

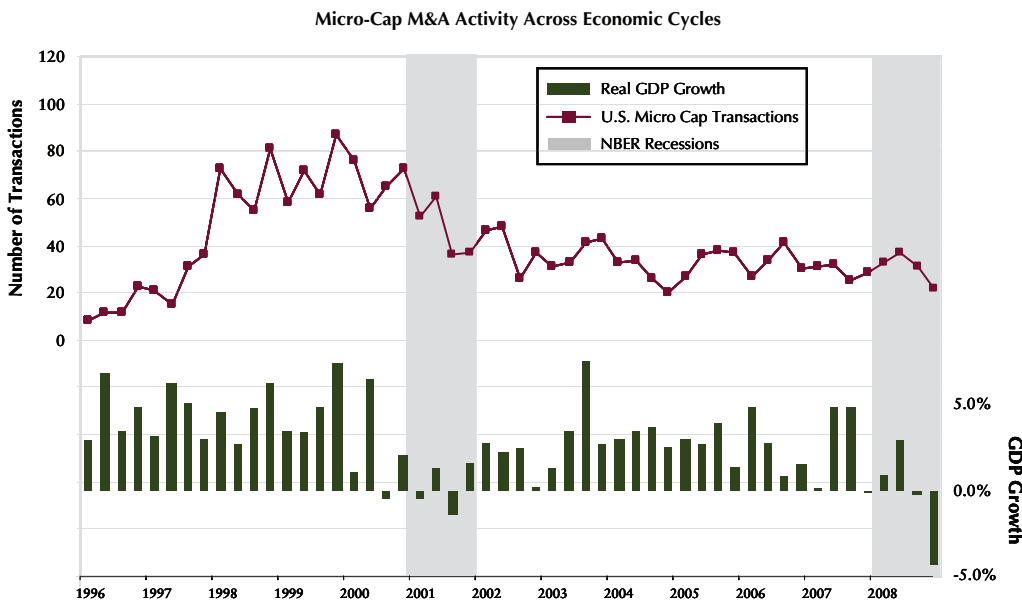


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**Micro-Cap M&A Activity**

The majority of micro capitalization stocks suffer from undervaluation, lack of research and low trading volume providing little upside for many investors. These small companies are frequently abandoned by Wall Street and will rarely see an increase in their stock price despite sound operating performance. In many instances, the best path to increased shareholder value is a sale of the company. But in a contracting economic environment, can investors expect M&A activity to provide an escape from this micro-cap dilemma?

One way to answer the question is to review historical micro-cap deal activity over various cycles. Discovery Group has been researching, investing in, and acting as advisors to, the micro-cap M&A sector since the mid 1990s. Our proprietary research and data includes a compilation of deal volume that tracks all M&A transactions for non-financial public companies that are valued upon takeover between \$25 million and \$500 million. Below is a graph of micro-cap deal volume on a quarterly basis from 1996 through the fourth quarter of 2008. The activity is shown versus GDP growth and the recessions of 2001 and today.



As the line shows, deal volume has been consistent since micro-caps became abandoned in the mid 90s, with the notable exception of the late 90s dot-com boom. During this time a frenzy of deal activity infiltrated the technology and communications sectors. But during the 2001 recession, the bear market of 2002, the economic expansion and bull market environment of 2003-2007, and even in the current contraction that started over a year ago, micro-cap M&A deal activity has been fairly steady. Each quarter we typically see the announcement of between 20 and 40 transactions. Deal volume was even resilient during the third and fourth quarters of 2008, arguably one of the most difficult deal climates in decades. This steady activity is a stark contrast to the boom and bust activity of the large cap M&A market that is frequently reported in the media. Expanding economies, flush markets, and easy credit can fuel billion dollar takeovers and company-transforming mergers, but large company deal activity fades quickly in a slowdown and in fact has come to a near standstill in the current economic climate. Micro-cap M&A volume is much more predictable.

The reason for this steady flow is the undeniable secular trend working against the very existence of many small public companies. It is often very compelling for a micro-cap company to merge with a larger public entity that can make a modest acquisition, without the need for debt financing, to continue its pursuit of growth. Micro-cap Boards increasingly realize that a handsome acquisition premium for shareholders can far exceed the otherwise extremely low valuations that the public equity markets may ascribe to their companies for many years to come. This compelling logic to sell should drive steady micro-cap M&A volume for 2009 and the foreseeable future.

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*Discovery Equity Partners, L.P. seeks to exploit the valuation anomaly associated with small capitalization public companies that trade at deep discounts to their economic value as a result of limited research coverage, low trading liquidity and rare institutional sponsorship. The Fund accumulates meaningful ownership stakes in anticipation of an accretion in value that will result from specific company and industry developments. Discovery Equity Partners, L.P. is managed by Discovery Group I, LLC. Return data is preliminary and subject to audit.*