October 2009

Mid-Atlantic Deal Review

Trial Edition *from* **Chessiecap, Inc.**

Editor's Note: Welcome to the 2nd Edition of the Mid-Atlantic Deal Review, a monthly review of transaction activity in the D.C.-Maryland-Virginia-West Virginia region. This edition is a Free Trial, which we hope will begin to add great value to your work and knowledge of the region. Our goal is to *measure actual transaction activity and get beneath the surface of deals, news and trends.* Your online edition is found at www.midatlanticdealreview.com.

Quick Stats[1]: ($M)

	Sep 2009	Oct 2009
Private Placement Volume	$124.9	$288.8
Private Placement # of Deals	24	28
Private Placement Adj Volume[2]	$123.1	$285.7
Private Placement Adj # of Deals	19	19
Venture Capital Volume[3]	$80.9	$263.7
Venture Capital # of Deals	11	14
M&A Volume[4]	$1,279.0	$231.3
M&A # of Deals	23	13
M&A Adj Volume[2]	$1,274.5	$229.4
M&A Adj # of Deals	15	8
IPO Volume	$160.0	$0.0
IPO # of Offerings	1	0
Follow-On/Secondary Volume	$1,083.6	$221.5
Follow-On/Secondary # of Offerings	5	2

[1] D.C., Maryland, Virginia & West Virginia [2] Excluding transactions less than $1 million [3] Institutional venture capital transactions [4] Including exclusive Chessiecap estimates

Deal lists are found at www.midatlanticdealreview.com

Stat Notes:

Quick Stats is the most comprehensive and thoroughly researched presentation of Mid-Atlantic transaction data available. Mid-Atlantic is defined as D.C., Virginia, Maryland and West Virginia. **Private placements** include all private equity investment including institutional equity, PIPEs, private investors and other forms of new investment. The **M&A** data are the first to capture true regional activity. Over 2/3 of all M&A transactions are "undisclosed," resulting in almost meaningless totals. Chessiecap reviews all reported regional transactions and uses its market knowledge and deal intelligence to assign probable deal values. The data above does not capture debt transactions, recapitalizations, non-corporate real estate financings (project financing) or purchases by local companies of companies outside this region. The primary filter is the addition or transfer of value into or within the region at the corporate level.

DEAL DATA: Oct. 2009

October Private Placements knocked the ball out of the park ($289M) with several major investments in Telecom and Biotech. Meanwhile, both M&A and the struggling local market for Public Offerings fell off the table.

Private Placements: October was dominated by several gigantic placements that blur the line between buyout and venture investment---a trend we all have observed for much of this decade as the asset class of “private equity” seeks to find a winning strategy. Biotech again had a busy month in October representing 21% of the total 28 deals and a whopping 60% of all funds raised. The giant deal of the month was **United BioSource** of Bethesda, which Berkshire Partners of Boston joined in supporting to the tune of an astounding $125M. When you add GlycoMimetics’ $38M raised to the total, then Biotech dwarfs all other sectors for October. With a $60M investment by TA Associates in TEOCO of Fairfax, Telecom Software & Services added its own mega-sized investment. The remaining 25 placements were spread across a broad array of regional staple industries including Healthcare Equipment, Energy, Internet Apps, Mobility and Security. In terms of distribution, Virginia and Maryland were about even with 12 and 14 deals, respectively. Obviously, the large Biotech deals tilted the volume of money raised toward Maryland. DC had 2 small transactions this month with none registering for West Virginia.

M&A: Unlike Private Placements, which held steady from September to October, the number of M&A transactions dropped precipitously in the region from 15 above $1M in value to only 8. Volume took an even bigger hit, dropping over 80% from $1.2B to a paltry $231M. The reason is the lack of any blockbuster M&A transactions such as SkyTerra and Iridium from the previous month. The largest transaction of the month by a factor of 2 was the sale of **IXI Corporation** to a bone fide strategic buyer, publicly held Equifax for $124M. Government M&A was well represented with 3 of the 8 deals over $1M in value, including the $51M sale of **Phoenix Consulting** to DynCorp. Two small banks were sold for approximately $10M each, reflecting the urgency of consolidation and survival in that industry. Security and Commercial IT Services each had two small transactions. Virginia sales dominated the field with 87% of the volume and 70% of the total number of deals.

Public Offerings: After a reasonably active September for local public market activity, October fell back into the doldrums. There were only two public market offerings for a total of $222M. The first was a pure secondary offering (selling shareholders versus new money for the company) by **FBR Capital Markets Corporation** (NasdaqGS: FBCM) where a related party Arlington Asset Investment Corp. sold out its total position in FBR representing 23% of the company. The second was a follow-on offering (new money into the company) of $133M by a REIT (Real Estate Investment Trust) named **American Capital Agency Corp** (NASDAQ:AGNC). AGNC was formed to purchase specialized instruments called “single-family residential pass-through certificates,” and this offering is a step-up funding of the company to purchase more. One selling shareholder of an investment bank and one refunding of a REIT---nothing really to crow about in the regional public markets.

Deal Notes: Oct. 2009

TEOCO Brings Home Huge Investment from TA Associates. 10/6/09 Private Placement. At $60M, it is hard to find a larger first-time minority tech investment than the one made by **TA Associates** of Boston--at least locally. Awkwardly named **TEOCO** of Fairfax really means The Employee Owned Company---not too catchy but clearly successful. The company provides critical cost, routing and revenue management software and services for telecom service providers. At least several locally funded companies have set sail in those seas only to end up on the rocks. TEOCO is unique not only because of the size of this investment but because this is the first institutional money ever taken. We don't know the revenues underneath the investment, but they are likely to be considerable. Not surprisingly, this amount of money will be used to help consolidate the industry (remember those ships on the rock). TA Associates can make this investment because it is one of the largest and oldest players in the private equity industry. Earlier this year, TA did the impossible. It raised $4B for a fund targeted to raise $3.5B. (The rich funds get richer---see the **NEA** story below in DEAL NEWS.) TA technically runs "buyout" funds, but this is clearly labeled as a minority investment. It is interesting to note that TA is not sharing its toys with any other funds, which means no local participation. When you are $4B, it is hard enough to find sizeable investments—sharing does not come easily.

United BioSource Opens Sluice Gates for Berkshire Partners. 10/8/09 Private Placement. In a transaction that has similarities with the TEOCO one, **United BioSource Corporat**ion of Bethesda took in a massive $125M "growth equity" investment from **Berkshire Partners**. United BioSource plays an interesting and potentially lucrative role in the Pharma industry by helping develop and commercialize products through providing evidence of safety, efficacy and value. This investment is similar to TEOCO's because of the size being such that only two local funds (NEA and Carlyle) could play. [Although this is twice the size of the TEOCO investment, we are more accustomed to Biotech-related investments having larger cash requirements. TEOCO still stands out on a relative basis as a tech investment.] Similar because Berkshire is another historic, Boston-based mega-fund reaching into the Mid-Atlantic. Similar because Berkshire like TA is technically a "buyout" fund, but this investment is labeled growth equity and the previous investors will "retain their equity positions." That's where the similarity ends. Prior to Berkshire, **Oak, J.H. Whitney** and, to a lesser extent, **Grotech** had put an unimaginable $222M into United BioSource over six years and multiple rounds. When $222M is not enough to bake a cake, just add another $125M. These funds from the previous rounds did not join Berkshire in this round. We are not sure what "retain their equity positions" means, but it does not sound positive. ("Too bad you didn't win the RV, but you still get to keep the toaster.") And also unlike TEOCO, it is hard to imagine what is the remaining equity position of the founders with this avalanche of investments on top of them.

Command Information Slips in a Small "Expansion" Round. 10/11/2009 Private Placement. Command Information of Alexandria burst onto the local scene in 2006 with an eye-popping $32M from **Novak Biddle**, **Paladin**, **Carlyle** and **Blue Water**. It announced an ambitious program, starting from scratch, to become the leader in spreading the new IPv6 Internet protocol throughout government and beyond. It jumped out of the blocks with the purchase of Digital Focus. Many of us at the time were curious how a company could arrange itself to capitalize on a standard. We were not sure what precedents there were in the tech world, unless you owned a portion of the technology (e.g., Qualcomm and CDMA). Still, figuring these things out is why the investors make the big money. Several CEOs later, several years later, and several investment rounds later, the company is still soldiering forward. This latest round came in an SEC filing, unheralded. Our guess is that the lack of a definable or harvestable IPv6 market has forced the company to morph into more of a traditional IT services company commonly found in the region. Current offerings include reasonably hot but more pedestrian offerings of cyber security, information assurance and network engineering alongside the IPv6 tag line. The way to make money with traditional, low margin IT Services is to limit your initial and on-going investment dollars while capitalizing on growth. It's not clear how these locally based funds will ever see a return on what started out as an ambitious investment in Command Information. Our guess is that there is a "game changing" merger lurking out there somewhere.

IXI Corporation Wins Big for Investors through Sale to Equifax. 10/28/2009 Sale of Company. Every now and then, an investment works the way it is supposed to. **Core Capital**, **ECentury**, and **Blue Chip** put $7.75M into IXI in 2004, followed the next year by a much smaller ECentury top-off round in 2005. Then, IXI management took over and created a ground-breaking information/research firm that measures consumer wealth through relationships with financial institutions. Flash forward to October 2009, and **Equifax, Inc.** (NYSE:EFX) buys the company for $124M. No bargain basement pricing here like you find in many of today's M&A deals. Although the fundamentals went unannounced, Chessiecap gleaned from certain public disclosures that the purchase price was probably around 4.4X revenues and 17.5X EBITDA. Why is this one of the few bright spots in M&A in our region or any region? If there is any trend that has caché in this poor market, it can be found in those companies that add value to information. Whether it is in advertising, research, publishing, or retailing, potential buyers are desperate to get what little edge they can from information businesses. In pronouncements to the press and to the investment community, Equifax was very clearly delighted with the advantages IXI gave Equifax in the highly competitive consumer credit and information industry.

News Notes: Oct. 2009

Allied Capital--End of an Era, End of a Local Institution. In October, **Allied Capital Corporation** (NYSE:ALD) announced that it was selling to **Ares Capital Corporation** in NYC (NASDAQ:ARCC). Thus ends one of the most storied finance companies in the region---a company whose origins pre-date almost all of us who have benefited from having this expertise in the region. George Williams, who is in his 80's, founded the company fifty years ago and took it public shortly thereafter. Allied was a clear pioneer in the realm of small business and mezzanine lending. Besides spearheading a whole new asset class, it is probably fair to say that Allied professionals invented and refined numerous lending practices and techniques that have spread through the industry. Scores of industry professionals cut their teeth at Allied or in its portfolio companies. Prominent among them in this region include David Gladstone and Chip Stelljes at Gladstone Capital, Will Dunbar at Core Capital and Jon Ledecky who was hyper-active locally in the last decade. These are among the positive things that can be said about Allied. Over the years, Allied has had or created more than its share of problems. First of all, like Drexel in its heyday, no one should ever confuse Allied with your friendly neighborhood banker. Mezz lending is a tough jungle to survive in, and it gets more dangerous when you concentrate on the smaller end of the market. Allied people learned early on that you had to exact tough terms from companies, so tough they were. Then, in the past decade, Allied has had institutional and regulatory problems in how it accounted for its assets which created a rescue situation and probably made the company's sale inevitable. The sale of Allied looks pretty good on the surface---$648M paid which represent a 27% premium on Allied Stock. Unfortunately, this is another example of a trend we described in last month's Deal News (see "SkyTerra" http://www.midatlanticdealreview.com/?p=91#more-91). A premium on a stock that has fallen off a cliff is not much of a premium. For most of the past decade, Allied traded between $20 and $30 per share. It is selling to Ares for $3.47 per share. As a postscript, we would like to list some of the names of those who passed through Allied or its portfolio companies, a list that flowed from the memory of Will Dunbar. If you know of more, please feel free to add them through Comments to this note. Cabell Williams and Susan Gallagher of Williams & Gallagher, still in D.C. Randy Klueger with Will at Core Capital. Phil McNeill of SPP Mezzanine Partners in Fairfax. Mike Grisius, still local. Tom Westbrook runs the Mezz/Buyout business at BB&T in North Carolina. Erik Shott is a buyout partner in NYC. Rob Edwards is in the buyout group of BofA. Ed Ross runs a mezz fund out of Chicago. Rick Fearon started a hedge fund in CT. Shep Robinson is doing real estate workouts for Wells Fargo. We are sure that the list is much longer.

TEOCO GlycoMimetics, Inc. UBC United BioSource Corporation

TEOCO, GlycoMimetics and United BioSource---Private Placement or Acquisition? It is an issue that has interested us for years. When is an investment a buyout and when is it a venture investment? The line used to be very clear. Buyout funds absolutely had to have control, and control was defined as over 50% of the voting stock. In the previous millennium, a buyout fund would run out of the meeting room if official control was not on the negotiating table. Likewise, venture investing was very clear. No venture fund ever wanted anything that looked like control. Venture funds depended upon management to run the company, so they shunned that responsibility. These parameters were clearly defined for limited investors in the initial fund prospectuses. But necessity is the mother of invention. It is universal that there is always more money than there are good deals. In the past decade, the competition for transactions coupled with abysmal industry returns across all of private equity have blurred the lines between buyout and venture. Buyout funds, in an effort to lure closely-held companies, have softened their stance on control to the point where many funds publicly market minority investments as well as partial cashing out founders. At the same time, we have seen firsthand how venture firms will not hesitate to take majority control of companies---even in a first round of funding. The reasons may range from too much money is needed to justify a minority position to needing to take control of a company with too many small shareholders. Key to this industry evolution has been a realization that "control" in today's world is a far more relative definition than 50%. Funds now understand what public investors and raiders have known for decades---under the right circumstances, with the right financial leverage, and with certain covenants or terms, you can control a company with far less than 50% ownership. October in the Mid-Atlantic was loaded with unusually large investments that begged the question of minority investment or buyout. **TEOCO** took in $60M from one investor, an investor known to be a prolific buyout fund. But in the press release, this was clearly labeled as a minority investment. Since it was a first institutional round, one can imagine that the founders maintained their 50% majority control, and TA is limited to protecting its investment in TEOCO through financial covenants and normal boardroom pressure. **United BioSource** is a different kettle of fish. The founders are still in the company, but the investment from Berkshire Partners represents a second massive influx of capital. There are now at least four venture funds eating at the table. With almost $350M invested in the company, the venture funds are the owners, and they are negotiating amongst themselves over the direction of the company. Any single fund may not have control, but collectively their interests are aligned, and they are the owners. It was probably fair for Berkshire to describe its investment as "growth capital," because Berkshire most likely did not get 50% ownership for its $125M. Nevertheless, you can imagine the strength of its leverage in establishing its investment and in future votes. **GlycoMimetics** of Gaithersburg just completed its fourth round of funding. The $38M coming equally from five funds adds up to $62M since 2003. After that much capital, who do you think owns the company---venture capital or founders? With GlycoMimetics, the venture funds have known for years that they are owners as well as investors. Like owners, they control board votes, they hire and fires executives, and they set strategy. One explanation is obvious. If you are in a capital intensive industry such as Biotech or Telecom, you may think you are taking on investors, but you are really negotiating with your current or future owner.

NEA

NEA, One of the First Mega-Funds. Will Smaller Funds Survive? NEA, for as long as most of us can remember, has been an elite leader in the venture capital industry. It comes as no surprise that NEA was listed at the top of all venture funds in terms of number of investments for the three months and nine months ending 9/30. We have seen NEA at the top of about every list for two decades, including key ones such as number of IPOs from its investments. In October, NEA announced it had reached its target of $2.5 billion for NEA Fund XIII. To put this in perspective, only eight other U.S. firms have raised billion dollar plus venture funds since 2004, and NEA is only one of two to raise this level of capital since the beginning of 2008. NEA has been raising billion dollar funds since 2000. Fund VIII in 1998 was the first to cross over the $500 million level. In venture capital, the only measure of success for the investors and the partners is a fund's return. Growth for growth's sake may work in the public markets, but it holds no water with the limited partners who provide the money for funds. Eventually, you must return capital to investors or close up shop. So it begs the question, why has NEA grown so large? How does this help produce better returns than the industry? Is this a calculated strategy or the consequence of some inexorable market momentum? Knowing some of the principals and founders as we do, we are dead certain that it is the former. No one in their right mind would take the time or trouble to organize and grow prima donna venture partners, unless the evidence for a growth strategy compelled you to do so. We have seen many self-serving arguments for why small and medium sized funds will produce better returns in this market, but there is no convincing evidence for this hoped for trend. Meanwhile, smaller funds are being strangled as they struggle to raise money from limited partners who "flee to safety' in the larger funds. What if the reality of venture investing is that it will mature along a model found in other financial segments and other industries? What if the answer is simply that bigger is better? In specific, what if larger investments in larger venture worthy companies are less risky than smaller investments in smaller companies? What if a large portfolio of large investments (and by that we mean investments that need at least $20M to merit attention) has less variability and risk than a diversified portfolio of smaller sized investments? Did we not learn in the high yield arena how difficult it is to maintain a viable market focused on middle market companies? Today, high yield, with all of its risk and defaults, is exclusively focused on large cap opportunities. For industries in general, is it not true that as they mature, the strong get stronger and larger, ultimately forcing the small and middle market players off the playing field? The modern era of venture investing is less than twenty years old. In a year when NEA can hit its $2.5B target, scores of mid-sized and small funds cannot lure a dollar to their cause. Scores of these funds are closing their doors or going on life support. If you look at NEA's track record (see Sept. Mid-Atlantic Deal Review, "CalPERS," http://www.midatlanticdealreview.com/?p=101#more-101), it becomes clear why a CalPERS has a fiduciary responsibility to choose NEA over dozens of other funds that it has invested in. How much of NEA's returns are idiosyncratic, based upon good management, training and internal controls? How much is dependent upon the ability to invest large sums in large projects through a score of general partners that the majority of the venture industry is constrained from considering? In U.S. investment banking and commercial banking, we are now down to a handful of mega players such as Goldman, Morgan Stanley, Bank of America, Citibank and JP Morgan Chase, with dozens of small players plying market niches underneath. We have seen a major shakeout of small and middle market venture funds in the Mid-Atlantic region. If the future belongs to the NEA's, then entrepreneurs and early stage companies who need $2M to $15M to grow their ideas will know no relief from the onerous funding environment they face now.

Commentary: **Oct. 2009**

Black & Decker: How Our System Rewards Failure.

Black & Decker Corporation (NYSE: BDK), based in the Baltimore suburb of Towson, announced in early November that it was merging with **The Stanley Works** (NYSE:SWK) based in Connecticut. As per the usual script, this "merger" was hailed as a great step forward for Black & Decker. Black & Decker shareholders would receive (in stock only) a 22% premium, Nolan Archibald (Black & Decker Chairman & CEO) would become the executive chairman of the combined company, and there would be cost cuts in order to increase value for shareholders. Yet another major Baltimore based company would be throwing in the towel. It is a long list dating back two decades that includes major insurer USG&G, developer Rouse, Maryland National Bank and Alex. Brown & Sons.

The capitulation of Black & Decker is a failure on three levels---corporate management, corporate governance and market regulation.

Black &Decker shareholders will get a small majority of shares in the combined company, but all power goes to Stanley. The Stanley CEO and CFO will run the company. Mr. Archibald will spend the obligatory three year period or less as chairman before retiring. The headquarters shifts north. Hundreds of good jobs will disappear in Maryland alone.

On an economic front, if you were a long-term shareholder, you will now receive with your "premium" a value (approximately $60) at the lower end of the range that Black & Decker traded at for four of the past ten years---$60 to $90. Why would you sell a company in a market low, prior to any up-turn in construction and housing, unless you had no faith in the company being able to prosper in a growth economy? Where is the strategic plan that should take a gold-plated brand name and makes it the surviving, value creator in the industry?

When you read the SEC merger announcements and filings, you surmise that not only will the Maryland headquarters be shut down, but there are no top jobs allotted to Black & Decker management. After over twenty years as CEO, why is there no clear successor in place for Mr. Archibald and where is the cadre of experienced, talented executives that he should have in the wings? Finally, why in the storied 100 year history of America's great tool company is Mr. Archibald, age 66, so unfortunate as to be the last CEO?

Nolan Archibald will realize, within a few years, a substantial fortune from the sale of Black & Decker. An online "New York Times" publication on November 5th praised Mr. Archibald for foregoing immediate vesting of stock and options plus other benefits worth $20 million upon the sale of the company. That is what you learn if you only read the Black & Decker filing, which highlights the $20M as if Mr. Archibald is making a personal sacrifice on behalf of the company. In the Stanley filing, you discover that Mr. Archibald, and Mr. Archibald alone among Black & Decker executives, will receive a far more lucrative package in the new company that will more than substitute for the Black & Decker one he is foregoing. It includes $20 million of equity payments over three years plus one million "sign-on options" plus a "cost synergy bonus" which ranges from $15 million to $45 million plus a multi-million dollar yearly salary, bonus and perks.

In addition, Mr. Archibald has enriched himself enormously in his twenty years as CEO, becoming the largest individual Black & Decker shareholder with approximately 2.5 million shares or over 4% of the total ownership. He ranks as the 7th largest institutional shareholder behind funds such as Fidelity and Alliance Bernstein. Even before the incentives and pay package provided in the transaction, Mr. Archibald's current stake is worth approximately $150 million.

[Amplification: $150 million was derived from shares listed as "beneficially owned" in the March 2009 annual prospectus. Apparently, this share count has little practical meaning. After subtracting "out of money" options and adding vested restricted shares, a better approximation of shares that could be controlled and voted is approximately 2.2 million (8th on the institutional shareholder list) worth approximately $62 million after subtracting option exercise prices. Mr. Archibald's current realizable Black & Decker holdings are estimated to be worth over $110 million. This would consist of approximately $26 million in common shares, $31 million of "in the money" options, $3 million of vested restricted stock, $35 million of Accumulated Pension Benefits and $15 million in a Supplemental Savings Plan.]

Mr. Archibald was not born a Black or a Decker. He certainly did not found the company. How did a hired employee amass such a fortune? No other Black & Decker executive even comes close to this level of wealth accumulation. Ask the board of directors. The CEO works for the board of directors. The board approves the pay package each year. So what does a board do when its 66 year old CEO, who is one of the largest shareholders and who has no winning strategic plan or second tier of management in place, comes before the board with a sale of the company that he has worked out over lunch with the CEO of a competitor?

In this case, as they approved the sale of the company, the board apparently worked with the CEO to achieve an even better pay package for him in his new job. This begs the question of how many board members were hand-picked by the Chairman and what is their industry or governance experience? With a twenty plus year CEO and Chairman to whom you have awarded institutional level ownership, how objective and independent can a board be? Who among us begrudges Bill Gates or any entrepreneur a penny of his wealth that he has accumulated by growing the company he founded? But in the U.S. system, CEO employees have achieved a level of control over corporations and boards that approximates founding ownership with the result that CEOs, in the history of our country, have never been wealthier employees.

There is a regulatory and systemic problem with this deal which is common in many takeovers and which undermines faith in our markets. It is clearly legal, but it is one of the seedier sides of our markets that the SEC seems powerless to expose or control. Not only will Mr. Archibald receive a bonus worth scores of millions of dollars to make this deal work, the top two Stanley executives are also issuing themselves almost 1.8 million “merger equity grants.” There is something for everybody in this deal as long as you work at the top.

These payoffs to senior executives happen in almost every major M&A deal. Buyout firms have used this tool for decades as they pry public companies loose from shareholders. When the selling CEO is faced with the difficult objective decision of whether a deal is appropriate or not, the buyer puts tens of millions of dollars on the table as “transition” money for the seller’s executives. In large deals, the payoff totals hundreds of millions. If you were 66 years old and near retirement, how would you answer this question? “Do I recommend this transaction and gain $50 to $100 million in additional wealth for my family, or do I recommend keeping the company independent and retire with my current package?”

In a total transaction worth billions of dollars, these tens of millions represent chump change—grease that insures the desired outcome. It works for almost everybody except maybe those Black & Decker employees who thought they had decent jobs in a well-managed company executing on a well-designed strategic plan----because now they will be helping Mr. Archibald achieve his “cost synergy bonus.”

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