SMALL BUSINESS INVESTOR ALLIANCE

Lower Middle Market Investment Insights

1H 2014

Volume 1, Issue 2
September 22, 2014

Perspectives

Chris Bradley, Director, Marketing and Communications, RCP Advisors

Overall, the U.S. PE market had a healthy Q2 2014. According to PitchBook, managers invested $108 billion into U.S. based companies in Q2, making it the fifth consecutive quarter above the $100 billion mark. In fact, between 2009 and 2012, only three quarters eclipsed that dollar amount, and all three were fourth quarters. It is worth noting that, while Q2's $108 billion is down slightly from Q1, just one deal closed in Q2 valued at more than $2.5 billion. Only a handful of other deals were above the $1 billion mark in Q2, suggesting that current deal flow is being sustained by an active middle market.

What is the Lower Middle Market?

The lower middle market is a subset of the US economy that represents small to medium sized businesses. For purposes of this newsletter, we define the lower middle market as:

- Businesses that earn between $10mm and $100mm in annual revenues
- Deals for businesses with between $10mm and $100mm in total enterprise value
- Private Equity Funds that raise up to $500mm in capital

The topic of dry powder is one of the most widely discussed in the PE industry. In the U.S. alone, about half a trillion dollars in uncalled capital has accumulated. However, a large portion of this dry powder remains in pre-crisis mega-funds. Almost $100 billion of combined capital remains uncalled in vintage 2006, 2007 and 2008 funds. Nonetheless, managers were highly motivated in 2013 to put capital to work before it expired as they drew down $56.3 billion from their LPs. As a result, total capital overhang, which was at $486 billion at the end of 2012, decreased by 5% by the end of 2013 according to data from PitchBook.

In contrast to PE's dry powder are the record distributions being made to LPs. According to a recent report by Cambridge Associates, in 2013, PE funds made the largest total annual capital distributions to LPs in the 28 years that Cambridge has been tracking the industry. Annual distributions hit an all-time high for the index in 2013 as PE firms returned $134.6 billion to their LPs for the year. To that end, PitchBook reported that exit activity remained relatively strong in the first half of 2014, as prudent managers took advantage of the seller's market and sold off about $102 billion in holdings through 354 liquidity events.

U.S. PE fundraising remained strong in Q2 as $50 billion was raised across 72 funds. While down slightly from Q1, the number of fund closings in Q2 still surpassed most quarterly totals post-crisis. Fundraising remains healthy, especially for established managers with solid track records as 88% of funds that have closed so far in 2014 have hit their fundraising targets. Overall, managers have closed a total of 144 funds, raising a total of $85.5 billion in the first half of 2014.

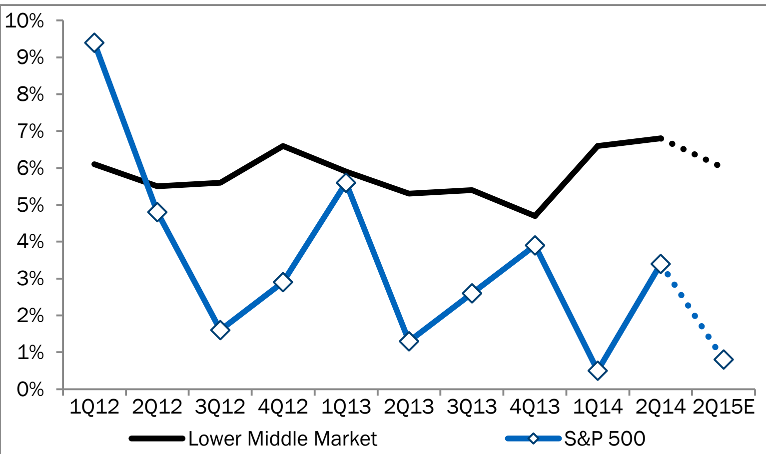
Based on the number of deals currently in the market, we expect the fourth quarter of 2014 to be the most active time since before the financial crisis. With many of these deals selling between private equity firms, LPs should expect large distributions and sizable corresponding capital calls. Finally, these large distributions will drive continued successful fundraising as LPs reinvest in private equity and perhaps increase their allocations as they reach for yield in the current interest rate environment.

Lower Middle Market Business Indicators

The National Center for the Middle Market (NCMM) conducts a quarterly survey of middle market businesses and provides us with data for lower middle market companies with $10 – 100 million in annual revenues. The data and our commentary below indicates how these businesses compare to larger firms on standard metrics like revenue and employment growth. We also feature the SBIA/NCMM Lower Middle Market Business Confidence Index, which combines revenue and employment growth in the preceding year, expectations for revenue and employment growth in the following year, and confidence in the national economy.

Revenue Growth (Last Twelve Months)

Lower Middle Market vs. S&P 500

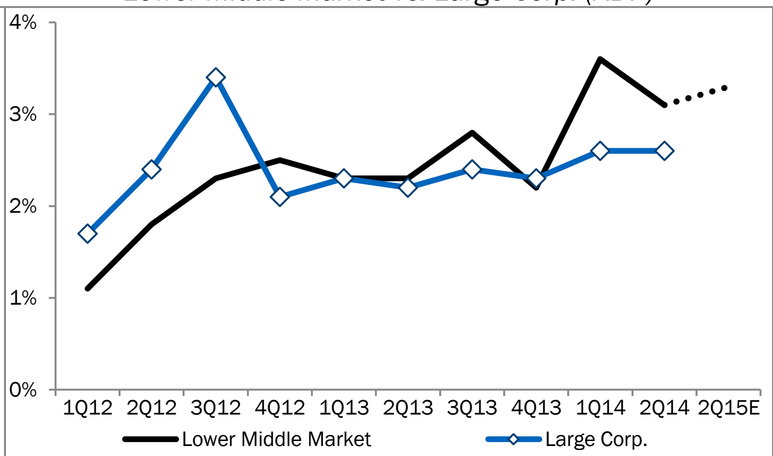


Source: National Center for the Middle Market

Revenue growth for lower middle market companies has been significantly more stable and higher than for S&P 500 firms. In the latest quarter, lower middle market businesses experienced an overall annual revenue growth of 6.8%, compared to 3.4% for the S&P 500. In the next 12 months, revenue growth at large companies is expected to slow to just under 1%, while small companies expect to grow their revenues at six times that rate.

Employment Growth (Last Twelve Months)

Lower Middle Market vs. Large Corp. (ADP)

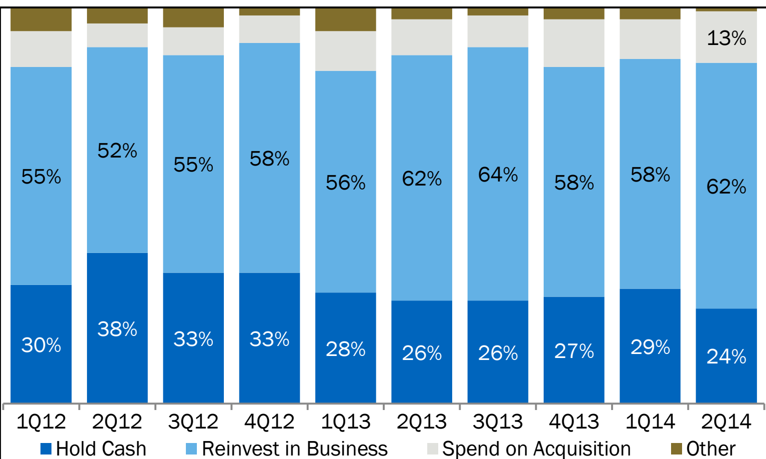


Source: National Center for the Middle Market

Employment growth at lower middle market businesses was in line with large businesses for most of 2013, before taking a sharp upward turn in the first half of 2014. Employment prospects for smaller businesses are still robust, with roughly half of respondents expecting an increase next year, at a rate of 3.3%. Past surveys have shown that, on average, businesses underestimate future employment growth by 74bps.

Incremental Investment Allocation

Where would an extra dollar be allocated?

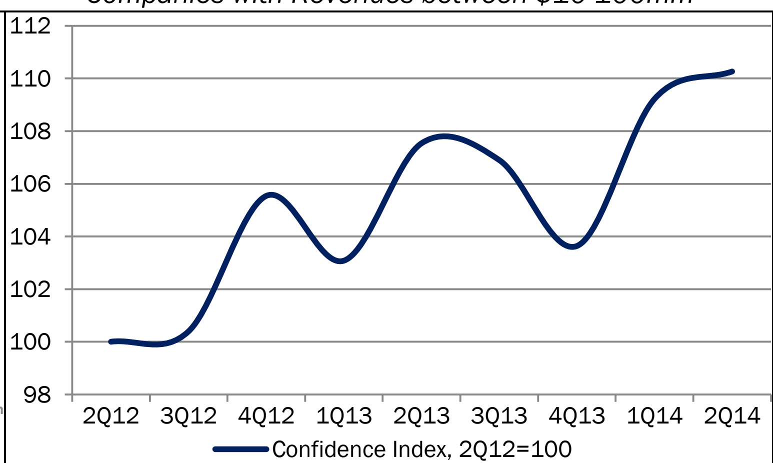


Source: National Center for the Middle Market

Lower middle market companies have a lower desire to hold cash than at any time in the last two years. Instead, executives of small businesses would rather reinvest capital in their own business or use it to fund acquisitions. In 2Q14, 13% of survey respondents indicated they would use an extra dollar of cash to acquire another company, and 62% indicated they would invest in IT and equipment to support and expand their own business.

SBIA/NCMM Lower Middle Market Business Confidence

Companies with Revenues between $10-100mm



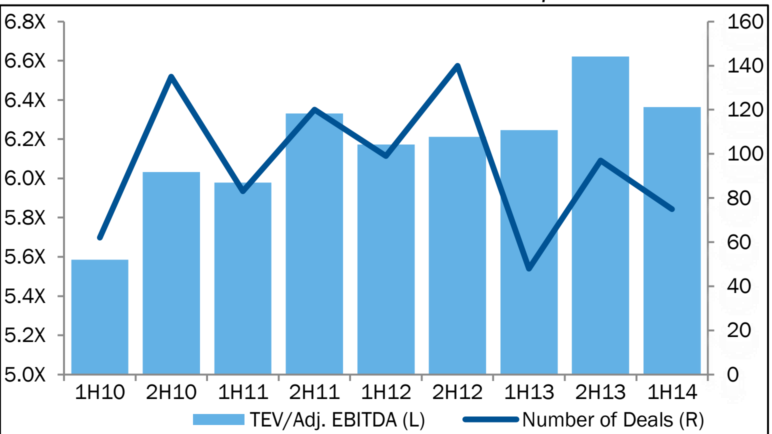
Source: SBIA Estimates and NCMM Survey

After taking a modest dip in 4Q13, the Confidence Index[1] increased significantly in the latest quarter, a sign of increased confidence in employment and revenue growth expectations, as well as the local and national economy. 58% of lower middle market executives expect the national economy to expand in the next year, while 68% expect to grow their own companies revenues.

Lower Middle Market Deal Trends

Average Multiples and Deal Volume

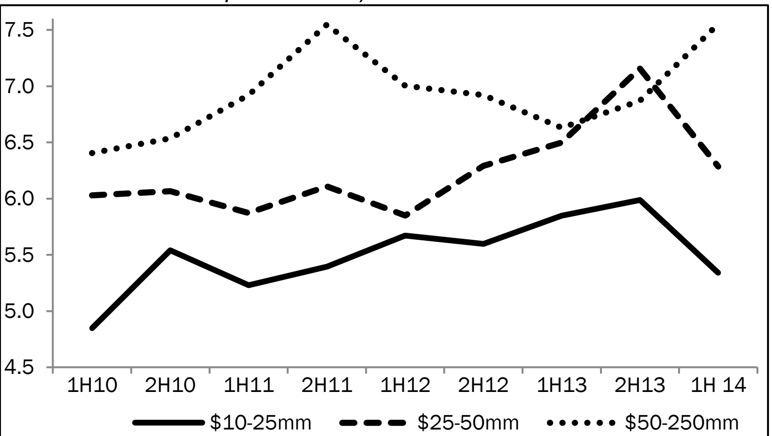
Deals between $10-250mm in Enterprise Value



Source: GF Data ®
Not to be copied, distributed, or reproduced

Valuation Multiples by Deal Size

Total Enterprise Value/EBITDA for all Industries



Source: GF Data ®
Not to be copied, distributed, or reproduced

In the second quarter of 2014, the private M&A market continued to be driven by scarcity and abundance – a scarcity of attractive middle-market businesses for sale and an abundance of debt financing available to their buyers, based on reports from GF Data's 191 active private equity data contributors on their completed deal activity.

Overall valuations in the year to date have averaged about 6.4X Trailing Twelve Months (TTM) Adjusted EBITDA. While this is in line with already-strong levels prevailing over the past year, debt levels – particularly on larger transactions within our size range – have never been greater. Total debt averaged 3.8X in the first six months of 2014. From 2011 through 2013, total debt to EBITDA averaged 3.4X in each year.

GF Data's contributors reported 41 completed second-quarter transactions meeting our parameters (Total Enterprise Value $10-250 million, TEV/adjusted EBITDA 3-12X). Volume is not torrential, but nevertheless represents a continued improvement from the arid conditions of a year ago.

The reward in valuation given to larger businesses remains at a high, although, as expected, there was some reversion to the mean from the unprecedented differential shown in 1Q. For the first six months of this year, the average mark for deals in the $10-50 million value range is 5.4X. For deals valued at $50-250 million, the average is 7.6X. That 2.2X spread compares to a historic average of 1.3X.

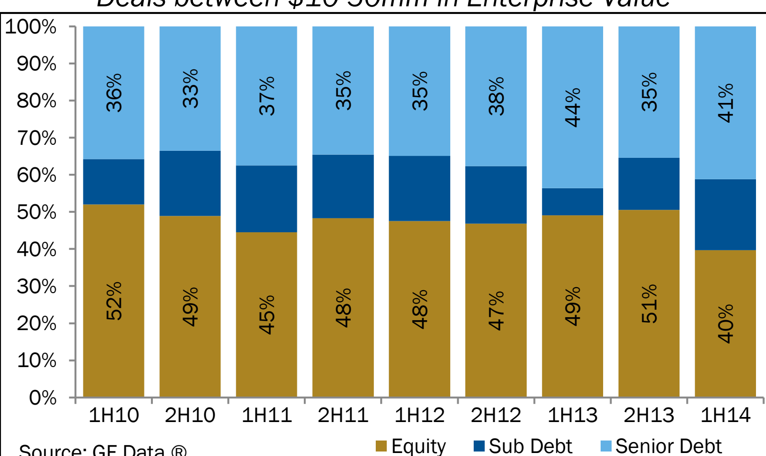
Leverage increasing at a faster rate than valuation means that financial sponsors are being required to contribute less to the average capital structure. Average equity contribution for the year to date is 42.7 percent. This is a precipitous decline from averages in the 47-50 percent range over the past several years.

The charts below suggest that year to date, financial sponsors of smaller deals have been the main beneficiaries of that dynamic. GF Data ® suspects that the magnitude of the difference is likely to narrow as the year progresses, but that the conclusion is directly correct. Notwithstanding a highly liquid and accommodating debt market, buyers of desirable and larger properties are under continuing pressure to pay up.

See page 6 for more information on how to access GF Data's full reports and searchable valuation database.

Equity and Debt Contributions – Smaller

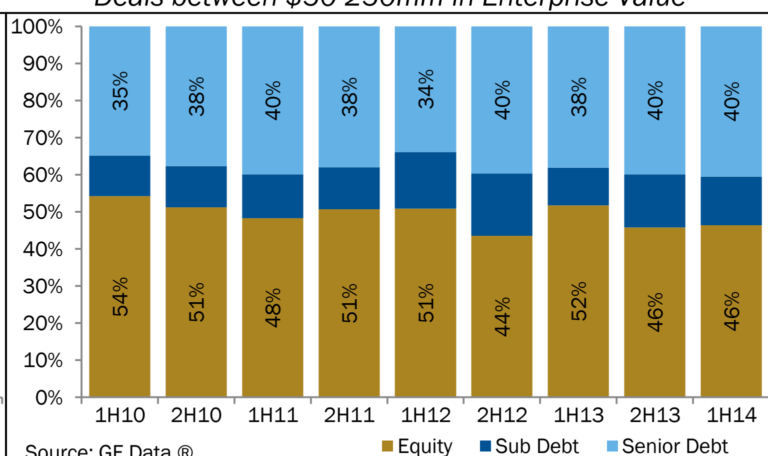
Deals between $10-50mm in Enterprise Value



Source: GF Data ®
Not to be copied, distributed, or reproduced

Equity and Debt Contributions – Larger

Deals between $50-250mm in Enterprise Value



Source: GF Data ®
Not to be copied, distributed, or reproduced

Lower Middle Market Private Equity Benchmarks

The Small Business Investor Alliance, in partnership with Atlas Diligence, is creating lower middle market private equity fund performance benchmarks.

We are currently collecting data from GP participants and structuring benchmarks based on data availability.

Project Overview:

- All collected data will be held strictly confidential and no individual Fund or Firm information will be published.
- Benchmarks will be separated by Investment Strategy[2], Fund Size[3], and Vintage[4].
- No benchmarks will be created unless there is a representative sample size.

Data Collected will Include:

- *Fund Composition*: Investment Strategy, Size, Target Capital Structure, Fund-level Leverage, and Vintage
- *Performance Overview*: Called %, DPI[5], RVPI[6], TVPI[7], and Net IRR[8]
- *Aggregate Investment Detail*: Number of Investments, Average Investment Size, Realized Value, and Unrealized Value

Data Published will Include:

- Net Median IRR and Net Median TVPI

SBIA members and GP participants will have additional access to Net IRR, DPI, RVPI, and TVPI metrics on a Median and Quartile basis.

For more information, or to participate, please contact:

Eneasz Kadziela | 202.400.3892 | ekadziela@sbia.org

Disclaimers, Definitions, and Access to Data

Disclaimer

This newsletter is intended only for informational, educational, and research purposes, and should not be distributed or disseminated for commercial purposes without the permission of the Small Business Investor Alliance (SBIA). The information, facts, figures, data, and analysis included in this newsletter are believed to be accurate, reliable, and credible, however SBIA is not liable for any inaccuracies or errors in the information contained within. The newsletter does not, nor could it, take into account the needs, objectives, and financial situation of its subscribers and should not be considered as investment advice by the recipient. SBIA retains ownership of the contents of this newsletter and reserves the right to alter or make changes to the information retained within without notice to subscribers.

Definitions

1. The SBIA/NCMM Lower Middle Market Business Confidence Index is an equal-weighted index based on five survey responses from the National Center for the Middle Market's Middle Market Indicator. The survey includes over 600 C-Suite executives of companies with annual revenues between $10mm and $100mm. The contributions to the index are: Revenue Growth, Employment Growth, Revenue Growth Expectations, Employment Growth Expectations, and an Outlook for Growth in the US Economy.
2. Investment Strategy: For the purposes of this newsletter, the two strategies we will publish benchmarks for are Private Equity Buyout funds and Private Equity Mezzanine funds, which comprise investors who invest debt and equity securities in privately held companies. This will be further segmented into funds that are licensed by the Small Business Administration as a Small Business Investment Company and those who are not.
3. Fund Size: Fund sizes will be split by funds that have less than $150 million of total capital and funds that have between $150 and $500mm.
4. Vintage years for fund benchmarks will include funds that were raised between 2000 and 2010. We may include certain metrics on funds raised after 2010.
5. DPI: Distributions to Paid-In Capital is equal to the total distributions to investors divided by the total contributions from investors.
6. RVPI: Residual Value to Paid-In Capital is a ratio of the remaining value of the portfolio to the total contributions from investors.
7. TVPI: Total Value to Paid-In Capital is a ratio of the distributions and the remaining value of the portfolio to the total contributions, or paid-in capital, from investors. TVPI is the sum of the DPI and RVPI, and is also known as the Net Multiple on Invested Capital.
8. The Net Internal Rate of Return (Net IRR) is calculated using all cash flows into and out of the fund including capital calls from investors (LPs), as well as distributions to LPs net of management fees, other expenses, and carried interest. It is the discount rate at which the Net Present Value (NPV) of all cash flows equals zero. For funds that have not been fully liquidated, the remaining value of the fund (NAV) is treated as a distribution, net of all fees and carried interest.

GF Data ®

To subscribe to GF Data's full reports and searchable valuation database, visit www.gfdataresources.com, or contact Bob Wegbreit at bw@gfdataresources.com or (610) 616-4607.

National Center for the Middle Market

More information about the Quarterly Middle Market Indicator survey, Benchmarking tools, and the Center can be found on their website: www.middlemarketcenter.org