

American Enterprise Institute

Sarbanes-Oxley: A Review

Panel III: Do the costs of the Act outweigh the benefits?

May 5, 2004

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Hot topics at small- and mid-cap companies

The cost of remaining public, in both money and time is killing us

No analysts will cover us, trading is non-existent, stock options provide minimal incentive to management

We are a public company, why don't we have access to public capital markets

I'm worried about the additional personal risk to management imposed by Sarbanes-Oxley, is it really worth it to remain public?

I'd like to be able to make the right strategic decisions for the long term, without worrying about next quarters' earnings release

We are trading below book value, the market will not recognize the true potential of our company

Is the S-O Act driving an increase in going private transactions?

- The S-O Act was signed into law on July 30, 2002
- Grant Thornton examined 222 announcements of companies seeking to go private
 - April 2001 to July 2002 (pre S-O)
 - August 2002 to November 2003 (post S-O)
- Compiled from information provided by Thomson Securities Data

Analysis of 222 companies announcing intention to go private

- Median revenues - \$59 million
- Median market cap - \$30 million
- Median enterprise value - \$55 million
- Top 3 industries
 - Consumer
 - Information technology
 - Industrials

Analysis of closed transactions

- 60% of announced transactions actually closed
 - Represents 137 transactions
- Transaction size is a major success factor
 - Under \$25 million - 54% closed
 - Over \$100 million - 73% closed

Analysis of closed transactions (continued)

- **Management buyout**

- Most often proposed (67% of announcements), but least successful form - 55% closed

- **Private strategic buyers**

- Proposed in 28% of transactions – 74% closed

- **Self tender**

- Least used (5%), but most successful form – 82% closed

The typical successful transaction

- Revenues - \$80 million
- Market cap - \$40 million
- Fairly inexpensive (consistent with offered multiples and premiums)
 - Offering p/e – 16 times net income
 - Premium - 33% over prior week share price
 - Enterprise value - 5.5 times EBITDA

Common characteristics of companies having successful transactions

- Low market capitalization
- Thin trading volume
- Limited analyst coverage (not helped by reduced ties to investment banking)
- Strong projected cash flows
- Well-respected management
- Growth in private equity & valuations falling to levels where LBO models meet targeted return requirements, is clearly contributing factor

Key findings during the post S-O Act period

1. Number of companies seeking to go private increased by 30%
2. Median deal size halved from \$81 to \$39 million
3. Number of proposed management buyouts increased by 80%

The next wave is about to break...

- Year 1 costs of implementing S-O Act § 404 internal control reporting requirements
 - Internal
 - External consulting and software
 - Auditor attestation fees
 - Capital markets reaction to identification of significant deficiencies and material weakness

One more related uncertainty...

- Capital markets and non Big 4 international and regional CPA firms
 - Domestically and globally, only 4 CPA firms are accepted as auditors of large- and mid-cap companies, which raises potential choice, price, quality, and concentration risk concerns

Conclusion

“By going private, companies can greatly reduce their level of risk associated with shareholder litigation, while cutting costs and regaining a sense of control and confidentiality. For many companies, these benefits are very appealing.”

Ed Nusbaum

CEO

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