M&A REVIEW

Core Capital Group
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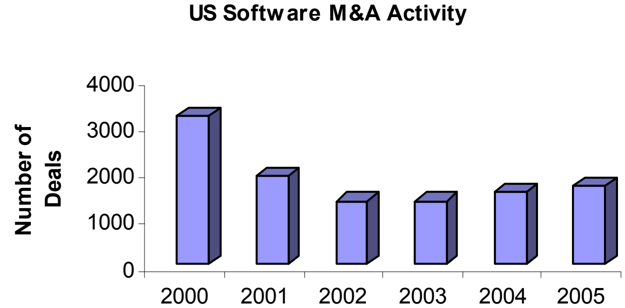
Software Industry Continues to Consolidate

In 2005, merger and acquisition (M&A) activity in the software industry remained strong, serving once again as the most active M&A sector and representing 16 percent of the 10,716 deals closed in the United States throughout the year. This level of activity was in large part driven by the overall health of the economy, the availability of capital and a number of software industry specific trends that aligned, making 2005 one of the most active M&A years since the 2000 "bubble." *Source: Mergstat*

Industry Trends

One of the principal drivers of this rise in software M&A activity is the corporate information technology (IT) managers' desire to get a broader suite of offerings from fewer vendors. During the late 1990s and early 2000s there was a dramatic increase in the number of new, often niche, software products brought to market. Many of these small to mid-size software providers offered narrow point solutions with hundreds of features. Many large organizations, governments included, found themselves dealing with dozens of software vendors which proved difficult and expensive to maintain, and more often than not, these different software products did not work well together. IT managers now prefer to deal with fewer strategic vendors who can offer a richer portfolio of products, and ensure those products work well together from the start. As a result, software providers are consolidating as customers demand reduced complexity and lower costs.



The demand for reduced complexity is also driven by stricter financial constraints placed on IT budgets. As overall IT spending grows at a relatively slow rate of 2 to 3 percent per year, IT providers, and especially software providers, cannot assume they will grow organically by 20 percent per year. With this in mind, software providers strive to make strategic acquisitions that will ultimately help them capture a larger portion of the overall corporate IT budget. (continued on back)

How is Value Determined in an M&A Transaction?

Whether you are a buyer or a seller, it is important to construct a range of values for your own internal use and for establishing a negotiating position. There are four generally accepted methods for calculating value. The first two shown below rely on trailing twelve months financial performance while the last two methods rely on future financial projections.

- **Comparable Public Companies**

The current stock market valuations of comparable companies are analyzed into multiples of selected financial data. Applicable multiples are applied to historical and projected financial results of the Company and discounted to reflect size and lack of a public market, as appropriate, to yield an implied valuation range.

- **Comparable M&A Transactions**

Recent comparable industry acquisitions are analyzed into multiples of selected financial and operating data in order to depict the mergers and acquisition market. Applicable multiples are applied to historical financial results of the Company to yield an implied range.

- **Discounted Cash Flow (DCF)**

A DCF provides a theoretical value of the Company by discounting the projected future cash flows over a five year period, plus a terminal value in year 5, to yield a net present value (NPV). The discount rate chosen approximates the Company's risk adjusted weighted average cost of capital (WACC), and the terminal value is calculated based upon an assumed multiple of year 5 earnings before interest, taxes, depreciation and amortization (EBITDA).

- **Recapitalization Analysis**

A recapitalization analysis provides a valuation range based upon the maximum level of investment (consideration to seller) that the Company could support where debt is the primary source of funds and the underlying equity demands an internal rate of return above 25%. The amount of leverage that can be applied is estimated using industry standards.

Core Capital Group focuses exclusively on providing a full range of M&A services to middle market companies within the technology sector. We are a member company of the International Network of M&A Partners (IMAP), a global partnership of leading merger & acquisition advisory firms with over 60 member firms located in 20 countries worldwide. We invite you to visit our web site at www.corecapital.net to learn more about us and how we might be of service to you now or in the future.

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Consolidation (continued)

Strategic Acquirers
At the same time, some of the larger well-known IT companies have benefited from improved profitability, which has translated into significant cash war-chests. Currently, Microsoft, Cisco, IBM, EMC, and Oracle combined have more than $63 billion in cash on their balance sheets available for acquisitions. Many of these larger players have shown they are ready to step back into the M&A market after periods of relative inactivity. For example, IBM acquired 16 companies during 2005, compared to four in 2003.

On the sell side, an increasing number of small to mid-size software companies are considering their exit strategies as it becomes progressively more difficult for companies with revenues less than $100 million to grow and make money. According to one industry commentator: "Small software vendors are facing a difficult situation with widespread commoditization of products threatening them from below and larger vendors invading their space from above."

These are signs that the software industry is maturing. While there are bright spots of growth (compliance software, open source software, security software, virus protection and anti-spam software), some sectors such as enterprise resource planning (ERP) and customer relationship management (CRM) have matured and largely leveled off. Take the ERP software market for example. This sector has transformed from 400 ERP companies 10 years ago to approximately 20 players today. And, while many companies remain profitable (especially large, global software providers), there is an undeniable glut of companies chasing a revenue pool that has ceased to expand quickly enough to support them all.

Valuation Multiples
Increased M&A activity typically leads to increases in valuation multiples, at least for a period of time. The median price paid for mid-cap software companies increased to 2.2 times sales in 2005—the first time since 2000 that revenue multiples have been in excess of 2 times. *Source: Capital IQ*

However, it must be noted that even though the median sales multiple is 2.2 times, there are significant variations depending on the specific sector in which a company operates. This is evidenced by the multiples of publicly traded software companies. A quick analysis of enterprise to sales multiples reveals that publicly traded companies providing software security products and Internet infrastructure are trading at a median multiple of 5.2 times trailing twelve month (TTM) sales, while some of the smaller ERP and CRM companies are trading at a median of only 1.7 TTM sales.

With corporate spending and deal making on the rise, the short-term outlook for M&A activity in the software industry remains positive. The continuous cycle of innovation which leads to growth in new products and services, followed by maturation and consolidation, will persist as long as low barriers to entry continue to provide start-up software companies with a reasonable chance of success, allowing them to develop unique solutions to address the information technology challenges of today and the future. Thus, the pool of small to mid-size software companies looking for an exit strategy will remain plentiful as long as the economy stays on track, and both consumers and business purchasers continue to accept and adopt new technologies.

Private Equity—An Alternative to the Strategic Acquirer

When a private equity group invests in a company as a platform, it's considered to be a recapitalization as opposed to a merger or acquisition. It is a nice alternative for owners who want to grow their companies more rapidly while incurring little risk, and to take some cash while retaining some ownership position. It is also a way to maintain corporate identity and culture, and to avoid rifts that occur when a company is acquired. In addition, private equity groups bring credibility and value to a platform company by providing "brand name" directors and access to public capital markets.

General characteristics a private equity group will seek in a platform company are:

- At least $50 million in revenue (any size deal for add-ons with a close strategic fit)
- Owners and managers willing to roll over 15 percent to 25 percent of their ownership
- A vision to grow organically and by acquisition
- A compelling growth plan
- A management team that can manage growth

Private equity groups are not interested in companies that require serious restructuring, although they will match up an experienced CEO or CFO with a platform company if required.

Recent Transaction Examples

For the first six months of 2006, announced transactions of US information technology and electronics companies totaled 834 compared to 802 in the first six months of 2005. There were 7 transactions over US$100 million cumulatively valued at US$4.5 billion. The largest was EMC's announced acquisition of RSA Security Inc. for US$2.3 billion. US buyers accounted for all but 22 of the 153 transactions. Foreign acquirers included companies headquartered in 8 countries with more than 1 announced transaction from Canada (7), the United Kingdom (6), Japan (2), Germany (2), and Hong Kong (2). **The software sector accounted for 35% of all announced transactions followed by IT Services-22%**, Hardware-16%, Telecom Services-15%, eCommerce-10%, and Systems-1%.

Level 3 Communications acquires Looking Glass Networks
Level 3 Communications (Nasdaq: LVLT), a provider of Voice over Internet Protocol services, definitively agreed to acquire Looking Glass Networks, a provider of bandwidth network services, for an estimated $165,000,000. The consideration was to consist of $9,000,000 cash, $87,000,000 unregistered Level 3's common stock, and assumption of estimated $69,000,000 in liabilities.

OpSec Security Inc. acquires GenuOne Inc.
OpSec Security Inc., a provider of anti-counterfeiting technologies and services, acquired GenuOne Inc., a provider of brand protection software, technologies and services, for $13,000,000 in cash.