SMALL BUSINESS INVESTOR ALLIANCE

Lower Middle Market Investment Insights

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SBIA
SMALL BUSINESS INVESTOR ALLIANCE

Perspectives

The Little Secret Most Investors in the Lower Middle Market Are Not Talking About

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

As evidenced by recent data, acquisition multiples are up, debt leverage multiples are up, and financing costs are down. What a great time to be buying growing assets, right? Logically, I would agree. But why were the number of transactions in the lower middle market down last year? Some will say we had an abundance of transactions at the end of 2012 in response to the changes in the tax code and the market took a "rest" in 2013. This is partially true, but I believe the real culprit is low interest rates.

When you look at the lower middle market, where companies are earning less than $10 million of EBITDA, many of them are family held businesses. There are many reasons to sell, such as retirement, asset diversification, lack of future leadership, etc. But for many of these companies, it is a lifestyle business. The cash flow is good, family members can be employed, and the owner is in control of his or her destiny. Even if a buyer paid 10X cash flow for the owner's business, it will be very difficult to replace that annual income with the income generated from their after-tax proceeds that have been conservatively invested and seeking income. Money market funds are paying less than 1%. Owners of businesses that support their lifestyle are extremely reluctant to sell in the current interest rate environment.

So how can we as investors convince that owner to sell?

- Generate some income via capital gains by selling a portion of their business and roll over an equity interest into the future company with a plan for more aggressive growth and value creation;
- Illustrate that the owner has a declining asset if the business continues to operate as it is currently operating (always a difficult conversation);
- Appeal to the owner's other personal desires that don't include their "baby";
- Develop a rapport with the owner and be patient since conditions and perspectives change over time;
- Become knowledgeable and familiar with the business, industry, and competitors so that you can offer perspective, often beyond what the entrepreneur/owner has considered to date;
- Convince the owner that you will be a good steward for his business and his employees; or
- Overpay for the business based on your evaluation of the future prospects of the business and hope future growth will justify the premium.

The real answer is that it is probably a combination of all the above. As far as overpaying for the business, it only makes sense if the acquisition creates strategic value or the acquisition serves as a platform to drive accelerating growth.

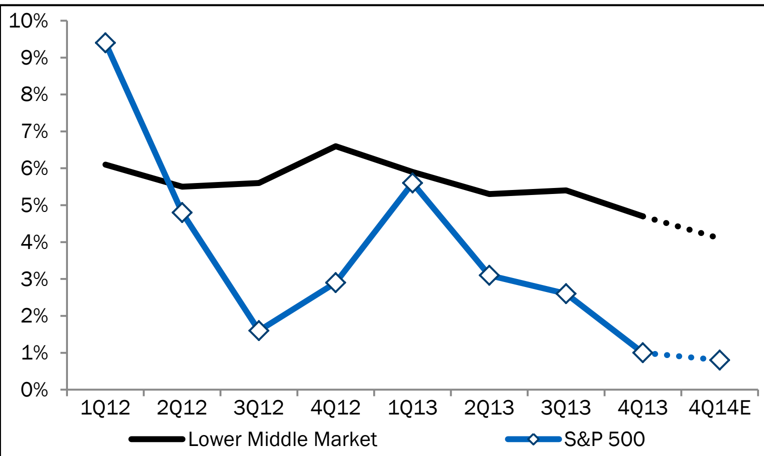
Well, there you have it. I hope interest rates go up to historical norms so that more baby boomers can retire and put their businesses on the market.

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 introduce the SBIA/NCMM Lower Middle Market Business Confidence Index, which tracks 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

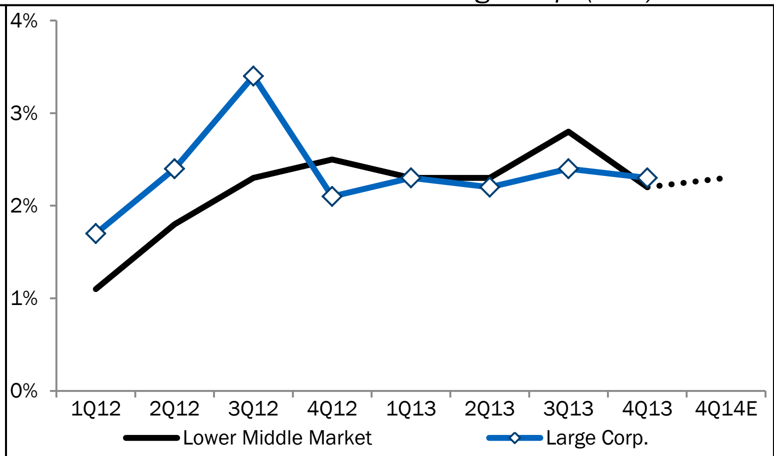


Source: National Center for the Middle Market

Revenue growth for S&P 500 companies fell meaningfully over the last twelve months, from a 5.6% rate in 2012 to around 1% in 2013. By contrast, lower middle market companies trended down slightly, from 6% in 2012 to 5% in 2013. 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 five times that rate.

Employment Growth (Last Twelve Months)

Lower Middle Market vs. Large Corp. (ADP)

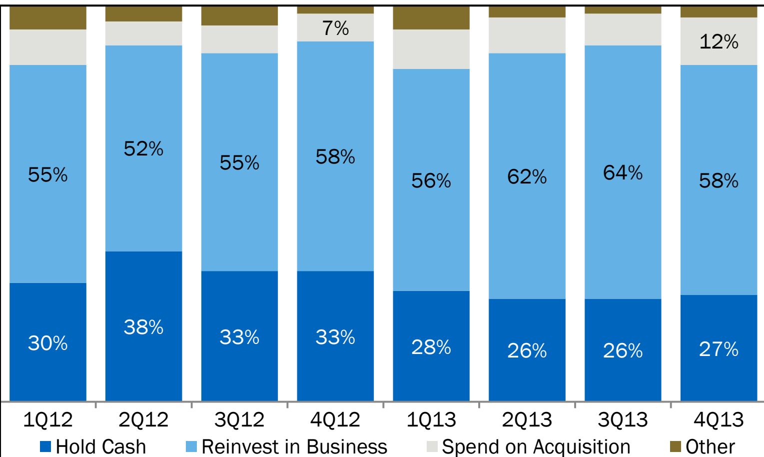


Source: National Center for the Middle Market

Employment growth for lower middle market businesses was in line with larger companies in the past year, ending 2013 with a 2.2% rate, compared to a 2.5% rate at the end of 2012. Growth should remain flat next year, with 53% of respondents expecting no change and only 36% a slight increase. However, past surveys have shown that, on average, respondents underestimate future employment growth by 60bps.

Incremental Investment Allocation

Where would an extra dollar be allocated?

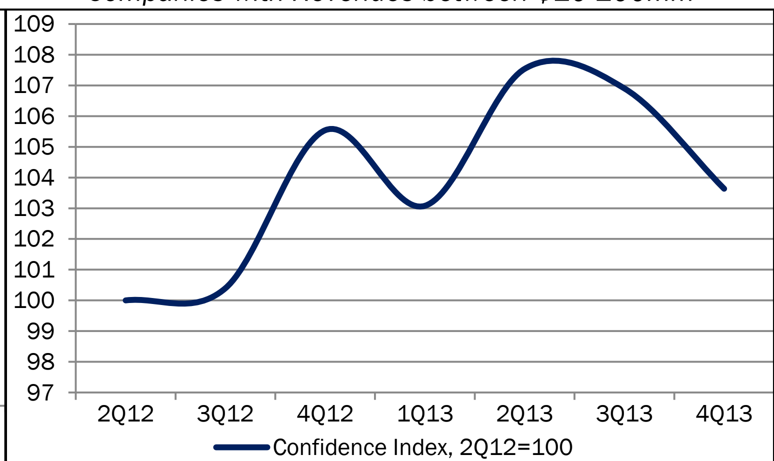


Source: National Center for the Middle Market

Lower middle market businesses are increasingly focused on investing in equipment, IT, and training their staff, as well as setting aside cash to fund acquisitions. When asked how they would spend an extra dollar, only 27% said they would hold onto it, compared to 33% a year ago, and 12% would use it to buy another business compared to 7% last year.

SBIA/NCMM Lower Middle Market Business Confidence

Companies with Revenues between $10-100mm



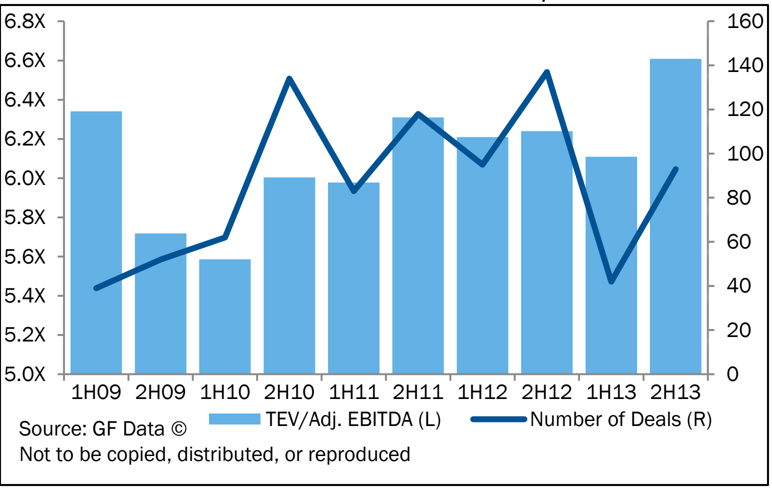
Source: SBIA Estimates and NCMM Survey

Although the Confidence Index[1] declined from the highs seen in mid-2013, overall sentiment is positive. Employment growth expectations in 2Q13 were unusually high, with only 5% of respondents expecting a decline in the coming year. By year-end, those expectations had come down slightly. Confidence in the US economy has been increasing since the survey began in 2012, and only 8% of respondents expect the national economy to contract next year.

Lower Middle Market Deal Trends

Average Multiples and Deal Volume

Deals between $10-250mm in Enterprise Value



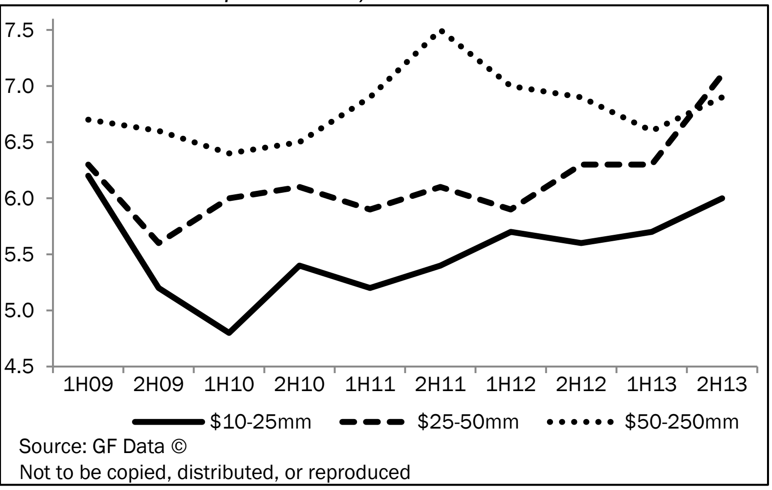
Somewhere between a bang and a whimper is the sound that most aptly describes middle market deal activity at year-end 2013, as reported by GF Data's 187 active private equity data contributors.

That group reported 56 completed transactions in the $10-250 million value range in the fourth quarter of 2013, well below the 101 deals closed in 2012's tax-driven year-end rush. However, this represents a steady pickup in activity over the course of this year. Our contributors and subscribers advise that they see this momentum continuing in the first months of 2014, which of course is a contrast to the "Death Valley Days" of a year ago.

Valuations averaged 6.7x Trailing Twelve Months (TTM) Adjusted EBITDA for the quarter, the highest mark since 3Q 2012.

Valuation Multiples by Deal Size

Total Enterprise Value/EBITDA for all Industries



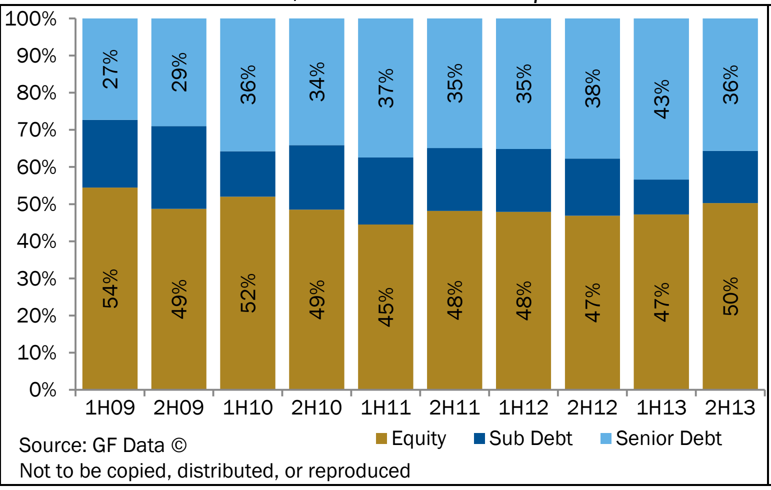
While differentials in valuation based on total enterprise value (TEV) size remain, there has been a steady narrowing over the past four years. Average valuations in the $10-25 million TEV bracket were 6.2x in 2013 – about .8x less than the average mark on larger deals. This is about half the valuation spread at its most pronounced in the aftermath of the 2008-09 financial markets melt down.

GF Data believes that this dynamic at the lower end of the middle market reflects two trends – greater sophistication in the marketing of smaller businesses and greater hostility on the part of their owners to later-stage requests for price concessions on the sale process. They either close at close to the price originally negotiated, or their deal doesn't happen.

The equity and debt structure charts provided below show that equity contribution for both larger and smaller deals has declined as debt financing has become more widely available. Elevated valuations have generally driven acquirers on larger deals to contribute more equity, but they have also had more access to senior debt. As a result, subordinated debt is a consistently more slender piece of overall capital structure.

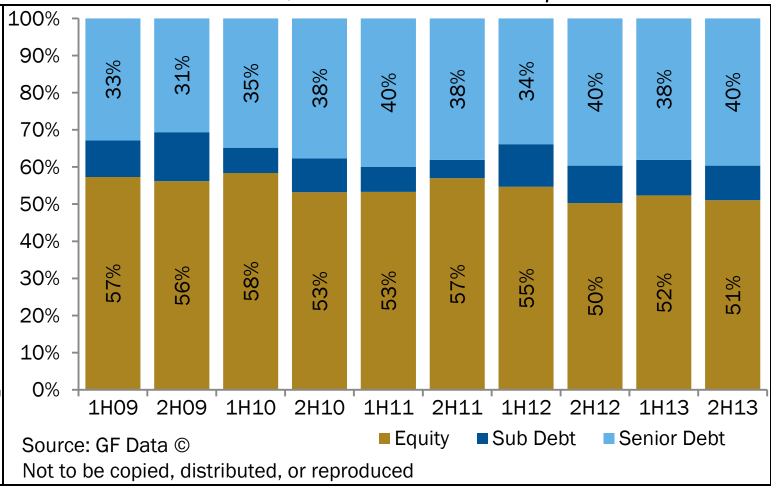
Equity and Debt Contributions – Smaller

Deals between $10-50mm in Enterprise Value



Equity and Debt Contributions – Larger

Deals between $50-250mm in Enterprise Value



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:

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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. More information about the Center can be found on their website: http://www.middlemarketcenter.org/
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.