SMALL BUSINESS INVESTOR ALLIANCE

Lower Middle Market Investment Insights

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SBIA
SMALL BUSINESS INVESTOR ALLIANCE

Perspectives:

Planes Landing Don't Make the News
Apparently Neither Does a Steady Lower Middle Market

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The 2016 elections are rapidly approaching, which the manufacturers of Tums and Rolaids could have told us by their sales without looking at the calendar. The national dyspepsia around this election is palpable, but is it all political or is it economic too?

National "news" media have obsessed about the Presidential candidates' emails, spouses, name calling, and all sorts of unpleasantries. However, there has been nearly no meaningful discussion on the state of the economy and trivial discussion of the candidates' proposals for tax and regulatory policies. While the name calling and soap opera drama might help ratings, it has done nothing help you or your portfolio companies know what to expect from the government that regulates and taxes them.

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

While the candidates have ignored the lower and middle market, that has not harmed our part of the market one bit. The lower middle market is simply chugging along. These are not the best of times or the worst of times. Deals are getting done. Companies are growing, albeit slower than normal. Pricing is stable and companies are generally not over levered. NAV for many BDCs is rising. Private equity funds are able to raise new funds. SBICs have record low costs of leverage. Good news is not newsworthy.

Steady as She Goes – Revenue growth in the lower middle market continues to significantly outpace the S&P 500 with a far less volatility – running at an average of 6.2% over the past 12 months. Employment growth in this sector continues to run at over 3% - about 50% faster growth than large corporations.

Slow and Steady Wins the Race – While faster revenue growth could be better, the portfolio companies in the lower middle market are increasingly optimistic. Consistent revenue and employment growth is not only what we have experienced for the past several years, but it is what executives are expecting for the future.

Keep Calm and Source On – Aside from the Q4 2014 "fiscal cliff" driven deal frenzy which represented a spike in multiples and volume, activity and pricing have been in a relatively stable band since the second half of 2013. Fund managers are seeing lots of deals and are able to be very picky about quality.

These indicators tell us where we have been, but not where we are going. However, GF Data's commentary on Page 4 provides some further insights into how some of the data points might be early indicators of changes in the market.

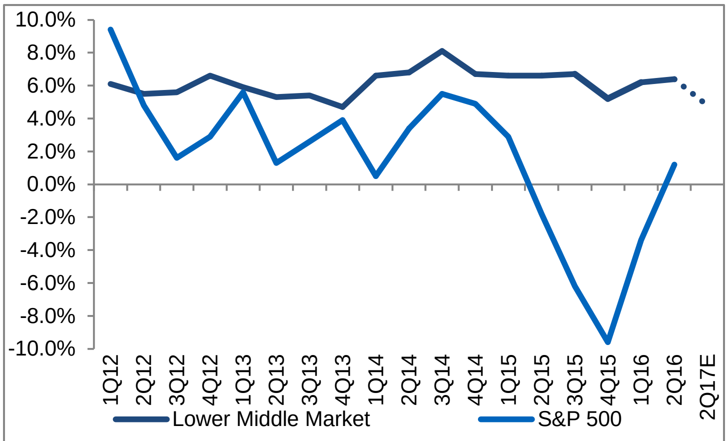
As you have seen several times over the past decade, policymakers affect our part of the market. You can be sure that with a new President there will be nearly 100% turnover in the appointed leadership that affects the economy (Treasury, SEC, SBA, etc.). Who will fill those seats is yet to be determined, but you can expect a more populist approach – finance and private equity is not popular. You can expect that banks will continue to be hammered by hostile regulators regardless of who wins. Despite the inattention given to the economy, we would be remiss to believe that the impending shakeup in Washington will not have an impact on the economic landscape. However, the lower middle market's consistency through previous storms and foundation built on value creation ought to neutralize some of the heartburn we have been experiencing in 2016.

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, and expectations for revenue and employment growth in the following year.

Revenue Growth (Last Twelve Months)

Lower Middle Market vs. S&P 500

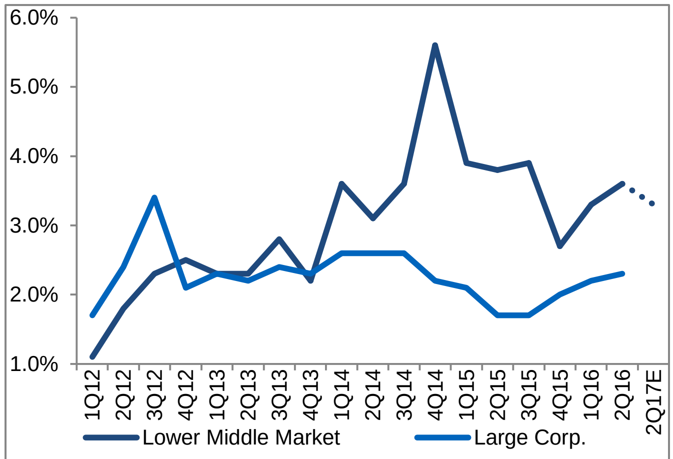


Source: National Center for the Middle Market

The lower middle market has seen more stable and consistent revenue growth than the S&P 500 over the last four years. A huge drop in the S&P 500 revenue growth in 4Q15 further contrasts the volatility of the iconic financial market indicator against the stability of the lower middle market. It is encouraging to note that the market pressures that caused the drop in S&P revenue growth did not cause more than a small dent in the LMM metric.

Employment Growth (Last Twelve Months)

Lower Middle Market vs. Large Corp. (ADP)

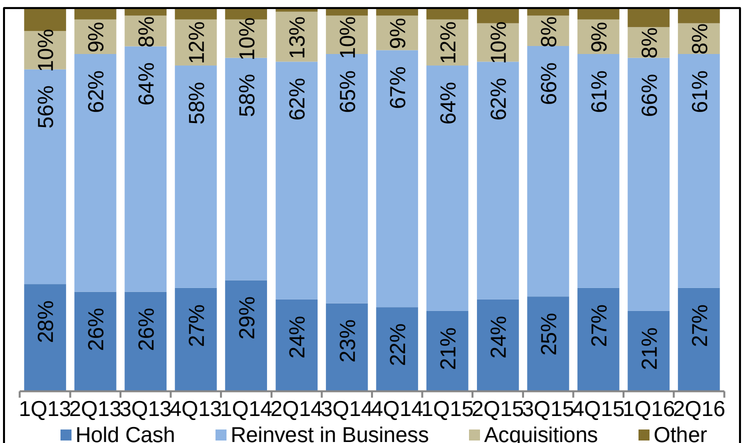


Source: National Center for the Middle Market, SBIA Estimates

Employment growth is rebounding from a downward trend that started at the end of 2014, with the 18-month low of 2.7% remaining above 2012 levels. Projections indicate that the trend will take another downturn in 2H16, as the contraction in the industry converges around the new normal.

Incremental Investment Allocation

Where would an extra dollar be allocated?

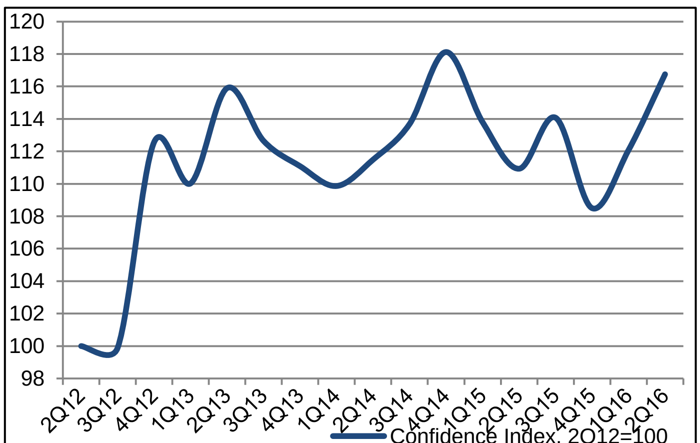


Source: National Center for the Middle Market

The past year has seen an appetite for acquisition that decreased after 2014 remain at consistent levels. The bulk of survey respondents are most interested in holding cash or reinvesting in their businesses. Between 1Q16 and 2Q16, interest in holding cash made a big incremental jump from 21% to 27%, likely a reaction to the domestic market's sluggish results from 1Q16.

SBIA/NCMM Lower Middle Market Business Confidence

Companies with Revenues between $10-100mm



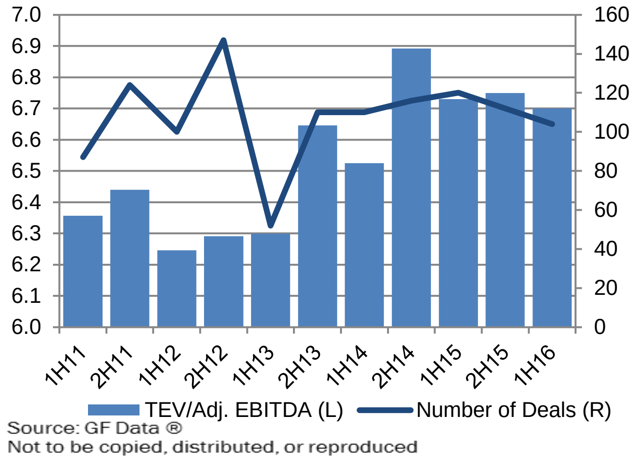
Source: SBIA Estimates and NCMM Survey

After hitting a peak in 4Q14, the Confidence Index[1] had an overall downward trend in 2015, ending with a low not seen since 2012. However, the index has rebounded in 1H16, with lower middle market executives reporting an almost 10% increase in those who predict that their revenue will grow in the next year. Those executives also reported a more optimistic outlook on their employment levels over the next year.

Lower Middle Market Deal Trends

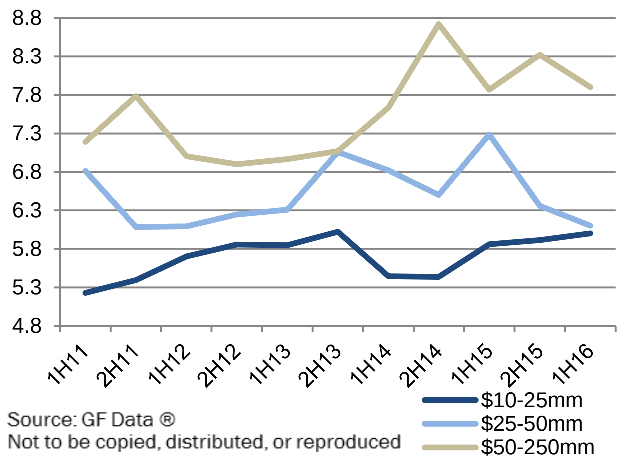
Average Multiples and Deal Volume

Deals between $10-250mm in Enterprise Value



Valuation Multiples by Deal Size

Total Enterprise Value/EBITDA for all Industries



See page 5 for more information on how to access GF Data's full reports and searchable valuation database.

Within GF Data's universe of middle-market deal sponsors, the slowdown in M&A activity has been neither as deep nor as prolonged as general industry reports would suggest.

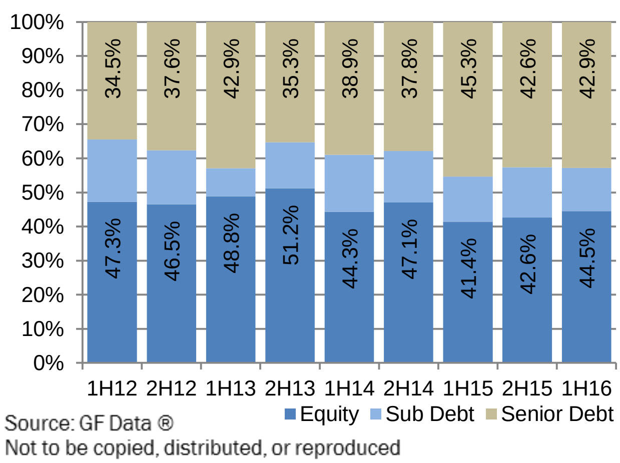
After a quiet first quarter, completed deal volume perked up in 2Q. Our 206 active contributors completed 58 deals meeting GF Data's parameters -- $10-250 million TEV and TEV/Adjusted EBITDA multiples of 3-15x. This is a marked pickup from 46 reported deals in 1Q and comparable to 54 deals in 2Q of 2015.

The second report placed a number of market trends in sharp relief:

- Valuations overall averaged 6.8x TTM Adjusted EBITDA, slightly up from the prior two quarters but essentially in line with market averages since 2014.
- Quarter-to-quarter shifts in valuation over the past two and a half years have not been material. In addition, the "size" premium – the spread between valuations on $10-50 million and $50-250 million TEV transactions has been remarkably steady. The spread of 2.2x (an average of 5.8x on the smaller deals and 8.1x on the larger ones) in the first six months of 2016 is exactly in line with the spread in 2014-15.
- While the market has been relatively stable in equity values, there has been more movement over time in debt levels. Total debt to EBITDA averaged in the "mid-threes" for several years before rising to 3.9x in 2015 and remaining at that level in the year to date.
- As we have discussed at length over the past year, debt loads rising while deal pricing holds steady has meant a decline in average equity contribution, from about 50 percent in 2013 to about 44 percent in 2015 and 2016 1H. We continue to believe that a material pullback in debt levels will result in a retrenchment in equity values, rather than a return to elevated equity share.
- Average total debt dropped a tick to 3.8x in 2Q. While this alone is not material, there have been several other subtle shifts which – if the leveraged finance market does at long last pull back – will come to stand out as early portents.
- Specifically, we are keeping a weather eye on: the return to higher valuation on platform investments compared to add-ons, the greater percentage of completed deals involving above average financial performers and reduced utilization of uni-tranche financing .

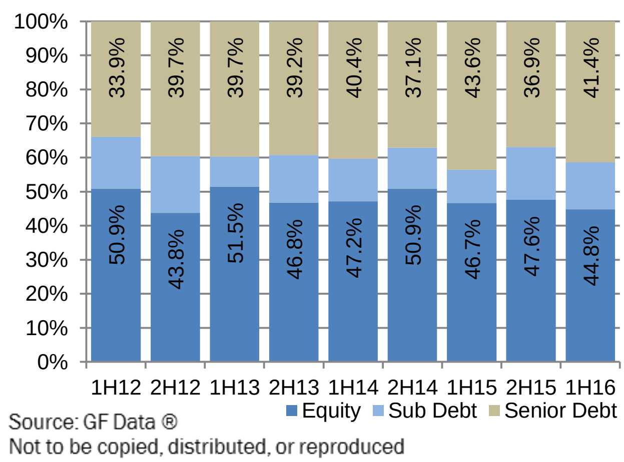
Equity and Debt Contributions – Smaller

Deals between $10-50mm in Enterprise Value



Equity and Debt Contributions – Larger

Deals between $50-250mm in Enterprise Value



Disclaimers, Definitions, and Access to Data

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Definitions

1. The SBIA/NCMM Lower Middle Market Business Confidence Index is an equal-weighted index based on four 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, and Employment Growth Expectations.

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

