# SMALL BUSINESS INVESTOR ALLIANCE

## *Lower Middle Market Investment Insights*

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SBIA
SMALL BUSINESS
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# Perspectives:

## A Time for Discipline for Small Buyout Funds

Peter Huff, Managing Member of Blue Sage Capital and Chair of SBIA Middle Market Committee

In prior issues, this letter has covered topics such as debt leverage, dry powder, and distributions to Limited Partners. In this issue, we want to touch upon the impact of larger firms swimming downstream.

**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

The upper market is frothy. Very frothy. The world's largest private equity funds are having a difficult time executing large transactions. They are facing very high leverage multiples and a shortage of quality large assets. According to a recent Bain & Company report, transactions with Enterprise Values of $5-$10 billion were down 50% year-over-year from 2013-14. The stock market's long bull run has made public-to-private transactions difficult as public companies are already trading at premiums. Additionally, many public companies have historically high cash balances and limited organic growth prospects, making them a difficult competitor for assets that have strategic value. At the same time, large funds are under great pressure to get a lot of dry powder to work. In response, large funds are stretching out of their target market and into medium sized and sometimes smaller businesses. According to the same study from Bain & Company, "Worldwide in 2014, one out of every five buyouts valued at between $250 million and $500 million involved at least one of the 15 largest GPs. In comparison, only one out of every eight middle-market deals attracted the biggest players at the height of the previous PE cycle."

Large firms moving into the middle market create ripple effects throughout private equity. Increasingly, bigger fish are moving into smaller ponds. As mega-funds stretch down into the middle market, often paying a premium, middle-market firms are increasingly being forced to move into the lower middle market. Anecdotally, we have participated in processes for businesses with less than $7 million of EBITDA and have found ourselves competing against firms with current funds in excess of $800 million. The lower middle market is attractive because of greater growth and profit potential, but these firms are coming in part because they have nowhere else to go. As valuations creep upward, transactions that were previously too small are now entering into the acceptable size range for firms that have historically not purchased companies with less than $10 million of EBITDA. Some of the bigger players will likely learn that lesson the hard way that there is a different skill set needed for small companies.

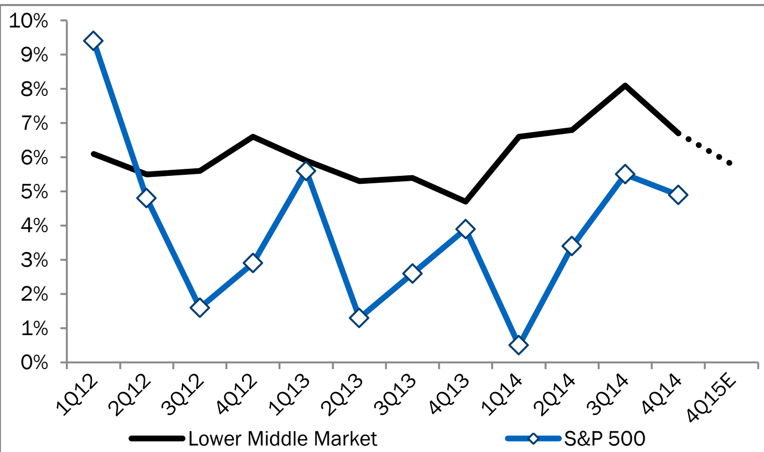
The implication for smaller private equity firms is that this is the part of the cycle that requires discipline and creativity. The best investors stick to their own market expertise and don't just follow the biggest names. Further, we must be creative in our sourcing efforts by using our networks to create proprietary opportunities outside of overpriced auctions. We must see the value creation potential in otherwise overlooked businesses. Firms that are able to source and execute transactions outside of auctions may easily be the most successful in the current environment. When the tide changes, as it inevitably will, those who maintained their discipline will be successful. Those who strayed too far will end up floundering.

# 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*

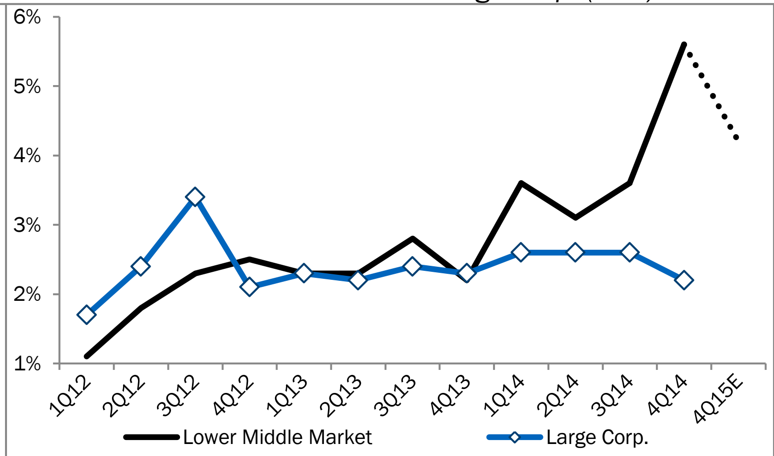



Source: National Center for the Middle Market

2014 was a strong year for lower middle market companies, when revenue growth outpaced S&P 500 companies by an average 3.5%. In the latest quarter, lower middle market businesses experienced an overall annual revenue growth of 6.7%, compared to 4.9% for the S&P 500. In the next 12 months, revenue growth is expected to be 5.8%.

### Employment Growth (Last Twelve Months)

*Lower Middle Market vs. Large Corp. (ADP)*

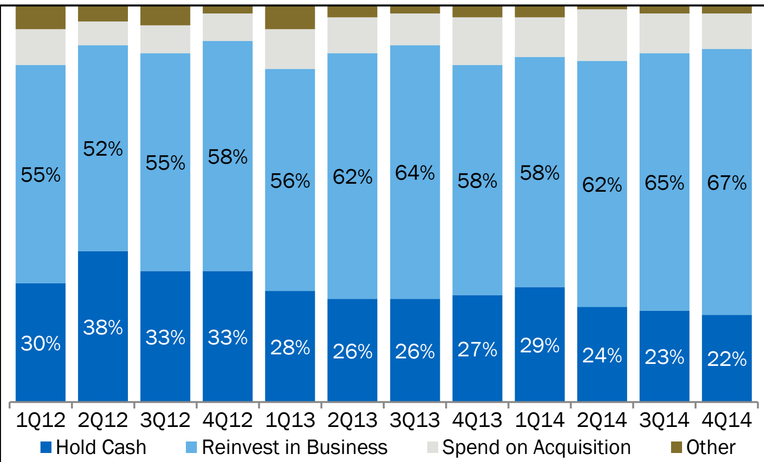



Source: National Center for the Middle Market, SBIA Estimates

Employment growth at lower middle market businesses took off in 2014, with a growth rate almost three times as fast as large corporations. Employment prospects for smaller businesses continue to be robust, with roughly half of respondents expecting an increase next year, at a rate of 4.2%. Past surveys have shown that, on average, LMM businesses underestimate future employment growth by 0.75%

### Incremental Investment Allocation

*Where would an extra dollar be allocated?*

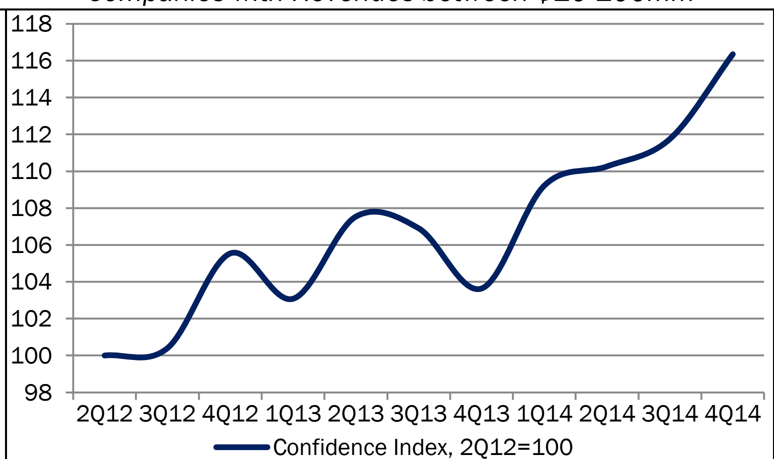



Source: National Center for the Middle Market

Lower middle market companies have a lower desire to hold cash than at any time since the survey began. Instead, executives of small businesses would rather reinvest capital in their own business. In 4Q14, 67% of survey respondents indicated they would use an extra dollar of cash to invest in IT, equipment, and facilities to support and expand their own business.

### SBIA/NCMM Lower Middle Market Business Confidence

*Companies with Revenues between $10-100mm*



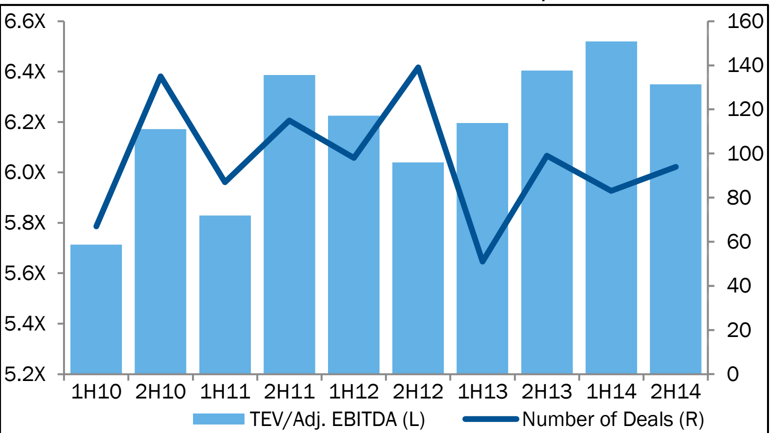

Source: SBIA Estimates and NCMM Survey

After taking a modest dip in 4Q13, the Confidence Index[1] increased significantly throughout 2014, a sign of increased confidence in employment and revenue growth expectations, as well as the local and national economy. 62% of lower middle market executives expect the national economy to expand in the next year, while 73% expect to grow their own companies' revenues (both being the highest levels ever recorded in the survey).

# Lower Middle Market Deal Trends

### Average Multiples and Deal Volume

*Deals between $10-250mm in Enterprise Value*




Source: GF Data ®
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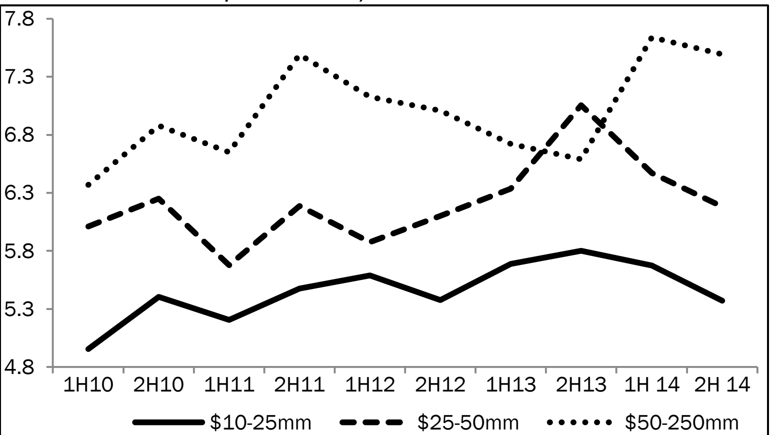
### Valuation Multiples by Deal Size

*Total Enterprise Value/EBITDA for all Industries*

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GF Data's 194 active private equity data contributors completed 51 deals in the $10-250 million Total Enterprise Value (TEV) range in the fourth quarter of 2014. Deal volume, valuation multiples and debt levels all firmed up in '14 in comparison to the prior year.

For some time, GF Data observed that the private middle market M&A activity is "all push and no pull." That is, many would-be business sellers had been lulled into believing that the favorable environment was not going to go away anytime soon. They resisted being pulled into the market by macro conditions, and instead waited until their individualized circumstances made them ready to sell.

GF Data's recently released year-end report offered the theory that if for the first time since early 2007, the market does have some pull to it, smaller businesses and/or those with less strong financial characteristics would be the ones starting to move first.

This is precisely what started to occur in the latter months of last year. The average multiple on businesses valued at $10-50 million and lacking above average EBITDA margins and revenue growth declined from 5.8x in the first nine months to 5.1x in 4Q. Multiples on larger and better performing businesses held steady.

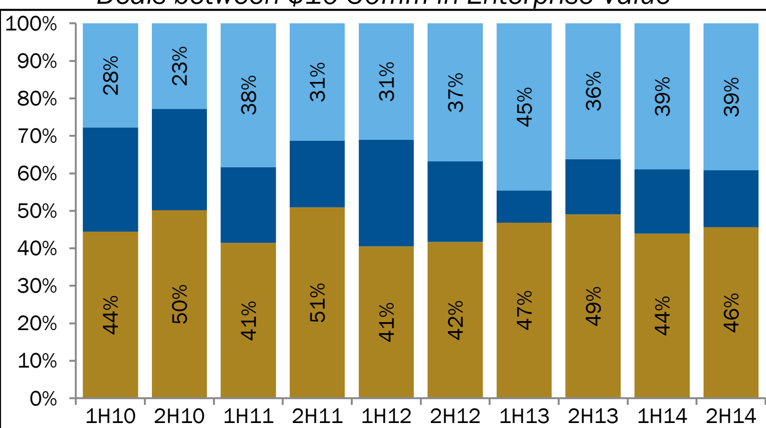
The reward in valuation given to larger businesses remains at an all-time high. For the second six months of 2014, the average mark for deals in the $10-50 million value range was 5.8x. For deals valued at $50-250 million, the average was 7.8x. This spread of 2.0x compares to an historical average of 2.0x.

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 in 2014 was 45.5 percent, down from about 48 percent in the prior two years.

*See page 5 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*

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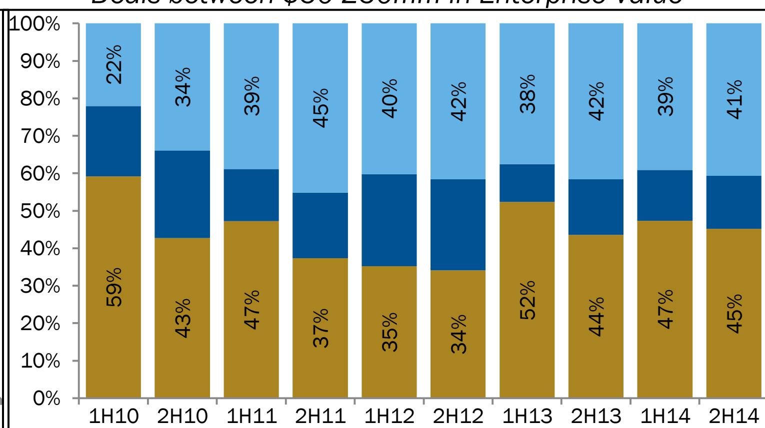
### Equity and Debt Contributions – Larger

*Deals between $50-250mm in Enterprise Value*

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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.

## 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