CORPORATE CARVE-OUTS

Observations by Scott-Macon’s Industrial & Automotive Group

May 2016

SCOTT-MACON, LTD.

800 Third Avenue, New York, NY 10022
Phone: +1 (212) 755-8200 | Fax: +1 (212) 583-9262
www.scott-macon.com
Summary – Corporate Carve-Outs

A company may carve out a business unit when it is underperforming or no longer considered core. Unlike a straight divestiture of a stand-alone business, a corporate carve-out is typically a sale of a business that is partially integrated with other operations of a company and, therefore, is often more complex.

The following report outlines the complexities of corporate carve-outs and how to tackle them in an M&A sales process. Scott-Macon has successfully completed numerous corporate carve-out transactions and we are sharing our observations based on the expertise we have developed. This report will cover the following topics:

- **Industry Statistics**
  About ¾ of the 2015 U.S. carve-out transactions were middle-market divestitures - having a total enterprise value less than $100 million per transaction. The consumer and financials industry accounted for about half of these carve-outs with information technology, industrial and healthcare, accounting for about 40%.

- **Drivers of Corporate Carve-Out Decisions**
  Companies often sell underperforming assets to implement growth plans using the capital to improve operational performance, gain HR capacity, and invest in M&A deals. In addition, selling non-core assets allows management to focus its attention on core-business opportunities. Divestitures of underperforming businesses eliminate the continued need for cash investment and tend to improve overall financial results.

- **The Separation, Preparation and Execution of the Corporate Carve-Out Transaction and the Critical Role of an Experienced Financial Adviser**
  Selling a carve-out entity is a complex and time consuming process where an experienced financial adviser’s execution experience can make a crucial difference in both timing and value creation in all phases of the process:

  - **Separation** - Carve-out entities are often inter-linked with the company’s other operations and can be extremely difficult for buyers to assess since stand-alone financial statements do not typically exist.
    
    While most of the work to actually separate the carve-out from the company is completed at the corporate level, an experienced financial adviser can help develop a roadmap to guide and complete the transaction.

  - **Preparation** - If the company has shared services with the carve-out entity, a clear plan of action is required for full separation. This action plan should clearly lay out a time frame for the carve-out entity’s full independence. A financial forecast with a dedicated management team provides significant comfort to buyers. The preparation phase is where most of the upfront work is performed.
    
    An experienced financial adviser can help in a number of areas, including interacting with management to develop the information memorandum and management presentation slides, defining shared services and determining the cost of third party contractors, and developing a detailed financial model showing historical and projected stand-alone financial statements.

  - **Execution** - A neatly-packaged sale process can create a competitive environment and optimize proceeds from the sale of a carve-out. Sellers should consider vendor due diligence and stapled financing to expedite the process. Transition agreements need to be developed for shared services and buyers may negotiate a non-compete clause to protect themselves from the company re-entering the carve-out unit’s market.

  Superior execution has the largest impact on value, and the quality of the materials presented and deadlines established send the most significant message to buyers that they are now part of a competitive process. An experienced financial adviser can move along the process with speed through documentation – the critical element on maintaining and increasing value.
Industry Statistics

Most Carve-Outs Are “Middle Market”

According to S&P Capital IQ, more than half of the U.S. carve-out transactions (announced or closed with disclosed deal values) in 2015 had a total enterprise value less than twenty-five million dollars. Transactions ranging in size from twenty-six to fifty million dollars and fifty-one to one-hundred million dollars accounted for fourteen percent and ten percent of the market, respectively. The remaining twenty-five percent of carve-out transactions had an enterprise value greater than one-hundred million dollars.

Carve-Outs Occur Across All Sectors

The consumer discretionary industry and financials industry led the U.S. in corporate carve-out volume, making up roughly twenty percent each. The next largest industry movers were information technology, industrial and healthcare, accounting for approximately thirteen percent each.

According to S&P Capital IQ, the total transaction value for corporate divestitures was $216.5 billion in 2015.

2015 U.S. Carve-Out Total Enterprise Value*

2015 U.S. Carve-Out Deal Count by Industry*

2011 – 2015 U.S. Corporate Divestitures*

*Source: S&P Capital IQ (Includes only disclosed information)
Drivers of Corporate Carve-Outs Decisions

The value of global divestitures has increased by 80% since the M&A low of 2009 according to a recent study completed by Ernst & Young. Of the companies surveyed, 45% recently divested (or placed on a watch list) a business unit that was not reaching performance criteria.

**Growth Considerations as Key M&A Driver**

According to a recent Firmex survey, among the many reasons for a company to decide on pursuing M&A transactions, the desire of reaching its growth targets is generally the most important. Growth targets can be impeded by underperforming business units, unfavorable product mix, geographic challenges, customer concentration, a lack of focus, a changing competitive environment, new technologies, as well as other factors. To overcome these hurdles and focus on growth, large companies often pursue a series of M&A transactions given that a single deal rarely addresses all of the aforementioned challenges. Such series of M&A transactions can take place simultaneously or in sequence depending on the strength of the company’s balance sheet and the availability of (internal and external) execution professionals.

Other leading drivers of M&A activity include divesting non-core assets, improving operational efficiencies, increasing market share, expanding into new products, and accessing new geographies.

**A Changing Competitive Environment Often Triggers Divestitures**

Carve-outs or divestitures in general can be triggered by many different factors. According to a recent Ernst & Young study, the most often mentioned consideration for a divestiture is a business unit’s weak competitive position in the market. Other considerations most often cited include a unit not considered core, concerns related to shareholder activism, the risk/reward balance of the business portfolio and a need to generate cash.

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**Leading Drivers of North American Mid-Market M&A**

- 38% Reaching growth targets
- 32% Divesting non-core businesses or assets
- 30% Improving operational efficiency
- 30% Increasing market share
- 28% Expanding into new products
- 28% Accessing new geographies
- 4% Gaining information technology
- 4% Boosting human resources
- 2% Rise in activity from family members

**Triggers That Prompted Most Recent Divestiture**

- Opportunistic (incl. unsolicited approach by a buyer): 14%
- Company is not the best owner for the asset / low synergies with rest of business: 29%
- A need to generate cash: 34%
- Unattractiveness of market that unit is operating in: 40%
- Negative impact on risk/reward balance of portfolio: 43%
- Concerns related to shareholder activism: 44%
- Not part of the core business: 45%
- Unit’s weak competitive position in the market: 46%
- 57%

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Source: Firmex Mid-Market: The Crux of North American M&A

Source: Ernst & Young Global Corporate Divestment Study (2015)
Drivers of Corporate Carve-Outs Decisions (cont.)

**DIVESTITURE PROCEEDS ARE OFTEN IMPORTANT DRIVERS OF GROWTH**

As previously stated, one significant factor in deciding whether or not to divest is the need to generate cash. As shown in the chart below, while there are many outlets for the cash generated from a sale of a business, the single most important factor is to drive growth. This can be accomplished by:

- Investing in the company’s core businesses
- Investing in new products/markets/geography
- Completing acquisitions

![Use of Funds From Most Recent Divestiture](chart.png)

Source: Ernst & Young Global Corporate Divestment Study (2015)

**THE TIMING OF M&A ACTIVITY OFTEN DEPENDS ON THE BUSINESS CYCLE**

- Limited growth opportunities during recession
- In order to expand, corporations tend to diversify over time - the result is reduced risk but can also lead to complex business models
- Rise in core-business opportunities with recovering economy requires additional attention
- In a recovering economy, a rise in carve-outs of non-core or underperforming operations allows management to shift its focus on core businesses
- Divestitures of underperforming businesses may reduce the continued need for cash investment
- Consolidated financial results typically improve after divesting poorly performing businesses
- Capital raised through divestitures can help fund growth
Unlike a straight sale of a stand-alone subsidiary, a sale of a carve-out business unit is much more complex. As with any sale, time never works in a seller’s favor and the goal is to complete a transaction as soon as possible. Given the complexities of a carve-out transaction, it is imperative that sellers complete much of the work prior to going to market. The phases of Separation and Preparation are where much of this work is required. Once those phases have been completed, the Execution phase is very similar to the Execution phase of a stand-alone entity – although due diligence is typically longer in a carve-out transaction as buyers need to verify all of the work completed in the Separation and Preparation phases and transition agreements need to be negotiated.

**SEPARATION**

- Carve-out entities are often inter-linked with the company’s other operations
  - It can be extremely difficult for buyers to assess from a financial standpoint as the company’s financial statements often do not show the business on a stand-alone basis which is critical for a buyer to understand exactly what they are acquiring
  - Normalizations to the financials frequently comprise (i) cost allocations from shared services; (ii) transfer pricing for raw materials and finished products; and (iii) cost advantages which the company achieved from its purchasing power due to size and which are then transferred to the carve-out entity
- A significant portion of transition activities occur between signing and closing
  - Planning ahead can shorten the time-frame
  - Crucial to execute deal in a timely manner because macroeconomic events may impact deal conditions
- Established roadmap shows buyers that an acquisition of a carve-out can be completed without disruption of the business and loss of value

<table>
<thead>
<tr>
<th><strong>Operations</strong></th>
<th><strong>Deal Structure and Timing</strong></th>
<th><strong>Legal &amp; Tax Issues</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Overlap of customers/suppliers</td>
<td>• Asset or stock sale – stock sale sometimes available if one entity in a sale of multiple entities is a stand-alone business.</td>
<td>• Legal structure of carve-out entity</td>
</tr>
<tr>
<td>• Separate key functions such as sales, mfg. and marketing</td>
<td>• Steps to separate activities</td>
<td>• Transfer of contracts</td>
</tr>
<tr>
<td>• Determine requirements to run stand-alone business</td>
<td></td>
<td>• Change of control clauses</td>
</tr>
<tr>
<td>• Handling of inventory/receivables</td>
<td></td>
<td>• Litigation claims</td>
</tr>
<tr>
<td>• Liquidity/debt/company guarantees</td>
<td></td>
<td>• Avoid taxes on hidden reserves</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Information Technology</strong></th>
<th><strong>Intellectual Property</strong></th>
<th><strong>Human Resources</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Handling of inventory</td>
<td>• Brands</td>
<td>• Employment contracts</td>
</tr>
<tr>
<td>• Collection of receivables</td>
<td>• Patents</td>
<td>• Pensions</td>
</tr>
<tr>
<td>• Software licenses</td>
<td>• Licensing agreements</td>
<td>• Planned vacancies</td>
</tr>
</tbody>
</table>

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Separation, Preparation & Execution (cont.)

**PREPARATION**

- Supply of Materials and Services Needs to Be Clearly Addressed
  - If the company has shared services with the carve-out entity, a clear plan of action is required for full separation
    - This should define products and services, volumes, terms and a time frame until the carve-out entity has reached full independence
  - If the company is a customer of the carve-out entity, the value of the entity may be tied to a continuing relationship
    - The company may have to execute a contract where it purchases a pre-determined amount of product/volume from the carve-out entity (at market or below market rates) for a finite period of time
- Solid Forecast Financials Drive Value
  - Acquirers look for attractive strategic positions in promising markets and sound business models that provide future growth and earnings potential
    - A financial forecast should be based on a set of reliable underlying measures which management is able to defend
- Existing Management Team is Key to Success of Completing Transaction
  - Once the decision has been made to dispose of a carve-out entity, the management team should be brought on board as soon as possible in order to solicit needed support and overall management buy-in
  - In addition to management providing critical input to the transaction process, they are also completing their day-to-day operating responsibilities
  - It is essential that incentives are provided to the existing management team so that they will remain in place until the completion of a transaction and, ideally, beyond
  - A complex carve-out transaction requires significant input from management during all phases of the transaction process
  - A lean organization structure with less bureaucracy combined with increased decision making authority for management typically improves cost structures and drives the business forward
EXECUTION

Positioning

- A neatly-packaged sale process can create a competitive environment and optimize proceeds from the sale of a non-core or underperforming business
- Providing a clear, stand-alone business model helps buyers understand the value of the carve-out
  - Rationale for the carve-out should be explained when positioning the business unit for sale
    - Strategic buyers look to improve market share or expand into new products/regions
    - Financial buyers seek strong growth potential, improved performance and add-on acquisitions

Consider Vendor Due Diligence

- Vendor due diligence can provide an in-depth and independent report on the financial health of a business unit
  - The due diligence report provides comfort to both buyers and sellers with an independent view of the business
  - This report can significantly reduce due diligence time and thus provide more competitive momentum
- The cost of a vendor due diligence report is not insignificant and, on smaller carve-out transactions, sellers are often reluctant to incur this expense
  - In that event, a thorough and professional preparation of all materials becomes even more critical

Consider Stapled Financing

- Stapled financing, a pre-arranged financing package offered to potential buyers, creates a competitive environment, expedites the sale process and reduces some of the risk
  - Stapled financing is typically arranged by a commercial bank and includes all details of the lending package
- The banks will have been given access to the vendor due diligence and will be expected to have obtained the requisite credit approvals, subject to final documentation and potentially other caveats
- The winner of the bidding contest can receive the loan offered - but it is an option, not an obligation
- Stapled financing provides more timely bids since financing is already in place
  - Buyers benefit from seeing terms of the pre-arranged lending deal and no longer need to scramble for last-minute financing
- Buyers have access to debt which it may not otherwise have been able to raise
- Stapled financing can reduce the risk of not closing because of buyers inability to arrange financing
- While this step provides a clear advantage in the M&A process, it does however require more time at the beginning of a deal and may incur additional upfront cost to the seller
Separation, Preparation & Execution (cont.)

- **Transition Agreement**
  - Buyer may want to cut ties with the company and purchase shared services from third parties or continue receiving services from the company for a specified time period at agreed upon pricing

- **Non-Compete Agreement**
  - Buyers may negotiate a non-compete clause to protect themselves from the company re-entering the market in which the carve-out was involved and competing against the buyer

- **Bridging the Valuation Gap**
  - Without a history of a stand-alone business, earnings potential of a carve-out entity are sometimes difficult to assess
    - Earn out structures that provide proceeds based on future earnings are often used to bridge the gap
  - Sellers are generally reluctant to accept earn out structures since they no longer control the company
    - In addition, the carve-out unit may become part of a larger organization which may allocate corporate charges to the carve-out unit and lower financial results making it harder to achieve targeted earn out goals
  - Often, sellers reluctantly accept these structures because they have just been through an exhaustive selling process and have been working with one buyer for some time
    - Sellers fear that any other buyer selected will (i) believe they are being re-contacted because of a broken deal and lower their initial offer; and (ii) come to the same conclusion as the originally selected buyer and then offer the same earn out structure
Companies looking to complete a carve-out transaction can avoid certain pitfalls inherent in executing the deal. Below is an overview of various steps in the process and potential pitfalls.

<table>
<thead>
<tr>
<th>HOW TO EXPEDITE THE PROCESS</th>
<th>POTENTIAL PITFALLS OF NOT TAKING THIS STEP</th>
</tr>
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<tbody>
<tr>
<td>Define what you are selling and clearly define dependence on parent company</td>
<td>Confusion among buyers</td>
</tr>
<tr>
<td>Determine potential buyers and value drivers</td>
<td>Buyers created own scenarios / negotiations lengthen</td>
</tr>
<tr>
<td>Position company such that buyers are bidding on identical information</td>
<td>Waste time analyzing irrelevant information</td>
</tr>
<tr>
<td>Provide a clear roadmap of business separation from seller to buyer</td>
<td>Lose credibility and momentum</td>
</tr>
<tr>
<td>Provide supportable, realistic market analyses and forecast</td>
<td>Bids may not be comparable</td>
</tr>
<tr>
<td>Provide stand-alone financial statements</td>
<td>Loss of time spent evaluating bids</td>
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<tr>
<td>Take time/resources to start legal entity set-up process</td>
<td>Buyers develop own view of stand-alone costs</td>
</tr>
<tr>
<td>Consider selling to buyer with existing platform</td>
<td>Loss of value and momentum</td>
</tr>
<tr>
<td></td>
<td>Loss of credibility</td>
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<tr>
<td></td>
<td>Buyers may discount price or walk away</td>
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<tr>
<td></td>
<td>Limit buyer pool</td>
</tr>
<tr>
<td></td>
<td>Fail to maximize value</td>
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<tr>
<td></td>
<td>Longer to close</td>
</tr>
<tr>
<td></td>
<td>Loss of value and time</td>
</tr>
<tr>
<td></td>
<td>Longer to create a new stand-alone company</td>
</tr>
</tbody>
</table>
ADVANTAGES OF HIRING AN EXPERIENCED FINANCIAL ADVISER

The process of selling a carve-out entity should be completed as quickly as possible to maximize value. However, the information flow needs to be complete and accurate to successfully close the transaction. This is a complex and time-consuming task where execution experience can make a crucial difference in both timing and value creation.

An experienced financial adviser can create significant value in all three phases of the process:

➢ Separation
  ▪ While most of the work to actually separate the carve-out entity from the company is completed at the corporate level, a financial adviser experienced in these types of transactions can be instrumental in developing a roadmap to complete the deal and guide the company through that roadmap

➢ Preparation
  ▪ The preparation phase is where most of the upfront work is performed. In this regard, an experienced financial adviser can help in a number of areas, including but not limited to:
    ✓ Work with the company to suggest incentives for management
    ✓ Explain to management what information is needed for the Confidential Information Memorandum (CIM) and for the management presentation given that management is typically unfamiliar with the sale process
    ✓ Define the shared services and determine the cost of third-party contractors
    ✓ Develop a detailed financial model showing historical stand-alone financial statements as well as projections based on management’s growth assumptions

➢ Execution
  ▪ Execution is the phase that has the largest impact on value
    ✓ The quality of the materials presented as well as establishing clear deadlines in different stages of the transaction sends the most significant message to buyers that they are now part of a competitive process
      • An experienced financial adviser who has completed many of these assignments and can move along the process with speed through documentation – the critical element on maintaining and increasing value
<table>
<thead>
<tr>
<th>Seller</th>
<th>Buyer</th>
<th>Description</th>
<th>Carve-Out</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Technologies</td>
<td>Hall &amp; Kay Fire Engineering</td>
<td>Hall &amp; Kay Fire Engineering engages in the design, installation, commissioning and maintenance of active fixed fire protection systems across the U.K. Within the active fixed fire protection segment, Hall &amp; Kay particularly specializes in water-based sprinkler systems.</td>
<td>H&amp;K</td>
<td>2014</td>
</tr>
<tr>
<td>SANTOLUBES</td>
<td>Envincio, LLC</td>
<td>Envincio, LLC is a manufacturer and distributor of natural and synthetic pesticides for the professional pest control industry. SantoLubes LLC sold certain assets of its Envincio, LLC subsidiary to Central Garden &amp; Pet Company.</td>
<td>Envincio</td>
<td>2014</td>
</tr>
<tr>
<td>UTC Climate, Controls &amp; Security</td>
<td>IEP Technologies</td>
<td>UTC Climate, Controls &amp; Security sold its industrial explosion protection businesses to IEP Technologies, a newly formed company established by Sentinel Capital Partners. The businesses provide systems and services that suppress, isolate and / or vent potential combustible dust or vapor explosions in process industries.</td>
<td>IEP Technologies</td>
<td>2013</td>
</tr>
<tr>
<td>United Technologies</td>
<td>ConGlobal Industries, Inc.</td>
<td>United Technologies’ Carrier division divested Refrigerated Container Services Group (RCS) to ConGlobal Industries, Inc. At the time of the sale, RCS was the largest distributor of refrigerated container parts in the world.</td>
<td>The RCS Group</td>
<td>2012</td>
</tr>
<tr>
<td>MAERSK</td>
<td>DCLI</td>
<td>At the time of sale, DCLI owned or leased approximately 66,000 chassis through a network of 129 locations strategically located on or near key ports and other intermodal hubs in the U.S.</td>
<td>DCLI</td>
<td>2012</td>
</tr>
<tr>
<td>MAERSK</td>
<td>GILBERT</td>
<td>At the time of sale, the Company was a leading provider of value added third-party logistics services to the retail sector, principally serving retailers, apparel and footwear companies, including import deconsolidation, warehousing, vendor consolidation, delivery and multimodal logistics.</td>
<td>GILBERT</td>
<td>2011</td>
</tr>
<tr>
<td>United Technologies</td>
<td>Mobile Climate Control</td>
<td>United Technologies’ Carrier division sold its bus air conditioning business in the United States and Canada to Mobile Climate Control, a leading global provider of climate control solutions to the commercial vehicle industry. Mobile Climate Control is owned by Ratos AB, a Sweden-based financial investment company.</td>
<td>North America Bus Air Conditioning Business</td>
<td>2011</td>
</tr>
<tr>
<td>LyondellBasell</td>
<td>Pinova Holdings, Inc.</td>
<td>LyondellBasell sold its Flavors &amp; Fragrances business to Pinova Holdings, Inc. It is the world’s leading producer of terpene-based F&amp;F ingredients for the food, beverage, personal care, fine fragrance and household products markets.</td>
<td>LyondellBasell Flavors &amp; Fragrances LLC</td>
<td>2010</td>
</tr>
<tr>
<td>United Technologies</td>
<td>Eberspächer GmbH &amp; Co. KG</td>
<td>United Technologies’ Carrier division, sold its Bus Air Conditioning Business in Europe, India and Mexico to J. Eberspächer GmbH &amp; Co. KG. The business provides complete air conditioning systems for transit buses and coaches to global bus manufacturers such as Volvo, Van Hool, and Irisbus.</td>
<td>SÜTRAK</td>
<td>2010</td>
</tr>
</tbody>
</table>
Scott-Macon Case Study I: Sale of UTC Hall & Kay Fire Engineering Business

**Business Description**
- Leading position in U.K. sprinkler industry
- Approximate 20% share of the fixed fire protection segment in which it participates
- Broad and diverse customer base
- Longstanding relationships with major customers
- Strong brand recognition
- Experienced management team
- Engineering provides two key services:
  - Design, supply and installation of water based extinguishing systems (“Installation”)
  - Service and maintenance of company-installed and competitor systems (“Service”)

**Key Investment Considerations**
- Leading position in U.K. sprinkler industry
- High barriers to entry
- High level of recurring revenue with large customers
- Growth prospects due to favorable legislation
- Strong competitive position
- Experienced management team
- Strong brand recognition

**Future Opportunities**
- Increased sprinkler demand due to stringent regulatory oversight
- Sales expansion through new relationships with key end-users and contractors
- Increased profitability due to improved supply chain management initiatives
- Increased productivity through improved technology

**Financial Overview**
- Significant revenues with turnaround margins
- Historical annual financial results not comparable due to phase out of large-volume, low-margin installation projects and departure from education sector

**Challenges**
- Complex reverse carve-out scenario
- Difficulty providing stand-alone financials
- International legal hurdles

**Results**
- Ran a highly competitive auction process
- Closed November 2014
Scott-Macon Case Study II: Advisory Role in Multi-Step Value Creation

**CARVE-OUT DECISION**
Decision by the company to sell non-core assets

**PACKAGING**
Marketing a stand-alone business with independent management and financials

**VALUE REALIZATION**
Previously undermanaged business units are able to thrive when given the proper resources

**SUSTAINABLE GROWTH**
Rapid growth due to unencumbered corporate structures is accelerated by add-on acquisitions
About Scott-Macon

**OVER 40 YEARS OF SENIOR LEVEL EXPERIENCE**

- **FOUNDED**: 1973
- **TOTAL DEALS**: 700+
- **TOTAL DEAL VALUE**: $40B+
- **BANKERS**: 20+

**SPECIALIZED SKILLS**

**ADVISORY SERVICES**
- Targeted acquisitions
- Divestitures / Carve-Outs
- Leveraged buyouts
- Fairness opinions
- JVs/Strategic alliances
- Mergers

**CAPITAL MARKETS**
- Capital market insights
- Equity/debt private placements
- Capital structure analyses
- Debt restructuring
- Selection of underwriters for public debt/equity offerings

**STRATEGIC DIFFERENTIATORS**

<table>
<thead>
<tr>
<th>DEDICATION</th>
<th>FOCUS</th>
<th>OUTSTANDING EXECUTION</th>
<th>CLIENTS ALWAYS COME FIRST</th>
</tr>
</thead>
<tbody>
<tr>
<td>Same business philosophy, name, CEO, ownership and strategy for over 40 years</td>
<td>Advisory services is the only business, not commercial banking, research, sales &amp; trading, brokerage or money management</td>
<td>All transactions executed by senior professionals</td>
<td>No conflicts, no internal venture capital or private equity fund</td>
</tr>
</tbody>
</table>

**SCOTT-MACON, LTD.**
About Scott-Macon

For additional information, please contact:

**SCOTT-MACON, LTD.**

Fabian Hassel  
Managing Director  
Group Head – Industrial & Automotive  
800 Third Avenue, New York, NY 10022  
(212) 755-8200  
fhassel@scott-macon.com  
www.scott-macon.com

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