AOS	SMITH A O	Industrials	1,397
AMSC	AMERICAN SUPERCONDUCTOR CORP	Industrials	1,388
TGI	TRIUMPH GROUP INC NEW	Industrials	1,249
AIR	AAR CORP	Industrials	670
MFW	M & F WORLDWIDE CORP	Industrials	531
HEI	HEICO CORP NEW	Industrials	524
AVAV	AEROVIRONMENT INC	Industrials	516
DM	DOLAN COMPANY (THE)	Industrials	344
CYMI	CYMER INC	Information Technology	998
HL	HECLA MNG CO	Materials	1,306
ARJ	ARCH CHEMICALS INC	Materials	880
CGC	CAPITAL GOLD CORP	Materials	182
KMGB	KMG CHEMICALS INC	Materials	172
GNCMA	GENERAL COMMUNICATION INC	Telecommunication Services	475

Source: Credit Suisse Small Cap Research

Herfindahl Index

The Herfindahl index (HI) is used to measure industry concentration and is calculated as the sum of square of the market share of the industry components. We define an industry as the 3 digit SIC code of the company and treat the ratio of the company's trailing 12 month revenue as the market share. For every vertical, we consider the companies in the Russell 3000 as it is a close approximation of the U.S. equity universe.

The obvious drawback in this method is if the leading market share is captured by a private company, however, we believe that this method calculates the industry concentration to a satisfactory level. We also ensure that the vertical we select contains more than 10 companies.

Exhibit 9 shows the HI values of the 25 most concentrated industries in the Russell 3000. We display the financial industries even though we exclude them from the current strategy.

The Herfindahl index (HI) is used to measure industry concentration

Exhibit 9: Herfindahl Index for companies in the Russell 3000

Higher Herfindahl index value implies a higher concentration of companies and a higher barrier to entry

Industry Description	SIC Code	# Companies	Herfindahl Index
INSURANCE AGENTS, BROKERS, AND SERVICE	641	12	0.63
VARIETY STORES	533	11	0.53
TRUCKING AND COURIER SERVICES, EXCEPT AIR	421	20	0.49
GOLD AND SILVER ORES	104	11	0.49
NEWSPAPERS: PUBLISHING, OR PUBLISHING AND PRINTING	271	12	0.44
HOME HEALTH CARE SERVICES	808	12	0.44
ELECTRICAL INDUSTRIAL APPARATUS	362	15	0.43
RADIO AND TELEVISION BROADCASTING STATIONS	483	15	0.40
PERSONAL CREDIT INSTITUTIONS	614	12	0.39
SOAP, DETERGENTS, AND CLEANING PREPARATIONS; PERFUMES, COSMETICS,	284	16	0.35
HOLDING OFFICES	671	30	0.33
PLASTICS MATERIALS AND SYNTHETIC RESINS, SYNTHETIC RUBBER, CELLULOSE	282	13	0.32
MOTOR VEHICLES AND MOTOR VEHICLE EQUIPMENT	371	33	0.32
GROCERY STORES	541	12	0.32
WATER SUPPLY	494	12	0.31
SPECIAL INDUSTRY MACHINERY, EXCEPT METALWORKING MACHINERY	355	16	0.29
TELEPHONE COMMUNICATIONS	481	36	0.25
PERSONNEL SUPPLY SERVICES	736	16	0.25
BEVERAGES	208	14	0.25
FAMILY CLOTHING STORES	565	11	0.24
DOLLS, TOYS, GAMES AND SPORTING AND ATHLETIC GOODS	394	11	0.24
LIFE INSURANCE	631	18	0.23
PETROLEUM REFINING	291	14	0.23
ELECTRICAL GOODS	506	12	0.22
AIRCRAFT AND PARTS	372	16	0.21
MISCELLANEOUS SHOPPING GOODS STORES	594	15	0.21

Source: Credit Suisse Small Cap Research

Core Buyout Identification Scheme

We use the guidelines discussed in Exhibit 5 to assign weights to factors that we think will highlight buyout target companies from our selected universe. This is the foundation of our core buyout strategy. The factor weights are provided in Exhibit 10.

All fundamentals based growth factors used to determine the company and industry positioning is measured over a period of two fiscal years prior to the selection date.

Exhibit 10: Factor Weights for Identifying Buyout Targets

Factor	Favorable Score	Weight
Revenue Growth Average	High	14%
Revenue Growth Coefficient of Variation	Low	6%
FCFF Growth Average	High	14%
FCFF Growth Coefficient of Variation	Low	6%
Average Margin	High	7%
Margin Coefficient of Variation	Low	3%
Company & Industry Positioning		50%
EV/EBITDA	Low & Positive	10%
Tangible Assets	High	10%
Capital Expenditures (TTM)	Low	10%
Current Working Capital	High	10%
Debt/EBITDA	Low & Positive	10%
Industry Relative Financial Position		50%
Total Weight		100%

Source: Credit Suisse Small Cap Research

References

Credit Suisse Small Cap Research: Searching for Buyout Candidates. Apr 27, 2010

Credit Suisse Small Cap Research: The M&A Factor – Return on Capital Employed. May 22, 2009

Quantitative Research: Many Happy Returns (on Capital)? Nov 17, 2004

Companies Mentioned (Price as of 05 Aug 10)

A.O. Smith Corporation (AOS, \$54.75)
 AAR Corp. (AIR, \$16.98)
 AEROVIRONMENT INC (AVAV, \$23.71)
 ALMOST FAMILY INC (AFAM, \$26.40)
 Amedisys Inc. (AMED, \$26.70, NEUTRAL [V], TP \$30.00)
 American Superconductor Corp. (AMSC, \$30.58)
 Arch Chemicals, Inc. (ARJ, \$35.18)
 CAPITAL GOLD CORP (CGC, 3.75)
 Chemed Corp (CHE, \$53.71)
 Cymer Inc. (CYMI, \$33.79, OUTPERFORM [V], TP \$38.00)
 DOLAN CO/THE (DM, \$11.34)
 Dress Barn, Inc. (DBRN, \$23.72)
 General Communication (GNCMA, \$9.15)
 Hecla Mining Co (HL, \$5.10)
 Heico Corp (HEI, \$39.89)
 KMG CHEMICALS INC (KMGB, \$15.28)
 LHC Group (LHCG, \$21.85, NEUTRAL [V], TP \$28.00)
 Lin Television (TVL, \$5.65)
 M & F Worldwide Corp (MFW, \$27.47)
 Odyssey Healthcare, Inc. (ODSY, \$26.83)
 PharMerica Corporation (PMC, \$12.73, NEUTRAL, TP \$10.00)
 PRICESMART INC (PSMT, \$27.24)
 Revlon (REV, \$12.50)
 REX AMERICAN RESOURCES CORP (REX, \$16.03)
 Ruddick Corporation (RDK, \$35.99)
 The Buckle, Inc. (BKE, \$26.11)
 The Children's Place Retail Stores, Inc. (PLCE, \$41.84)
 Triumph Group, Inc. (TGI, \$74.83)
 VILLAGE SUPER MARKET-CLASS A (VLGEA, \$27.34)
 Wet Seal (WTSLA, \$3.32)

Disclosure Appendix

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