CREATION OF VALUE IN A MANUFACTURING COMPANY

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SUPER LABEL INC. –
STAGE I: ENTERING THE LABEL INDUSTRY

The production of labels is an essential part of any economy; they are found on nearly every consumer item and on numerous industrial products; their design helps to sell products, and contains essential information; ranging from a list of ingredients to the bar code. In Canada, labels make up around 4% of the printing industry's volume of approximately $7.5 billion a year. In Ontario, the largest province, the label market is about $150 million a year.

The industry is diverse, some large printers serve high volume markets, while a number of smaller firms handle lower quantity purchasers and niche markets. In general, gross margins are constrained on high volume business, which tends to be price sensitive, and satisfactory to good for the shorter runs where service is the key selling point.

The label market is both seasonal and cyclical; they are principally used for consumer products, which are mainly purchased at retail in the last quarter of the year. As manufacturers buy their labels well in advance, the industry's major selling period is from June to October. Volume is highly influenced by economic conditions, but for many customers competitive pricing is not a major factor because of the high cost of re-cutting dies etc., switching suppliers does not normally result in a better deal.

A significant trend in the Canadian printing industry over the past five years has been consolidation; while sales grew by about 2% annually, the number of firms declined by 20%. The concentration has mainly been among small and medium sized firms who have combined their operations to offer their customers "one-stop shopping" as well as greater efficiency. In 1996, 82% of printing companies in Canada had less than twenty employees, and fewer than 3% more than 100.

Industry Trends

Traditionally, the label business priced its products at three times the cost of the stock; this was geared to give a margin of 40% after production costs. Recently, industry margins have been under pressure, especially for suppliers with long runs; the Company's short run segment has suffered less.

As in many industries, technology has a major impact on the label business; presses now handle up to twelve colours, compared with the four of traditional printers. Photopolymer plates have replaced rubber mats in the commonly used flexo-label printing process, which dramatically improves the quality of the printing.

Another technological trend is ultraviolet (UV) curing of the coatings and varnishes used to protect the printed product. As with the main stream printing industry, the pre-press activity of label manufacturers is becoming computerized; some label printers are able to receive their designs digitally over the telephone.

Fast service and attractive pricing due to the low Canadian dollar has enabled a number of the Canadian suppliers to obtain reasonable job volumes from the United States; such orders often build on the successful relationships with Canadian subsidiaries of multinational enterprises. One Toronto firm, Metro Label, does about 45% of its business in the States, and several others obtain about 15%.

The Partners

In 1994, the three partners listed below saw an opportunity to consolidate the low volume, specialized label industry by forming a holding company for acquisitions. Mr. Smith was to have a 63% controlling interest through his family trust; Mr. Jones would own 25%; and, Mr. Green 12%.

Robert Smith (52), BA, MBA, Chairman & CFO
Mr. Smith has more than 30 years' experience in the graphics industry. He sold labels from 1957 to 1973; in 1978 to 1979, he was a sales representative for a supplier of label material. Since 1981, he has been a senior manager and part owner of various printing companies. Most recently, (1988 to 1997), he was President and a major shareholder of Angel Direct.

William Jones (37), President
Mr. Jones has been involved in the graphics industry for the past twenty years, having progressed from being a press man to production management. His responsibility was day-to-day operations.

John Green (51), Vice President-Sales & Marketing
Mr. Green has been involved in Marketing & Sales for 25 years; he has been associated with Mr. Smith since 1988, when he joined Angel Direct.

Purchase of Super

They had identified Super Label Inc. ("Super" or the "Company"), as a potential target and engaged CVS to value it. Super had been founded in 1983, and operated from a 9,000 square foot plant,

Revenues were running around $2.7 million with a gross margin of 55% and normalized net income of $220,000, for a net margin of 8.2%. Considering the amount of equipment on hand, most of which had been either expensed or written off through accelerated depreciation, CVS selected a Capitalization Rate of 18%, for a Fair Market Value of $1,250,000.

After negotiation, a deal was reached, by which, as of December 31, 1994:

1. The principal withdrew all the current assets from Super and assumed the liabilities through a dividend of $620,000. This left the Company with the business and equipment; this had a depreciated replacement cost of $520,000, but a net book value of $47,000.
2. A newly formed holding company purchased the shares of Super with a 7% Promissory Note for $650,000, payable in equal monthly instalments over ten years. This Note was to be reduced by $1.00 for each $8.00 by which the revenues of Super from its existing customers fell below those of the preceding year.

The Promissory Note was reduced by $93,000 in 1995, as $745,000 of revenue was not retained, but the operations of Super continued to be successful. Revenues for the fiscal years ending August 31, 1996 and 1997 were each just over $2 million, with profits of $155,000 and $135,000 respectively.

Sales & Marketing

Service appeared to be the key to growth, and the Company devoted a great deal of effort to develop a computerized estimating system. Using essential information, such as design, size, colours, material and quantity, the system prepares an immediate quotation which can be given to the client immediately over the telephone or automatically by fax.

Super's aim is to develop strong relationships with its customers and a diversified client base so that it is not dependent on any single buyer or industry. The Company has over 750 customers in food, retail, automotive and toys, with an average invoice of less than $800, and therefore has avoided the situation of many businesses, where 80% of revenue comes from 20% of customers; the Company's, a largest video cassette operation, had sales of $275,000 (13.5%) in fiscal 1997.

Another advantage is that the business is not dependent on any particular sales person. About 30% of revenue is from direct sales through the customer service staff. Another 35% comes from brokers, who are attracted by the convenience of immediate quotes, rapid turnaround times and high quality. The remainder is from relationships with companies in complementary businesses or other segments of the industry. As a sub-contractor, Super, handles some of the small runs of Canada's largest short-run label printer.

The Company emphasizes service, word-of-mouth and "relationships" rather than direct sales or marketing activities. Advertising is placed in industry publications and regional editions of the Yellow Pages.

SUPER LABEL INC. – STAGE II: ESTABLISHING AN ACQUISITION PROGRAM

In early 1997, after two successful years of operations, the partners came to CVS to discuss ways of increasing the value of their shares. Based on normalized net income for Holdco of $113,000, their original investment of $100 in common stock was now worth $650,000.

Mr. Smith had sold his interest in Angel Direct and wished to expand Super. CVS recommended that the consolidation process should be continued and an aggressive acquisition program developed to add more volume to the Super plant by consolidating smaller firms.

The approach was to purchase label businesses with sales between $1 million and $3 million, which had a small sales staff. As Management believes that a departing sales person can take some of their customers with them, they wished to avoid acquiring such customer lists. The target did not have to show profits, but a gross margin in excess of 40% was essential. The purchase price would be based on working capital, the liquidation value of equipment, and up to $0.25 for each dollar of revenue retained.

Initial Transaction

From responses to an ad run by CVS in a trade magazine, Labelmark Inc. was identified and negotiations started. This business, which had the same year end, August 31, as Super, was rather less profitable; the key figures are:

$'000

Year to August 31	**1997**	**1996**
Revenue	1,919	1,814
Gross Profit	703	501
Net Income	132	34
Equity	294	162

Working capital was $182,000 and the equipment had a liquidation value of $671,000; after deducting long term debt of $155,000 and notional recaptured tax on the equipment of $170,000, the Net Tangible Assets were $528,000.

On August 31, 1997, the Company purchased Labelmark as its initial transaction for $900,000 cash; this was mainly obtained through a loan from a bank affiliated "asset lender", which supplied $720,000, of which $120,000 was used to repay existing debt. Mr. Smith lent a further $350,000, while his partners advanced $100,000.

The acquisition gave rise to $370,000 of "goodwill", $0.194 for each dollar of revenue. In addition, the previous owner received a $60,000 retiring allowance, and a $40,000 consulting fee to help integrate the businesses.

On September 1, the Company and Labelmark merged under the name, "Super". Within a month, the operations of both firms were successfully combined and the lease on the Labelmark plant terminated.

Operations

The acquisition of Labelmark not only approximately doubled the revenues of the Company, but also enabled production of 5, 6 and 7 colour high quality labels with a width of up to thirteen inches. Previously Super had been limited to 1, 2, 3 and 4 colour seven-inch labels. The Company was now capable of satisfying virtually all label demand outside specialized 8 to 12 colour products and long run consumer items. Super maintains a desktop publishing department to create designs and develop the necessary art work. To improve turn-around and reduce costs, its photopolymer plates are created in-house.

An in-house computer program allows the order desk to create instant quotes; once the quote is accepted, the software then generates the purchase order and a bar coded manufacturing docket. When the labels are ready for shipment, the software prepares the invoice, which is enclosed with the product. This reduces administrative costs, ensures uniformity in the quotations, and accelerates payment, due to speedier billing and the ability to immediately confirm receipt of the items.

The Company has four major suppliers with whom it maintains strong relations. One furnishes approximately 80% of the roll stock on which the labels are printed; this firm grants extended terms of between 60 and 75 days. The others cover additional raw material, ink & adhesives, and photopolymers.

Excluding the partners, Super has eighteen employees, of which two are in pre-press, three in customer service, two in administration, and eleven in manufacturing. Once revenues exceed $6 million, it will add a second shift, with an additional ten employees.

Building Purchase

On May 1, 1998, the Company purchased a 20,000 sq. ft. building about two blocks from its previous rented facility. The cost was $1 million, with an $800,000 8% first mortgage; Mr. Smith, advanced the balance on a 10% second mortgage. The existing lease expires in July 2001 and a replacement tenant was found starting August 1, 1998.

The new building had one tenant, occupying 8,000 sq. ft., whose lease can be terminated on six months' notice. The Company will occupy 12,000 sq. ft., with 3,000 of offices and 9,000 for manufacturing and storage. The net cash carrying costs are $22,000 a year ($1.83 per sq. ft.) plus $50,000 of depreciation; the previous rent was $54,000 ($6.00 a sq. ft.).

Future Plans

By June, 1998, Super had moved all the equipment it was keeping from both companies into the new plant. Management believes that, with two shifts, to handle sales of $12 million a year, approximately three times the combined revenue of Super and Labelmark ($3.9 million) in the year to August 31, 1997. The intention is to integrate further acquisitions into the new plant and to recover part of the purchase prices by selling off much of the acquired companies' equipment.

Fifteen possible targets in the Toronto area were identified which satisfy its criteria. Approaches were made to eight, of which two, with a combined revenue of about $1.8 million, were bought as of August 31, 1998. One of these allowed the Company to start serving the cosmetics industry.

The price for those two acquisitions was $720,000 in cash and shares, and the assumption of $86,000 of equipment loans. Working capital was $164,000 and the equipment had an appraised value of $322,000; the remaining 320,000 was paid for customer lists and "goodwill". Subsequently, $258,000 cash was received from the sale of equipment no longer needed.

Benefits of Future Acquisitions

Until the capacity of the new plant is reached, estimated at $12 million in revenues, Management expects that each dollar of acquired sales will, on a continuing basis, add $0.30 to operating profit. This contribution, before amortization of goodwill, is based on a 40% gross margin, 6% of additional selling costs, and 4% in extra administration.

During the year of the purchase, the profits from an acquisition will be reduced by: losses on disposal of equipment, write-offs of existing leasehold improvements, lease termination charges, legal fees, retirement allowances, termination expenses, as well as integration and training costs.

Profitability

The year to August 31, 1998, was satisfactory, ending in a merger with Holdco and the two new label companies. Revenues were $4,024,060 and pre-tax profits of $363,322, after non-recurring expenses, as follows:

Professional Fees	27,879
Moving Expenses	54,980
Labelmark Rent before move	2,560
Leasehold Write-off	20,340
Building Maintenance	15,602
Super Rent-vacant period	4,106
.	125,467

Adding these amounts to the pre-tax profit gives a normalized amount of $489,000; deducting $169,000 for tax results in normalized Net Income of $320,000.

The two new acquisitions increased 1998 pro forma revenue to $5,857,000. Assuming 5% growth for the previous customers of Super and a 2.5% decline for the new acquisitions, Management budgeted fiscal 1999 revenues at $6,000,000 and pre-tax profit of $1,065,000 for a 17.8% pre-tax margin. After income tax of $465,000, Net Income was expected to be $600,000 for an 87% increase in profits and a 10% Net Margin.

Trend & Ratio Analysis

Trends in revenues and margins from the purchase of Super by the parties on December 31, 1994 have been favourable. In their first fiscal period, eight months to August 31, 1997, revenues were $1,287,800, ($1,931,700 annualized). In fiscal 1996, they increased 4.3% to $2,114,000, and were virtually flat at $2,017,000 in the following year. Labelmark revenues were $1,814,000 in fiscal 1996, rising by 5.8% to $1,919,000 the next.

On a combined basis, revenues in fiscal 1997 grew 2.8% from $3,827,500 to $3,936,000; for fiscal 1998 they amounted to $4,024,000, for a similar gain of 2.2%. Therefore, Management concluded that, other than through acquisitions, the Company is unlikely to show any significant growth in revenues.

Margins for Super were above those for similar printers in the United States (Manufacturers-Commercial Printing, Letterpress & Screen) as reported by Robert Morris Associates ("RMA").

%	August 31 1995	1996	1997	1998
Gross Margin				
Super	42.6	39.0%	36.2	36.5
Labelmark	n/a	29.0%	34.3	n/a
RMA	36.0	36.7%	n/a	n/a
Pre-Tax Margin				
Super	9.9	9.9	8.8	9.0*
Labelmark	n/a	2.7	9.0	n/a
RMA	3.7	3.7	n/a	n/a

* after normalization adjustments, this is 12.1%

SUPER LABEL INC. – STAGE III: VENTURE CAPITAL FINANCING

The two new acquisitions involved $500,000 of vendor notes and $220,000 in convertible preferred shares to an owner who was joining Management. To reduce its leverage in the fall of 1998, Super decided to raise $1 million of venture capital, for which it requested CVS to value its common and preferred shares.

The negotiations with the venture capitalists culminated in the following:

- the sale of common shares for $1,400,000 of new cash, half to pay down debt, and the balance for further acquisitions;
- the $220,000 convertible preferred were converted to common at the price to be paid by the venture capitalists; and
- Super merged with a publicly traded shell whose shareholders are to receive about 10% of the fully diluted equity.

Our assignment was to value Super so as to:

- determine what percentage of the equity should be received by the venture capitalists; and
- estimate the market capitalization of Super as a public company.

Capitalization Rate from Comparables

Our preferred approach is to find comparable public companies as "guidelines". Their implicit Capitalization Rates, the reciprocal of the Price/Earnings Ratios, are adjusted for the differences in growth, risk and marketability. Large numbers of companies in many industries are traded on the Canadian and US stock markets, and usually, several "guideline" companies are easily identified.

CVS found two US and one Canadian guidelines:

- Multicolor Corp., a label manufacturing firm in Cincinnati, Ohio, trading on NASDAQ as LABL;
- Katz Digital Technologies, Inc. in New York, N.Y., handles short run printing, trading on NASDAQ as KATC;
- PLM Group Ltd., a full service printing firm that produces labels in Markham, Ontario, trading on the Toronto Stock Exchange as PGL.

Summary information about these guideline companies is as follows:

	LABL*	**KATC***	**PGL**
12 months to September 1998			
Revenue **$'000**	48,438	19,840	61,371
Net Income **$'000**	902	868	4,231
Valuation Date Price **$**	6.50*	4.25*	2
Shares outstanding	2,272	4,989	27,831
Market Capitalization **$'000**	14,768	21,203	55,662
Capitalization Rate	6.1%	4.1%	7.6%
Price/Revenue Multiple	0.30	1.07	0.91
* US funds			

The Capitalization Rates of these guidelines were adjusted as follows:

	LABL	**KATC**	**PGL**
Capitalization Rate	6.1%	4.1%	7.6%
Adjustments			
Location	1.0%	1.0%	0.0%
Size	1.5%	1.0%	2.0%
Level of Debt	1.0%	1.0%	0.0%
Growth Rate	-3.0%	-0.5%	-2.0%
Adjusted Capitalization Rate	6.6%	6.6%	7.6%

The average Adjusted Capitalization Rate from these guidelines is 6.9%.

Consolidators

The consolidation of medium and small sized companies in a particular industry is as significant a feature of North American business life in the 1990s as it was with the "trusts" early in the century. This activity, which is likely to continue, is resulting in the domination of many historically fragmented business sectors by a few large, professionally managed, firms operating throughout the country.

The trend, which has caused an unprecedented number of recent mergers and acquisitions is a response to the strategic forces that affect practically every industry; they have delivered the clear message that "business as usual" is no longer a satisfactory choice. It is estimated that half the mergers in the United States during 1997 were undertaken by Consolidators. A number of industries, such as document storage, travel agencies, packaging, physicians' offices, auto dealers, and money managers have realized that success depends on simultaneously getting bigger and better.

Consolidation is not a new concept; however, the speed at which it is taking place, the power of the forces causing it and the "mom and pop" industries involved are unusual. Over 100 Consolidators had Initial Public Offerings in the United States between 1992 and 1998, nearly 60% of them in 1997. Irrespective of the industry, US securities markets appear to now consider "Consolidators" to be specific investment group, for tracking share performance and management's ability to create value. The success of the IPOs demonstrates that many industries ignored by big business, are being treated as such, by Consolidators.

Howard, Lawson & Co., a Philadelphia investment banking firm, in early 1998, undertook a research report on "IPO Consolidations". This listed 101 companies with a Market Capitalization of US $18.25 billion as shown below. The Price/Earnings ratios varied from 10.5 times to 684 times, with the medians of the groups ranging from 21.7 times to 34.7 times, with an average of 27.4 times.

		Market Cap	Price/Earnings	
	Number	**US**	**Range**	**Median**
Business Services	31	4,280	11.8 to	34.7
Consumer Services	20	2,387	15.2 to	23.3
Distribution	11	1,886	10.5 to	26.4
Financial Services	8	1,643	15.3 to	26.4
Health Care	12	1,355	20.1 to	29.8
Manufacturing	10	1,902	12.2 to	29.3
Miscellaneous	9	4,799	19.1 to	21.7
	101	18,252	Average	27.4

Super intends to be a Consolidator of the Canadian label industry; the average of the median Price/Earnings ratios among US Consolidators is 27.4 times, for a Capitalization Rate of 3.7%. Adjusting for the differences in location (1% extra in Canada) and size (1%), CVS believes the Capitalization Rate applicable to Super, as a Consolidator is 5.7%.

Valuation Conclusion

The guidelines give a Capitalization Rate of 6.9% for Super, while, as a Consolidator, it would be 5.7%. Considering that the investment group "Consolidators" is only in the process of being accepted in Canada, CVS has selected 6.5% as the appropriate Capitalization Rate; this is equivalent to a Price/Earnings ratio of 15.4 times.

Applied to fiscal 1998 normalized Net Income of $320,000, this gives a value of $4,923,000; using fiscal 1999 Projected Net Income of $600,000, results in $9,230,000.

CVS applied a 21% minority discount and valued Super, including the convertible preferred shares, at $3,900,000, giving the venture capitalists a 26.4% interest for their $1.4 million cash.

Expected Outcome

The merger with the public company is not yet completed, but when it is, the situation is expected to be:

	Shares	**%**
Partners	1,387,600	62.8
Convertible Preferred	83,000	3.8
Venture Capitalists	530,000	24.0
Shell Shareholders	207,267	9.4
.	2,207,867	100.0

For the first quarter to November 30, 1998, costs were almost as budgeted, while revenues came in $140,000 below. However, with the additional cash and lower interest, Management is satisfied that it can exceed its budgeted Net Income of $600,000 which would result in Earnings-Per-Share of $0.27.

With the acquisition "war chest", they expect to be able to add at least one more company for fiscal 2000, giving sales of $8 million in that year. As very little additional equipment would be required, pre-tax profit should amount to $1,755,000, resulting in Net Income of $1 million for a 12.5% net margin and Earnings-Per-Share of $0.45.

The intended market maker, expects that, after the merger, the shares of Super, as a public company will trade at between $3.00 and $3.50. The lower figure, puts a value of $4,163,000 on the partners' common shareholdings, which originally cost $100.00; allowing for the $450,000 of shareholders' advances still outstanding, the value of their investment will have increased by more than ten times, in just over four years.

