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2020 Advisory Conference

October 27–29

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to deepen client relationships

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SUCCESSION PLANNING

Avoiding common obstacles to delivering client value

October 27-28, 2020

Speaker

Al Mattaliano

Partner

Al is a founding partner of Rock Island Capital. His prior experience includes:

- Founding partner of Catalyst/Hall, a $150 million middle market private equity and mezzanine fund
- Founding partner at Vine Street Partners, a middle market investment bank
- Vice President at Bankers Trust Company (now Deutsche Bank)
- American National Bank and Trust Company of Chicago

Speaker

Mike Nugent

Partner

Mike is a founding partner of Rock Island Capital. His prior experience includes:

- Dresner Capital, a middle market investment bank
- Vine Street Partners, a middle market investment bank
- KPMG Peat Marwick LLP

Speaker

Brian Bastedo

Partner

Brian is a partner at Rock Island Capital. His prior experience includes:

- Managing Director at RedRidge Finance Group, a middle market debt placement and due diligence firm
- Associate Director at Bridge Finance Group LLC, a middle market commercial lender
- Manager at PriceWaterhouseCoopers LLP (transaction services group)
- Senior Associate at Arthur Andersen LLP

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Agenda

Topic	Minutes
Succession and exit planning	5 minutes
Ownership opportunities for the next generation	15 minutes
Operational control	15 minutes
Delaying until business hits financial targets	15 minutes
Q&A	10 minutes

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Breakout objectives

By the end of this course, you will be able to:

- Identify advantages and disadvantages of common exit options
- Understand common obstacles in succession planning

Succession planning

- We know that many member firms provide succession planning services to their clients.
- Unless a family member will be named as the successor, succession planning discussions often also involve exit planning to facilitate an ownership transition.
- We understand that many business owners are particularly reluctant to engage in exit planning exercises. Today, we'll address some of the more common challenges posed by business owners.

Succession planning

"Charlie and I long ago entered the urgent zone… That's not exactly great news for us. But Berkshire shareholders need not worry. Your company is 100 percent prepared for our departure.

– Warren Buffet"

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A quick overview: exit options

	Advantages	Disadvantages
Sale to competitor (strategic buyer)	+ Potentially higher price due to synergies + Support for organic growth and/or acquisitions	– Likely loss of equity participation – Usually not employee-friendly
Sale to private equity (financial buyer)	+ Additional capital to support acquisitions and growth + Option to retain ownership + Company retains identity and employee base + Flexibility for minority ownership	– Valuation may be lower than strategic buyers – May not obtain 100% liquidity
Management buyout	+ Ownership opportunity for existing management + No need to share information with third parties	– Valuation likely lower than other alternatives – Cash at closing will be significantly reduced – Owners will need to provide "seller paper"
Debt recapitalization (mezzanine and/or senior debt)	+ Maintain control of business + Limited ownership dilution	– Increased debt restricts financial flexibility – High interest cost for mezzanine debt
ESOP	+ Allows all employees to share in ownership of the company + Tax advantages to seller	– Cash at closing will be reduced – Restricts the company's go-forward financial flexibility because of additional debt – Increased go-forward professional fees
Status quo	+ No disruption to the business	– No liquidity or diversification in net worth

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Obstacles to exit planning discussions

1. Transaction impact on next generation of leadership
2. Loss of operational control in a transaction
3. Delaying until business hits financial targets

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The next generation of leadership

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"If I sell the business, the next generation of leadership won't have an ownership opportunity!"

- Many business owners are hesitant to engage in exit planning discussions because they are concerned about the impact a transaction will have on the junior leadership team.
- Owners oftentimes feel that they owe it to their key managers to not plan for a future liquidity event – when in fact, they are likely doing them a disservice.
- Transactions can be structured in a way that gets ownership into the hands of the next generation of leadership and allows them to thrive.

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Case study: ownership opportunity for next generation

Situation overview

- A family-run business included the parents and three children
- Mother and father were seeking liquidity as they approached retirement
- Two children wished to continue their involvement in the business, while one preferred to move on to a new opportunity
- The owners (parents) had been hesitant to engage in succession planning discussions – and all ownership was held by parents

Transaction structuring

- Rock Island collaborated with the family and their advisors to develop a number of transaction structure alternatives to address everyone's individual objectives.
- Lack of succession planning complicated the transaction. Rock Island was able to work through the complexities – but many investors would not be as patient.
- Rock Island developed a structure which provided substantial liquidity to mom and dad, while allowing two daughters to own more than 30% of the company post-closing (structured as a tax-free rollover).

Go-forward leadership

- Company has two divisions that are each run by a daughter
- Daughters have been able to go after new business opportunities with support and financial backing from Rock Island

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Case study: ownership opportunity for next generation

Initial

Mom and dad
100% Ownership
Objectives: Liquidity, retirement

Daughter
No ownership
Objectives: Ownership, continued leadership

Son
No ownership
Objectives: Liquidity, transition

Daughter
No ownership
Objectives: Ownership, continued leadership

Today

Daughter
Meaningful ownership
Division president

Daughter
Meaningful ownership
Division president

Rock Island
Majority ownership

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Tip: incentive equity structures

	Vesting mechanics	Mechanics example
"Promote" Units	Units are vested at closing	
Time-Vested Units	Units vest over a period of time (provided continued employment)	1/3 of units vest on the 1st/2nd/3rd anniversary of the transaction
Returns-Based Units	Units vest if the cash investors exceed the target return	Pro-rata vesting from 15% to 25% Internal Rate of Return (IRR)

Other Points to Consider

- Forfeiture provisions
- Put/call on incentive units
- Valuation parameters for put/call
- Ensure all awards will be tax-free

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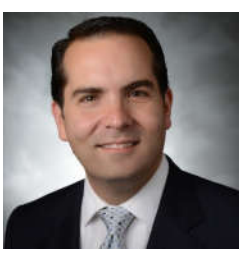
Speaker



Scott Olinger, CPA, CGMA, CPIM

Harding, Shymanski & Company, P.S.C.

Chief Executive Officer

Scott has been with the firm since he began his career in 1995. In addition to serving as the firm's president and chief executive officer, he serves as a trusted advisor to closely-held and family owned enterprises while serving as a leader and resource in the firm's HSC STEPS team (succession, transition, and estate planning services).

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Case study: ownership opportunity for next generation

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HARDING, SHYMANSKI & COMPANY, P.S.C.
Certified Public Accountants and Consultants

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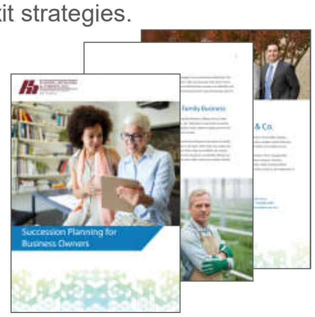
RUNYON EQUIPMENT RENTAL
and
RUNYON SURFACE PREP
has been recapitalized by
Rock Island Capital
and
Management
April 2019

- Runyon/Rock Island engaged **Harding, Shymanski & Company, P.S.C. (HSC)** after closing for audit and tax services.
- HSC's services and involvement were long-overdue – the company would have benefited from HSC's STEPS (succession, transition and estate planning services) prior to the Rock Island transaction.
- HSC STEPS is a process supported by a cross-functional team with deep knowledge of business valuation, tax planning, wealth management, and business exit strategies.

HSC STEPS
Succession, Transition & Estate Planning Solutions



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The seven planning steps

1

The Seven Step Process

HSC STEPS
Succession, Transition & Estate Planning Solutions

STEP ONE — YOUR OBJECTIVES

Where do you want to be? Step One identifies and establishes your unique objectives so that your Exit or Transition Plan works to achieve your goals.

STEP TWO — YOUR BUSINESS & PERSONAL RESOURCES

The starting point for reaching your objectives begins here: How much is your business worth today? How much cash flow does it currently generate? How much income do your non-business assets produce?

STEP THREE — BUILD AND PRESERVE VALUE

Based on the first two Steps, we make specific recommendations to help grow business value, protect existing value from the actions of others, and preserve company value by minimizing income taxes. For example, these recommendations may include updating financial reporting systems, aligning employee performance to your profitability goals, or protecting proprietary information through covenants not to compete with key employees.

STEP FOUR — PLANNING FOR A THIRD PARTY TRANSFER

If your eventual plan is to sell your company to a third party, we design strategies to improve the likelihood of a successful sale, minimize the taxes you will pay upon sale, and maximize your sale price and terms.

STEP FIVE — PLANNING FOR AN INSIDE TRANSFER

If your eventual plan is for an internal transfer, we create a detailed plan to ensure that you receive the money you desire from your business, minimize the risk of non-payment, and ensure that you retain control of the business until you have been fully paid.

STEP SIX — BUSINESS CONTINUITY

As part of your Plan, we coordinate your business continuity planning with your lifetime objectives. The purpose is to ensure that your goals, such as transferring the company to the successor of your choice and having your family receive full value for your ownership, are met whether you survive to see your business exit or not.

STEP SEVEN — PERSONAL WEALTH & ESTATE PLANNING

In Step Seven, we coordinate your estate and long-term personal financial plan with your Step One objectives. Our design emphasizes tax efficiency (in the transfer of wealth or transfer of the business to family members or charity) and ensures that your family receives the amount of annual income necessary to satisfy the financial security goal you set in Step One.

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Positioning for advisory: pre-transaction

EXAMPLE QUESTIONS

1. Do you know your exact retirement goals and what it will take, in cash, to reach them?
2. Do you know how much your business is worth today?
3. What are the value drivers to maximize the value?
4. If you were to sell, who might be a likely buyer?
5. When it comes time for you to leave, are you thinking an internal or external transaction? Who would/could lead?
6. Do you have a continuity plan for your business if the unexpected happens to you?
7. Does your family know your exit or succession plan?

2

Operational control

"If I sell my business, I'll lose control of the business and be working for the investment group!"

- Small and mid-sized business owners are typically accustomed to being in charge.
- As such, some owners are often fearful of continuing to run their business under a new ownership structure and board.
- They worry that the new ownership group will micromanage day-to-day decision-making, limit capital investment, and impose strict cost-cutting measures.

Case study: operational control

Situation overview

- The majority shareholder of a manufacturing business sought to diversify his net worth by "taking some chips off the table."
- He wanted to run the business for an additional three to five years before retiring.

Transaction structuring

- After getting to know the owner over the course of 15+ years, Rock Island presented the owner with majority and minority ownership proposals.
- As the owner grew more comfortable with Rock Island – and the fact that he would maintain operational control of the business regardless of his ownership stake – he elected to proceed with the majority ownership proposal.

Go-forward leadership

- The owner continues to run the business.
- With the backing of a capital partner, he has the ability to pursue accretive acquisitions. In the first nine months since Rock Island's initial investment, the company has evaluated four potential acquisitions.

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Example minority structure

($000's)	Pre- Deal Ownership	Deal Consideration	Rollover	Pre-Tax Cash At Close	Ongoing Ownership
CEO	73.3%	$ 24,922	$ (9,000)	$ 15,922	51.4%
Other Owners	26.7%	9,078	-	9,078	
Incentive Equity					7.5%
Total	100.0%	$ 34,000	$ (9,000)	$ 25,000	58.9%

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2

Example minority structure

$34 Million Recapitalization = $25 Million Cash + 51% Rollover Equity

Uses ($000's)			Sources ($000's)		
Cash Available to Shareholders	$	25,000	Cash	$	-
Payoff Existing Bank Debt		-	New $6.0 million Revolver		2,150
Rollover Equity		9,000	New Senior Term Loan		12,500
Transaction Fees		650	RIC Junior Note		2,500
			RIC Cash Investment (49%)		8,500
			Rollover Equity (51%)		9,000
			Incentive Equity (7.5%)		-
	$	34,650		$	34,650

- Shareholders receive $25 million cash at closing and CEO retains 51% ownership
- Additional 7.5% incentive equity available to be earned by the management team
- RIC invests $11 million
  - $8.5 million equity (49% ownership / 44.9% fully diluted)
  - $2.5 million junior note
- RIC will work with RSM to ensure the recapitalization is completed in a tax-efficient manner
- No personal guarantees
- CEO and other members of the management team are welcome to invest cash on the same basis as RIC (both junior note and equity – pro-rata)

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Tip: minority offer considerations

…It's not just price and ownership % that matter

Debt	**LOW**		⟷		**HIGH**
Equity Structure	**Same basis**	vs.	**Same basis w/ preference**	vs.	**Redeemable preferred**
Key Rights	• **Springing control**		• **Sale blocking right**		• **Compensation plan approval**
Special Liquidity Options	• **Minority owner put**				• **Majority owner call**

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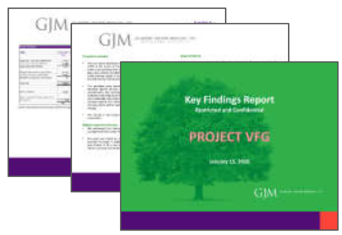
Case study: operational control

GJM GILMORE JASION MAHLER, LTD
INNOVATIVE IDEAS. TRUSTED ADVICE.

+

- Rock Island engaged **Gilmore Jasion Mahler, Ltd (GJM)** during due diligence to complete a quality of earnings report.
- Beyond typical financial performance and metrics, Rock Island was focused on evaluating the business and management.
- GJM helped assess the operational strength of the business and the strength of the management team. This assessment allowed Rock Island to grant certain minority rights outside of a typical deal structure to the owner.
- Due to their experience and familiarity with Rock Island, GJM was also able to help management gain comfort with how Rock Island operates and works with their portfolio companies.



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Speaker

Greg Taylor, CPA

Gilmore Jasion Mahler, LTD
Consulting and Assurance Partner
Leader of Assurance and Consulting Practice
Leader of Transaction Advisory/Private Equity Practice

Greg is the leader of the private equity/transaction advisory practice at Gilmore Jasion Mahler, LTD. He specializes in assisting clients with transaction advisory services, including due diligence and quality of earnings projects and assisting clients on working capital and opening balance sheet activities during an acquisition.

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Case study: operational control

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Importance of a quality of earnings (QofE) report

- Difference between an audit or review
- What is a QofE? Sustainability, accuracy, achievability
  - Breakdown of revenue
  - EBITDA - Determination of recurring vs. one-time expenses (EBITDA addbacks)
  - Analysis of key balance sheet accounts
  - Working capital needs, current and future
- Operations review
- Conduct management interviews

A quick step back – when should you get involved with your clients? "It is never too soon."

- Introduction to strategic partners like Rock Island for assessment of value of your client's business
- Transaction advisory (tax/financial)
- Sell-side QofE – most investment bankers are requiring - finding the "skeletons in the closet"
- Other - data governance/data review, hosting data, **PSYCHOLOGIST**

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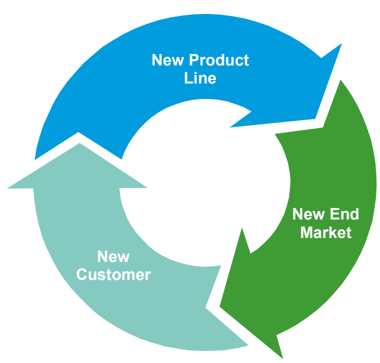
Delaying until business hits financial targets

3

I'm not ready to sell my business. Let's talk about it in a few years after I hit my numbers.

- As entrepreneurs, most business owners are always looking to capitalize on the next growth opportunity.
- Many fear they will "leave money on the table" if they sell a portion of the business before their new product/customer/market has scaled.
- This can turn into an endless cycle — a good entrepreneur is always thinking about the next opportunity.



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Case study: delaying until business hits financial targets

3

Situation overview

- The majority shareholder of a waste services business was considering a transaction as he approached retirement.
- The company was about to open a second location that was expected to grow the company's profitability by 25%.
- The owner had a number in mind (after-tax) and didn't think a potential buyer would be able to hit his number given the current profitability.

Transaction structuring

- Rock Island worked with the company and its advisors (RKL) to understand the owner's objectives and structure a transaction around these objectives.
- It was very clear that after-tax cash at close was the KEY consideration.
- By giving credit for the forecasted increase in revenues and profitability, Rock Island was able to "hit the owner's number."
- RIC also purchased a representation and warranty insurance policy so the seller's cash at closing would not be reduced by an escrow.

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Case study: delaying until business hits financial targets

3

Ways to increase value:

- Clearly articulate the businesses' core competency and competitive advantage
- Develop KPIs to better analyze financial performance and trends
- Develop management depth with a strong track record
- Ensure end market and customer base diversity by limiting dependence on one product or customer
- Assess growth prospects with specific details and action steps on how to achieve the growth targets
- Develop proprietary products and recognized brands

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Case study: delaying until business hits financial targets

3

ERC

has been recapitalized by

Rock Island Capital

and

Management

February 2018

Forward Multiple Example

Illustrative Figures

($ in millions)	Today	@ Closing	In 12 Months
EBITDA	$10.0	$11.0	$12.5
LTM EBITDA Mutliple	6.0x	6.0x	
Forward EBITDA Multiple			5.5x
Valuation	$60.0	$66.0	$68.8

Initial Gap

Narrowed Gap

Company needs to hit its projections during due diligence to narrow the gap

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Speaker

Eric Wenger, CPA, MST

rkl

Tax Partner, RKL, LLP (Pennsylvania)

Eric is a partner in RKL's tax services group, advising closely held and family owned companies with a variety of tax, succession and business issues.

Eric also serves as the managing partner of the firm's Lancaster, PA office, overseeing operations and fostering a positive work environment for the team.

Eric has prior experience with Arthur Andersen LLP and KPMG LLP.

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Case study: delaying until business hits financial targets

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rkl
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- **RKL** was ERC's accountant when Rock Island first approached ERC regarding a transaction.
- As the discussion between ERC and Rock Island grew more serious, ERC engaged RKL to assist with the transaction.
- RKL's M&A experts played a key role in the sale process:
  - Due diligence reviews
  - Net proceeds analysis
  - Business valuation for ERC and Rock Island
- RKL was instrumental in helping to close the deal.
  - RKL ensured the seller was able to maximize his after-tax proceeds
  - RKL facilitated clear, efficient communication between all parties during a sometimes hectic process
  - RKL helped to position key concepts, including representation and warranty insurance, with the seller
- ERC/Rock Island continue to utilize RKL for post-closing audit and tax services.

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RIC, RSM ALLIANCE AND RSM

Rock Island Capital overview

- Rock Island Capital (RIC) Is located in Oak Brook, IL and began investing in 2006.
- RIC has more than $310 million in committed capital.
- RIC typically invests in companies that fall within the following parameters:
  - Company size: Enterprise value of $10 million to $150 million
  - Investment type: Majority and minority equity and mezzanine debt
  - Industries: Manufacturing, distribution or service
  - Geographic location: United States and Canada
- RIC has made investments in 21 platform companies.
- RIC's portfolio companies have completed 30+ add-on acquisitions.

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Rock Island Capital investments

BAKER	*/**	Manufacturer of Water Well Equipment and Pumps
Piedmont CANDY Company	*	Candy Producer
PUMPS AND CONTROLS	**	Water Treatment Equipment Distributor
MASCARI	**	Foodservice Sales & Marketing
	**	Pressure Relief Valve Repair and Distribution
		Steel Service Centers
VENTURE SALES GROUP	**	Foodservice Sales & Marketing
TALMER BANCORP, INC.		Regional Bank
WELCH ATM	*	ATM Management
Advanced Industrial Devices	**	Manufacturer/ Distributor of Control Panels and Electric Motors
CONTINENTAL SERVICES		Contract Food Management
KEMCO SYSTEMS	**	Water Heating & Filtration Systems Manufacturer
CENTRAL	**	Industrial Equipment Distribution and Service
dgs retail	**	Décor Products & Fixtures
Silo Network Solutions	**	Broadband internet, television and telephone service provider
ERC	*/**	Wastewater treatment & disposal
ERC MIDWEST	**	Wastewater treatment & disposal
RUNYON	**	Equipment rental & concrete polishing products
VFG VALLEY FASTENER GROUP	*/**	Industrial Fastener Manufacturer
Excel Engineering	*	Testing Services

* RSM involved

** RSM Alliance firm involved

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Our most important relationship

- Our most important relationship is with RSM and its Alliance Firms
- 21 RIC portfolio investments
- 18 relationships with RSM Alliance Firms or RSM
  - Eleven new relationships and seven relationships maintained/grown
- Nine new relationships for RSM Alliance firms and RSM over the last four years

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How RIC and Alliance Firms work together

- Provide services to RIC and portfolio companies
- Get new relationship or maintain a relationship
- Referral fees for transactions

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Referral fee arrangement

- Majority transaction – Lehman Formula
  - 5% on the first $1 million of transaction value
  - 4% on the next million
  - 3% on the next million
  - 2% on the next million
  - 1% on the transaction value over $4 million
  - For example, $300,000 fee on a $20 million transaction
- Minority transaction – 3% of RIC investment amount

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