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MERGERS & ACQUISITIONS

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ENDANGERED SPECIES UPDATE

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ENDANGERED SPECIES UPDATE: THE EXTINCT, THE SURVIVORS, AND THE NEW WATCH LIST

Introduction

One year ago, the M&A group at U.S. Bancorp Piper Jaffray published a report describing the difficulties small public companies face in the equity markets. With limited analyst coverage and low trading liquidity, many well-run, small companies post significantly lower valuation multiples than both large caps and small, high-risk growth firms. Our conclusion at the time of the report was simple:

This is a secular, not cyclical trend and the undervaluation will continue. The best strategic move to increase shareholder value is to pursue a change of control transaction. Management and the Board should either sell their company to a large strategic acquirer, with the hope of gaining the buyer's higher trading multiple, or take the company private.

In this update report we test our original thesis and provide the "Darwin's Darlings Class of 2000," which is a list of what we view as the most undervalued, yet profitable and growing small cap public companies.

How Did The Class Of 1999 Fare?

Our 1999 Darwin's Darlings list compiled some of the most attractive, undervalued companies between \$50 million and \$250 million in market capitalization. After excluding specialized industries such as financial services, health care, and energy companies, we found 110 firms that had an annualized five-year EBIT growth in excess of 10%, yet were valued in the market at less than 7.0x EBIT. The summary statistics for the group are shown in the exhibit below:

Exhibit 1

DARWIN'S DARLINGS CLASS OF 1999—SUMMARY STATISTICS

(\$ in Millions)

	Market Capitalization	EBIT Multiple	5-Year EBIT CAGR	Number of Equity Analysts	Insider Holdings
Mean	\$115.2	5.6x	41.7%	3.1	46.8%
Median	105.0	5.8x	31.2%	3.0	48.7%

Source: FactSet and U.S. Bancorp Piper Jaffray research

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We predicted that a meaningful number of the Darwin's Darlings would pursue a major strategic or financial transaction. With their focus on large cap, growth companies, most institutional investors were uninterested in the typical Darling. The liquidity of small caps made investment prohibitive for fund managers who were responsible for increasingly large portfolios. As a result, these well-run companies were valued in the market at trading multiples that were *lower* than typical valuation multiples seen in the private M&A market. With this arbitrage opportunity and some concerned board members, many of these small caps were likely to "evaluate strategic alternatives." The actual activity of the group since early 1999 is shown below:

Exhibit 2

DARWIN'S DARLINGS ACTIVITY

	Number of Companies	% of Total
Sold		
- Strategic Buyer	16	14.5%
- Going Private Transaction	3	2.7%
Pursued Major Acquisition	18	16.4%
Announced Share Repurchase	20	18.2%
No Significant Action	53	48.2%

Source: FactSet and U.S. Bancorp Piper Jaffray research

About half of the Darwin's Darlings pursued some significant strategic alternative during the year. A significant percentage (19 of the companies) pursued a sale or going-private transaction to provide immediate value to their shareholders. Others are attempting to "grow out of" their predicament by pursuing acquisitions, and many are repurchasing shares. However, about half of the Darlings have yet to take any significant action. Presumably, these companies are ignoring their current share price and assuming that patient shareholders will eventually be rewarded through a reversal in institutional investing trends or, more likely, a liquidity event at some later date. The path chosen clearly had a significant impact on shareholder value.

The Sellers

The 19 companies that pursued a sale easily outperformed the Russell 2000 and achieved an average premium of 51.4% to their 4-week prior share price. The vast majority of transactions were sales to strategic buyers who were able to pay a handsome premium to the selling shareholders. In general, the acquirers were large cap public companies. By simply valuing the profits of a Darwin's Darling at their own market multiple, these buyers delivered a valuation to selling shareholders that far exceeded any share price the company might have independently achieved. Note in the summary statistics below that the average deal was at an EBIT multiple greater than 10x.

Exhibit 3

DARWIN'S DARLINGS SELLERS

Transaction Averages

(\$ in Millions)

Pre-Transaction Market Capitalization	\$130.0
Insider Holdings	46.5%
Number of Equity Analysts	3
Premium - 1 Day	20.3%
Premium - 1 Week	34.9%
Premium - 4 Weeks	51.4%
EBIT Multiple (LTM)	10.4x
EBITDA Multiple (LTM)	7.8x

Source: FactSet and U.S. Bancorp Piper Jaffray research

Examples of transactions include General Cigar Holdings (sold to Swedish Match AB), Omniquip International (sold to Textron Inc.), and Optek Technology (sold to Dyson-Kissner-Moran). The returns to shareholders are evident in these sample share price graphs shown on the next page.

Exhibit 4

GENERAL CIGAR HOLDINGS

Weekly Stock Price/Volume Performance

12/31/98 - 5/12/00

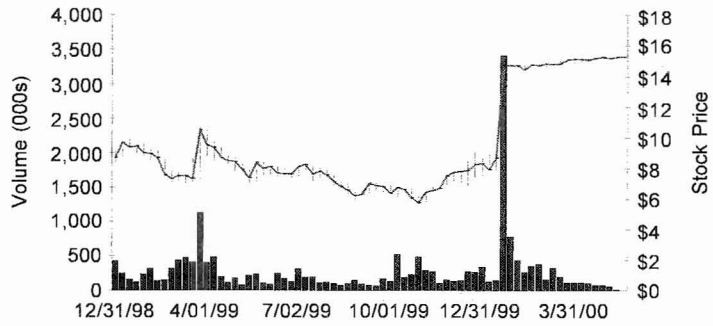


Exhibit 5

OMNIQUIP INTERNATIONAL INC.

Weekly Stock Price/Volume Performance

12/31/98 - 12/31/99

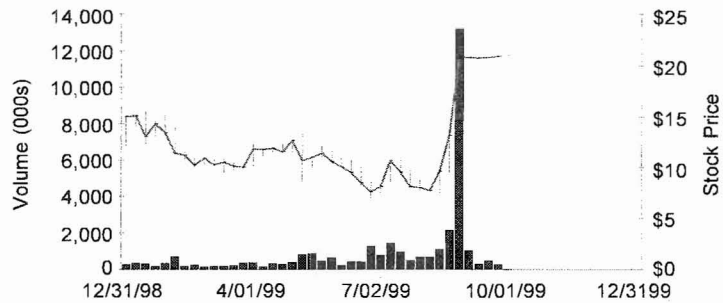
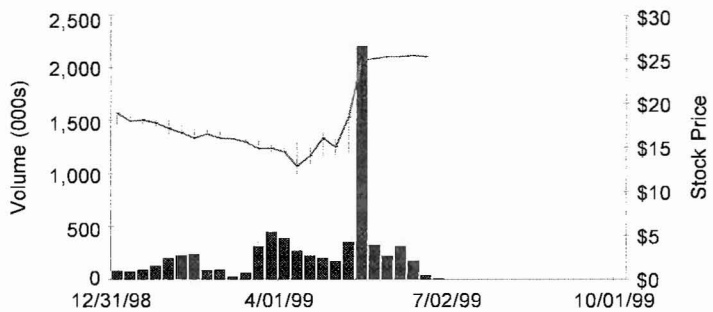


Exhibit 6

OPTEK TECHNOLOGY INC.

Weekly Stock Price/Volume Performance

12/31/98 - 10/01/99



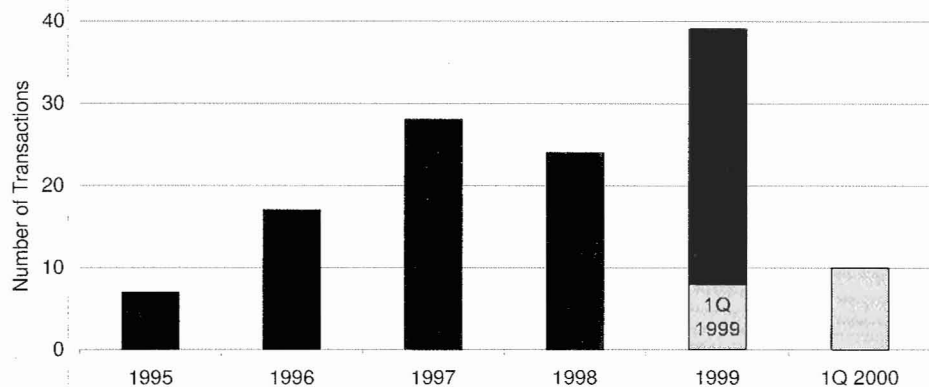
Source: FactSet

From Public To Private

Only three of the Darwin's Darlings announced a going-private transaction. At first glance, this is a surprisingly small number given the group's low trading multiples and ample debt capacity. With private equity firms expressing a very high level of interest in these transactions, one might have expected more activity. Indeed, the market for going-private transactions has seen a significant increase for firms between \$50 million and \$250 million in market capitalization. As Exhibit 7 shows, 39 going-private transactions were announced in 1999 and 10 were announced in the first quarter of 2000.

Exhibit 7

SMALL CAP GOING-PRIVATE TRANSACTIONS



Source: Securities Data Corporation and U.S. Bancorp Piper Jaffray research

However, this activity must be kept in perspective. There were 244 public middle market M&A deals in 1999. The 39 going-private deals represented about 15% of these M&A transactions. So, three going-private transactions out of 19 Darwin's Darlings deals (or 15%) is in-line with the overall market.

Why isn't the percentage higher? In our opinion, it is a mix of economic reality and an ironic impact of corporate governance requirements. The financial sponsors typically involved in taking a company private are constrained with respect to the price they can pay for a company. With limits on prudent debt levels and minimum hurdle rates for equity investments, the typical financial engineer quickly reaches a limit on the price he can pay for a company. As a result, several factors come into play:

- A Board will typically assume that if a "financial" buyer is willing to pay a certain price, a "strategic" buyer must exist that can pay more.
- Corporate governance rules are usually interpreted to mean that a Board must pursue the highest price possible if a transaction is being evaluated.
- Management is reluctant to initiate a going-private opportunity for fear of putting the Company "in play."
- Financial buyers and management worry that an unwanted, strategic "interloper" can steal a transaction away from them when the Board fulfills its fiduciary duty.

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Therefore, oddly enough, the corporate governance structure built into the public markets *prevents* the initiation of a greater number of going-private transactions that could provide immediate value to shareholders.

Repurchasing Shares

To many of the Darwin's Darlings, their undervaluation was perceived as a buying opportunity. Twenty companies announced a share repurchase, either through the open market, or through more formalized programs such as Dutch Auction tender offers (see our *M&A Insights: "What About a Dutch Auction?"* April 2000).

As we expected, these repurchases had little to no impact on the companies' share prices. The signaling impact of their announcement was minimal, since few analysts or investors were listening, and the buying support to the share price was typically insignificant. Furthermore, the decrease in shares outstanding served only to exacerbate trading liquidity challenges. **From announcement date to present, these 20 companies as a group have underperformed the Russell 2000 by 17.5%.**

For many of the Darlings and other small cap companies the share repurchase may still have been an astute move. While share prices may not have increased, the ownership of the company was consolidated as a result of buying-in shares. The remaining shareholders were, in effect, "accreted up" in their percentage ownership. When a future event occurs to unlock value, these shareholders should reap the benefit of the repurchase program. Furthermore, the Company may have accommodated sellers desiring to exit their investment, thereby eliminating potentially troublesome, dissenting shareholders.

Some examples of the minimal impact of share repurchases are shown in the following share price graphs of Chromcraft Revington and K-Tron International.

Exhibit 8

CHROMCRAFT REVINGTON INC.

Weekly Stock Price/Volume Performance

12/31/98 - 5/12/00

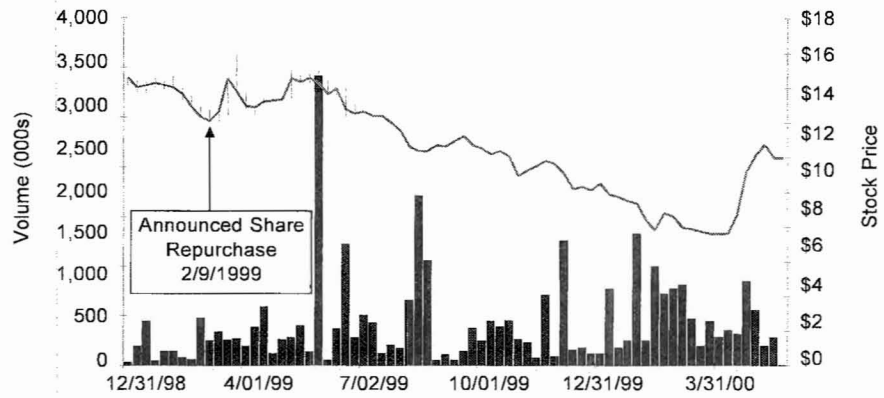
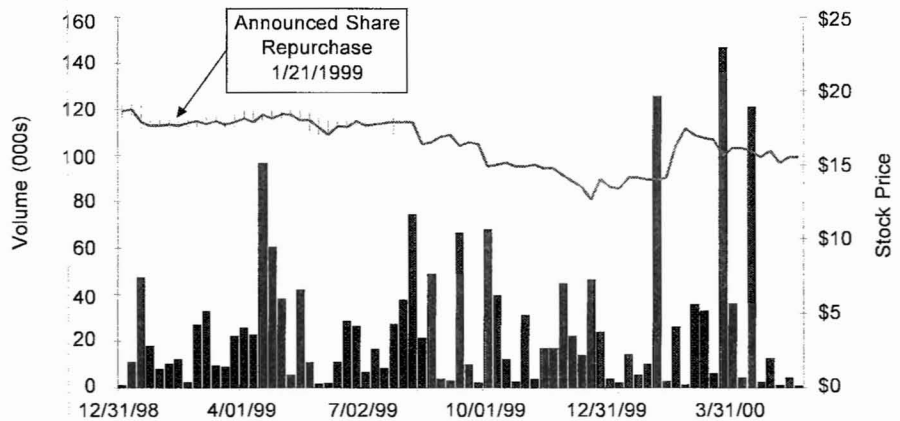


Exhibit 9

K-TRON INTERNATIONAL INC.

Weekly Stock Price/Volume Performance

12/31/98 - 5/12/00



Source: FactSet

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Status Quo And Growth Through Acquisitions

About half of the Darwin's Darlings stayed the course and did not announce any significant event over the past year. Another 18 sought and consummated an acquisition of some significant size. While surely these acquisitions had several strategic reasons, they were presumably pursued in part to help these companies grow out of their small cap valuation problems. Larger firms will, in theory, gain more recognition, additional liquidity, and higher valuations. However, for both the acquirers and the firms without any deal activity, the result was largely the same: little benefit for shareholders was provided.

Management teams and directors of many small cap companies have viewed the last few years as an aberration in the markets. "Interest in small caps will return" is a common refrain. We disagree, and our statistics prove us right thus far. Without a major change, we believe the shares of these companies will continue to meander. **For the 53 Darwin's Darlings that did not pursue any major activity in the last year, 80% are still below their 1998 high and 60% have underperformed the Russell 2000 over the last year.** These are results, keep in mind, for some of the most *attractive* small cap firms.

Class Of 2000

U.S. Bancorp Piper Jaffray has compiled an updated list of Darwin's Darlings. This year we were even more selective with our criteria. The maximum multiple to make our short list was lowered from 7.0x to 6.1x EBIT. The market capitalization screen remains the same (\$50 million to \$250 million) and minimum annualized EBIT growth over five years was held at 10%. Exhibit 11 presents our updated list of Darwin's Darlings; some of the best performing, yet undervalued small capitalization companies in the United States.

Exhibit 10

DARWIN'S DARLINGS CLASS OF 2000—SUMMARY STATISTICS

(\$ in Millions)

	Market Capitalization	EBIT Multiple	5-Year EBIT CAGR	Number of Equity Analysts	Insider Holdings
Mean	\$119.9	4.6x	44.2%	2.5	50.1%
Median	108.7	4.8x	24.1%	2.0	49.8%

Source: FactSet and U.S. Bancorp Piper Jaffray research

Conclusion

The public markets continue to ignore companies with a market capitalization below \$250 million. Most institutional investors have large amounts of capital to invest and manage, and small caps have become problematic due to their lack of analyst coverage and minimal public float. As a result, these "orphans" of the public markets are valued at a significant discount to the remainder of the market. We do not see this trend reversing, and therefore recommend an active approach to the directors and management teams at most small cap companies. Without serious consideration of a sale to a strategic or financial buyer, we believe these companies, despite their sound operating performance, will not be able to deliver value to their shareholders.

Exhibit 11

DARWIN'S DARLINGS CLASS OF 2000

Ticker	Company	Industry	Market Capitalization (\$ in Millions)	EBIT Multiple	5-Year EBIT CAGR	Number of Equity Analysts	Insider Holdings
GAN	GARAN INC	APPAREL & OTHER FINISHED PDS	\$137.0	4.3 x	22.4 %	1	66.2 %
HWKN	HAWKINS CHEMICAL INC	CHEMICALS & ALLIED PDS-WHSL	89.0	5.2	10.1	1	36.0
MDA	MEDIA ARTS GROUP INC	COMMERCIAL PRINTING	108.4	4.7	22.7	1	55.3
PSCX	PSC INC	COMPUTER PERIPHERAL EQ, NEC	60.4	4.6	29.1	1	46.8
ABTEE	ABLE TELCOM HOLDING CORP	ELECTRICAL WORK	56.6	5.3	98.5	1	15.9
PDM	PITT-DES MOINES INC	FABRICATED PLATE WORK	161.2	4.5	17.8	1	77.0
BDOG	BIG DOG HOLDINGS INC	FAMILY CLOTHING STORES	51.0	5.3	42.5	1	74.2
ARDNA	ARDEN GROUP INC -CL A	GROCERY STORES	110.2	5.0	16.8	1	60.9
WN	WYNN'S INTERNATIONAL INC	GASKETS, HOSE, BLTNG-RUBR, PLSTC	248.5	4.4	14.1	1	50.8
RAM	ROYAL APPLIANCE MFG CO	HOUSEHOLD APPLIANCES	89.4	4.7	188.6	1	50.3
BOSA	BOSTON ACOUSTICS INC	HOUSEHOLD AUDIO & VIDEO EQUIP	72.1	5.4	13.6	1	59.6
DW	DREW INDUSTRIES INC	METAL DOORS, FRAMES, MOLD, TRIM	92.2	4.2	26.8	1	49.6
AP	AMPCO-PITTSBURGH CORP	METAL FORGINGS AND STAMPINGS	116.3	5.2	21.1	1	61.5
ACTN	ACTION PERFORMANCE COS INC (#@)	MISC DURABLE GOODS-WHSL	150.5	4.8	107.8	1	14.8
CAV	CAVALIER HOMES INC	MOBILE HOMES	65.8	3.5	18.2	1	17.8
RHH	ROBERTSON CECO CORP	PREFAB METAL BLDGS & COMP	158.1	3.6	97.2	1	73.9
ESCA	ESCALADE INC	SPORTING & ATHLETIC GDS, NEC	51.6	5.1	34.7	1	58.3
TAGS	TARRANT APPAREL GROUP	WOMENS, MISSES, JRS OUTERWEAR	116.5	5.4	30.7	1	60.8
MAGI	MCNAUGHTON APPAREL GROUP INC	WOMENS, MISSES, JRS OUTERWEAR	64.7	5.1	22.3	1	57.7
DCO	DUCOMMUN INC	AIRCRAFT PARTS, AUX EQ, NEC	92.3	4.0	34.5	2	56.4
AMWD	AMERICAN WOODMARK CORP	MILLWORK, VENEER, PLYWOOD	131.2	5.2	20.5	2	43.8
LYTS	LSI INDS INC	ELECTRIC LIGHTING, WIRING EQUIP	165.0	4.9	27.9	3	32.5
GDYS	GOODY'S FAMILY CLOTHING INC	FAMILY CLOTHING STORES	231.6	5.0	17.6	3	42.1
ALRC	ALTERNATIVE RESOURCES CORP	HELP SUPPLY SERVICES	52.4	5.7	13.2	3	20.8
KIDD	FIRST YEARS INC	MISC PLASTICS PRODUCTS	81.2	5.0	22.6	3	29.3
STRT	STRATTEC SECURITY CORP	MOTOR VEHICLE PART, ACCESSORY	156.3	5.1	25.4	3	61.7
FGH	FRIEDE GOLDMAN HALTER INC	OIL & GAS FIELD MACHY, EQUIP	123.0	5.2	94.0	3	50.0
SIDE	ASSOCIATED MATERIALS INC	PLASTICS PRODUCTS, NEC	77.0	3.7	12.0	3	90.0
AMIE	AMBASSADORS INTERNATIONAL	TRANSPORTATION SERVICES	116.1	3.5	30.7	3	49.8
AMTR	AMTRAN INC	AIR TRANSPORT, NONSCHEDULED	208.5	4.2	61.0	4	86.7
TBAC	TANDY BRANDS ACCESSORIES INC	APPAREL & OTHER FINISHED PDS	54.0	4.9	14.6	4	41.4
GEHL	GEHL CO	CONSTRUCTION MACHINERY & EQ	105.2	3.9	18.4	4	31.9
WAK	WACKENHUT CORP -SER A	DETECT, GUARD, ARMOR CAR SVCS	194.3	4.4	19.2	4	88.5
FNCO	FUNCO INC (#)	HOBBY, TOY, AND GAME SHOPS	64.4	3.1	76.4	4	63.4
AFP	UNITED CAPITAL CORP	MISC FABRICATED METAL PRODS	76.4	3.6	13.6	4	57.8
ABFS	ARKANSAS BEST CORP	TRUCKING, EXCEPT LOCAL	186.1	4.5	14.4	4	38.8
MAIR	MESABA HOLDINGS INC	AIR TRANSPORT, SCHEDULED	231.8	3.3	51.8	5	44.2
CGX	CONSOLIDATED GRAPHICS INC	COMMERCIAL PRINTING	208.4	5.8	61.9	5	34.0
NVH	NATIONAL R V HOLDINGS INC	MOTOR HOMES	136.4	2.1	50.7	5	27.5
MLG	MUSICLAND STORES CORP	RECORD AND TAPE STORES	246.4	4.3	13.4	5	35.9
IEE	INTEGRATED ELECTRICAL SVCS	ELECTRICAL WORK	237.2	4.8	343.3	6	40.9
PGDA	PIERCING PAGODA	JEWELRY STORES	109.0	5.3	23.2	6	64.0
STLY	STANLEY FURNITURE CO INC	WOOD HSHLD FURN, EX UPHOLSRD	124.9	4.7	29.5	6	56.4
CBUK	CUTTER & BUCK INC	MEN, YTH, BOYS FRNSH, WRK CLTHG	99.3	6.1	103.6	10	20.7
HNFS	HANOVER FOODS CORP/PA	CAN FRUIT, VEG, PRESRV, JAM, JEL	50.4	5.7	10.7	—	44.1
EML	EASTERN CO	CUTLERY, HAND TOOLS, GEN HRDWR	55.0	5.8	25.0	—	45.3
MARK	MARKET AMERICA INC	DURABLE GOODS-WHOLESALE	92.3	2.0	21.3	—	80.0
ABL	AMERICAN BILTRITE INC	PLASTICS PRODUCTS, NEC	50.9	4.5	34.2	—	80.1

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NOTES

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