

THE CATALYST

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Looking Beyond the Numbers
Ron Nixon to Judge Texas A&M MBA Tech X-fer Challenge
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PROVIDING VALUE-ADDED CAPITAL

Welcome to our first newsletter of 2005. In this issue we discuss enterprise value. While it is always necessary to review a company's financial standing, taking a good look at their internal structure will also provide valuable information on potential investments.

We continue to seek to partner with excellent management teams who are looking for more than just capital. We emphasize long-term relationships and a process of building value over an extended time horizon.

Thank you for your interest and support.
The Team at Catalyst/Hall

Looking Beyond the Numbers

By Rick Herrman, Principal, Catalyst Hall, Houston

Our investment partnerships fund mezzanine loans and/or equity investments in privately owned, middle-market companies. A portion of the time we invest in the process of developing the "partnership" is directed to the subject of enterprise value. We believe early agreement on enterprise value and the contemplated investment structure enhances the likelihood of successful closing and funding.

The capital markets seem fixated on multiples of either earnings before interest, taxes, depreciation and amortization ("EBITDA") or its derivative, free cash flow ("FCF"), as the primary metrics driving value. In this newsletter, we suggest parties at interest consider a more comprehensive approach to determining enterprise value that includes a customized set of subjective risk factors. We believe a more qualitative approach to deciphering enterprise wide risk factors is equally important to the conventional monolithic focus EBITDA or FCF.

We've elected to categorize certain qualitative risk factors that enhance or reduce enterprise value as follows: (1) capacity of the human capital; (2) strategy definition; and (3) visibility of the management team. The factors may have little direct correlation of EBITDA but are likely to meaningfully affect value. The following expands the risk categories and presents various actions to mitigate the risk, thereby enhancing enterprise value.



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Catalyst/Hall specializes in middle market equity and mezzanine debt investments from its offices in Dallas, Houston, Oklahoma City, and Westchester (Chicago).

Catalyst/Hall provides capital for growth and expansion, recapitalizations of family owned or closely held companies, generational changes in ownership, and management buyouts.

Capacity

Does the company possess a complete collection of management resources to optimally execute the operational, sales and marketing, and financial elements of the strategy and plan? Is management actively accessing, developing and motivating its workforce, and does management seem receptive to outside expertise, feedback, and collaboration? Specific actions to improve the capacity of a business include:

- ♦ Improving the depth and quality of the key management team;
- ♦ Engaging third parties to assist in an analysis of business process focusing on efficiency, reduced costs, and enhanced repeatability;
- ♦ Having well defined position descriptions for each major functional area in the company, and regularly assessing compliance of the occupant to the ideal;
- ♦ Subject every person, even the primary owner/operators, to objective, comprehensive performance reviews;
- ♦ Developing or enhancing employee incentive programs;
- ♦ Surveying employees to determine that management's desired values, purpose and mission are understood and affect and guide mindsets and behavior; and
- ♦ Assembling an independent, qualified and properly remunerated board, dedicated to serving as a key source of perspective as to performance, opportunities, and direction.

Strategy

Is management's strategy presented in a thoroughly documented business plan, that possesses an appropriate depth-of-field to broadly address the range of competitive threats and opportunities? Can management present a clearly defined operationally specific segue from the "PowerPoint" to the implemented reality? Specific actions to refining and making operational the company's strategies include:

- ♦ Maintaining five or fewer core goals to occupy top management's focus;
- ♦ Analyzing major cost drivers and assessing relative performance using competitor benchmarking;
- ♦ Developing and refining a sales and marketing plan, including success measurements, while also considering "out of the box" approaches to sales growth;
- ♦ Maintaining a current year budget including supporting details and listed dates of key events, and three year fully integrated financial plan, including logically sequenced critical path factors and anticipated impediments;
- ♦ Surveying customers to confirm the company's perception of its value proposition;
- ♦ Developing a standard of customer acceptability, and occasionally firing certain customers; and
- ♦ Developing a realistic analysis of the competition, using a broad definition of competitor.

Vision

Does a system exist to produce timely and accurate information, which is essential to management assessing progress towards the strategy? Has the variability of expected outcomes been defined as high, or relatively low (i.e., has the enterprise “beta” been defined, and is there a plan to lower risk)? Specific actions to enhance and align the investors’ and management’s vision regarding a company include:

- ♦ Developing and refining financial metrics and developing a financial “dashboard” of reports that are succinct, but possess high impact and high utility for routine reference by management and employees;
- ♦ Implementing enhanced information systems, to provide more complete, timely and useful/useable management information;
- ♦ Performing a thorough and timely analyses of variances, positive and negative, from budgets and plans, including “early warning indicators”;
- ♦ Developing and refining forums for frequent and productive interaction among the functional departments that enable each key executive to develop an enterprise wide view of the company;
- ♦ Documenting and ensuring compliance with existing policies and procedures;
- ♦ Implementing employee training programs that reward compliance; and
- ♦ Reducing undocumented risk factors and re-assessing adequacy and cost competitiveness of all existing insurance coverage (workers comp, medical, property, casualty, liability, business interruption, D&O, and other), and assessing and reducing other factors (i.e., utilizing hedging, re-pricing longer term sales contracts to include “pass through” provisions relating to unforeseen changes in cost drivers, etc.)

Summary

While EBITDA and FCF are indicators of a company’s “yield” on revenues for a single period of time, neither provide insight into the inherent “risk profile” of the business. Investors and owner/managers alike should strive to understand and document the more determining elements of enterprise value, namely those internal and external factors and add to or reduce risk. From this process and the implementation of mitigating actions, management and investors can make a more accurate determination of repeatable and sustainable nature of revenues, EBITDA and FCF, and ultimately enterprise value.

Ron Nixon to Judge Texas A&M Tech X-fer Challenge

Ron Nixon has been invited to be a judge at a competition at Texas A&M’s Mays Business School. In this competition, the entire first year class develops commercial applications that are not currently utilized. This program demonstrates how knowledge management principles can be used to help evaluate the potential of patents and other raw technologies. The winning team will receive a cash prize of \$3,000.

Catalyst/Hall participates in Texas ACG Capital Connection

The Texas ACG Capital Connection brings together the nation's private equity community. This is an opportunity for networking among the leading middle-market service providers. The conference will take place on Thursday, February 24th, in Dallas.

For more information go to our Website :: www.catalysthall.com

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