CHAPTER 1

The Middle Market Is Different!

Business Process Innovation, Growth Spurts, Regulatory Imperatives, and Capital

Historically, at least for the last 120 years or so, the United States' mergers and acquisitions (M&A) activity has paralleled business growth spurts, regulatory imperatives, or both. In turn, business growth spurts have been driven by business process innovation, particularly in transportation and communications infrastructures and most recently in technology. A third ingredient for this stew, along with businesses growth spurts and regulatory imperatives, is the need for ample excess capital to properly flavor the pot.

In the late 1800s and very early 1900s, the real and effective establishment of a national railroad system was a primary driver of a rapidly expanding U.S. economy, and of course high stock prices and new capital were an accompaniment. Typically, during periods of innovation, monopolies or seeming monopolies tend to develop (witness Microsoft in our own era), people complain, regulators react, and thus did this first wave finally slow down with a 1904 U.S. Supreme Court decision which frowned upon the monopoly situations and the ever-larger companies that were developing. In fact, the first regulation to emerge regarding M&A in the United States was the Sherman Act in 1890.

By the 1920s, the continued substantial improvement of transportation (automobiles and trucks) and communications systems (widespread use of radio and telephone) were driving a thriving U.S. economy. A booming stock market meant abundant capital, and mergers and acquisitions predictably resulted. Since horizontal merger activity had been discouraged by the Supreme Court earlier, the tendency during this period was to merge forward or backward through the supply chain. History has well memorialized that this wave in turn ended with (but that is not to suggest that it caused) the 1929 crash of the stock market; the impediment to the capital markets was to last at least 30 years.

Despite the World Wars, 30 fairly quiet business years followed, with steadily increasing improvements in infrastructure. These improvements occurred partly out of concern for national transportation policy prompted by the wartime activity of the Second World War, and of course communications took center stage again (television) as a marketing device. By the 1960s, 14 years after World War II, business seemed ready to truly grow again. Fourteen years of veterans' housing programs and job and educational opportunities began to show real results in the economy. Another factor, the "military industrial complex," accompanied growth in national government spending. By this time, though, regulators and politicians were opposed to either type of merger, sideways or up and down, that might impede free competition. The result was a tendency toward mergers and acquisitions to form conglomerates, driven by the desire to employ capital and grow large without running afoul of regulators, politicians, and courts. But conglomerates were not succeeding particularly well because focus and as a result, good operating practices were dampened. In addition, the passage of antitrust laws started to make even conglomerate mergers of disparate parts more difficult.

M&A resumed again in the 1980s, fueled by junk-bond financing, leveraged buyouts, and strong stock prices. It was also driven in part by financial engineering—mostly from arbitrage, in which the real money was made from the deal by the promoters themselves as opposed to improved operations. The 1980s' financially engineered deals were somewhat different from the type we were to see in the 1990s (many now in the Middle Market) from roll-up groups.

By the 1990s, we were beginning to see a great influx of capital driven in one way or another by the productivity and consumerism of those ubiquitous baby boomers (the sons and daughters of World War II veterans), the youngest of whom were then entering their 50s, as well as from the abrupt turn toward deregulation of industries such as banks, utilities, communications, and airlines, among others. Consolidation was another factor and to some degree a result, especially when it was conducted by the financially engineered roll-up groups, which, just like their counterparts in the 1980s, made their money when the deal was done by rolling up and repackaging Middle Market businesses as public companies, not as a rule by conducting sound financial operations. Of course, the mid-1990s was also the dawn of the information age, and that too was accelerating the pace of business and the pace of change in business enormously. The end of this last wave paralleled the telecom and dot.com crash of 2000. Much of M&A was Wall Street activity, but a more than gradual and steady incursion was coming from the Middle Market and Main Street in the 90's.

Since 2003, we have been observing another wave that by now heavily involves the Middle Market. The Middle Market, as of early 2008, accounts

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for approximately 300 to 350 deals per quarter in the United States and Europe respectively, when the deals are defined as those with transaction values in excess of $30 million. Larger business are seen as necessary to successfully compete in the competitive global economy as well as in cross-border transactions, which are of course a product of that global economy. Technology, often developed by Middle Market companies, is being acquired by larger companies through acquisitions. In addition, massive changes in the health care, communications, and financial services industries (usually associated with technology advances) are also drivers, especially Middle Market drivers. Increased government spending associated with war and terrorism, as well as huge influxes of capital from private equity groups and hedge funds, are also real factors.

Not "Mom-and-Pop" Businesses

I did not write this book to address the roughly 80% of U.S. businesses (Mom-and-Pop businesses) that typically are served by business brokers. But I do want to discuss them briefly.

Mom-and-Pop businesses typically are valued using rules of thumb that are not grounded in finance theory, particularly return on investment calculations. Furthermore, Mom-and-Pops typically generate very little interest among the predominant strategic and financial buyers of Middle Market businesses. If I define "Mom and Pop" as businesses with at least one employee and with less than one million dollars in annual sales there are some 4.5 million of them in the United States and these resoundingly affirm the genius of Adam Smith: capitalism really does work and flourish. Mom-and-Pop businesses are also frequently called "lifestyle businesses," because quite often their proprietors launched them to suit lifestyle preferences: to escape the "rat race," to control their own destinies, or just to get a foothold in American capitalism. Such lifestyle businesses often result in longer hours and far greater challenges for their founders/proprietors than the former nine-to-five jobs ever required. Still, the financial and psychological rewards can be significant.

Mom-and-Pop businesses provide an underpinning for our economy. They constitute the starting line in the entrepreneurial marathons for millions of citizens, who in turn employ millions more. While most Mom-and-Pop businesses will remain Mom-and-Pops throughout their business lifecycles, many thousands of them eventually will become Middle Market businesses. In addition, first- and second-generation entrepreneurial families running corner stores across America frequently produce third- and fourth-generation MBAs and CEOs in the Middle and Upper Markets.

For the most part, though, Mom-and-Pop businesses cannot be valued with the primary techniques used in the Middle Market, in which business valuation is based on return on investment (ROI). The impracticality of applying Middle Market valuation tools to Mom-and-Pop firms quickly becomes obvious. Why would someone pay, say, $300,000 (probably on terms) to buy a corner business that nets its owner $60,000 a year in return for the owner's 80-hour work weeks? So Mom-and-Pop businesses tend to be valued according to rules of thumb that take into consideration their type and other factors, but typically do not give that much explicit weight to return on investment.

The Upper Market

Nor is this book intended to address the Upper Market, which usually is considered to comprise companies with $1 billion or more in annual sales.[1] Such companies in turn command valuations of at least $500 million and up—often considerably more in the case of publicly held companies. Upper Market businesses account for less than 1% of U.S. firms and are mostly, but by no means always, public companies. Middle Market firms, unlike their Upper Market counterparts, typically are owned by ten or fewer individuals. Often, they boast only one owner. Upper Market firms generally are publicly owned by thousands of stockholders.

In the Middle Market, the term *merger* is for the most part a misnomer. A merger fundamentally implies that both companies will continue to exist with more or less the same original owners (stockholders), albeit in a combined sort of way in the form of a new and larger company. This scenario is much more a "Wall Street" or Upper Market phenomenon than it is a Middle Market concept. In the Middle Market, the vast majority of deals involve *acquisitions*, in which one company and its shareholders acquire another company, and the shareholder-owners of the acquired company are no longer involved in its ownership.

Furthermore, the idea of hostile takeovers is also pretty much a Wall Street or Upper Market phenomenon, as the majority of Middle Market companies are not publicly owned and thus not subject to hostile takeovers.

Additionally, whether the deal is *accretive* or *dilutive* is not usually a real issue (as it is in Upper Market deals) when it comes to the effect on earnings in Middle Market deals. There is usually no public stock market to judge, more or less immediately, the deal and the immediate increase or decrease in the blended trading prices of the two companies' shares.

Finally, the time it takes to market and sell a Middle Market company is usually far longer (6 to 24 months) than the time it takes to do a deal in the Upper Markets, especially as Upper Market companies are more frequently one-on-one deals, whether hostile or friendly. The Middle Market is fundamentally inefficient when it comes to M&A transactions. As a result of Middle Market owners' natural concerns with confidentiality, a central computer-based market (i.e., a stock market, where these businesses could be traded) is basically impossible and impractical. Difficulties in finding all possible capable buyers contribute to this inefficiency. For these and other reasons startup investment banks who deal in the middle market typically have very short life spans, estimated at 24 to 36 months, and usually employ only one or two people. While success payoffs can be large, this is not a field for the faint of heart or for those with a paucity of cash reserves. I intend to make the reasons for this apparent later in this book.

What Exactly Is the Middle Market?

The Middle Market is extraordinary for its diversity and breadth of opportunities. But what exactly is the Middle Market? A typical characterization among M&A professionals views the Middle Market as businesses with values of from $1.5 million to $250 million. Others suggest that Middle Market businesses range from $5 million to $500 million in value. The point is, there is no standard definition.

For example, Bank of America Business Capital defines Middle Market firms as those businesses generating revenues of between $25 million and $1 billion. (This would suggest that their sizes in terms of value are $12.5 million to $500 million). As defined by the Bank of America, some 50,000 Middle Market businesses account for approximately 25% of the U.S. gross national product (GNP). On the other hand, the U.S. Department of Commerce reports that there are approximately 300,000 Middle Market companies that, according to its own definition, generate $5 million to $250 million in annual revenues.

To put the M&A business opportunity for Middle Market investment bankers into perspective, consider this: The U.S. Census Bureau, in 2002, estimated there were a total of 5,697,759 businesses in the United States,[2] with aggregate sales totaling in excess of $22 trillion. Assuming a very conservative two-to-one revenue to value ratio,[3] that equates a market value of $11 trillion. While the census data indicates that many of the totals are small businesses (under $1 million in sales), just over 21%, or 1.2 million, are Middle Market firms with sales of $1 million to $1 billion annually. Collectively, these 1.2 million firms had sales totaling $9.8 trillion and carry a conservative market value of $4.9 trillion.

Middle Market business also constitute a driving force in the U.S. economy, accounting for fully 68% of our GNP, according to the Department of Commerce. Clearly, no matter how you slice it, the Middle Market is huge as an engine of the U.S. economy. It also presents incredible opportunities to investment banking specialists representing its business owners.

If we assume the widest range of revenues ($5 million to $1 billion), this translates into business with average values of about half that, or $2.5 million to $500 million. This definition is probably a pretty good one that most would accept. Furthermore, in practice, most M&A professionals agree that the lower Middle Market (which is the most robust segment of the Middle Market in terms of numbers of deals) is in the $2.5 million to perhaps $150 million value sector which could also be stated as $5 million to $300 million in sales.

Does Size (Alone) Matter?

Even size can be a gray area in defining the Middle Market, though. Many ostensibly Middle Market businesses generate sales of between $4 million and $8 million without ever being of any interest to strategic buyers. These are very difficult firms to find buyers for, as they are of no interest to strategic buyers and too large for individual buyers. Many of these firms will take two or more years to be sold or perhaps will never be sold, at least other than to management, which is something that should always be given serious consideration in these cases. If they are fortunate, they might be sold to another buyer in the same industry, but not one that has formally mounted a strategic acquisition program (thereby truly meeting the definition of a "strategic buyer") in other words a passive buyer and therefore not willing to pay top dollar. These same-industry buyers are what I will call later *opportunistic industry buyers*. I would suggest that such ostensibly Middle Market firms as I describe here are in fact are really larger and more sophisticated Mom-and-Pop hybrids.

But just as there are firms that would qualify as Middle Market on the basis of revenues but for all intents and purposes remain Mom-and-Pop companies, so too are there firms that would appear to be Mom-and-Pops on a revenue basis that in fact should be considered Middle Market firms, based on their business prospects and scalability. For example, I have participated in the sale of several businesses generating less than $1 million in annual revenues that sold for more than $20 million. Such firms are recognized easily, based on "killer app" goods and/or services and on their scalability and future prospects. They often are either growing very rapidly or have the potential to do so. Frequently, they are technology businesses that have something very special to offer both their current clients and the strategic buyers that compete aggressively to acquire them.

Brokers and Investment Bankers Servicing the Three Markets

Middle Market investment bankers quite understandably are more interested in a business's likely market value than its revenues when determining whether or not to represent a prospective client. Their fees ultimately will be reflect the selling price of the business. At a bare minimum, most serious Middle Market investment banks would have a substantial retainer and a minimum fee of $200,000, and would expect a prospective client to be worth at the very least $3 to $4 million in the marketplace and be attractive to serious strategic buyers before agreeing to represent it, leaving businesses of lesser value to business brokers, consultants, and, not infrequently, freelancing accountants.

More akin to residential real estate agents, business brokers usually operate as relatively nontechnical "matchmakers," marketing their clients through newspaper classified advertisements, online advertisements, and tabloid-type catalogues of "businesses for sale." They typically charge fees of around 10% of the transaction values (which are usually under $1 million) and mostly operate with no retainer. Business brokers do provide Mom-and-Pop firms with valuable, if somewhat nontechnical, support. Unlike investment bankers, who usually focus more on sellers than on buyers (strategic and financial buyers can be easily identified, once a sales side client has been engaged an investment banker), business brokers tend to develop stables of (usually individual or similar smaller business) buyers to whom they present their new sales "listings."

Finally Wall Street and/or major regional investment banks serve the Upper Market by providing services in support of mergers and acquisitions of large companies, divestitures, and leveraged buyouts, among other transactions including initial public offerings (IPOs) of stock.

Chapter Highlights

- The Middle Market has been described in various ways by different authors and organizations, but a good definition would be businesses having from $2 million to $500 million in revenues.
- At its broadest definitional limits, Middle Market firms generate from $4 million to $1 billion in annual revenues, so for all practical estimation purposes, Middle Market firms so defined generate from $2 million and $500 million in business value.
- The Middle Market represents approximately 21% of U.S. businesses, while Mom-and-Pop firms (often lifestyle businesses for which formal financial theory valuations seldom are relevant or applicable) account for 79% of businesses. Upper Market firms account for the remaining less than 1%.

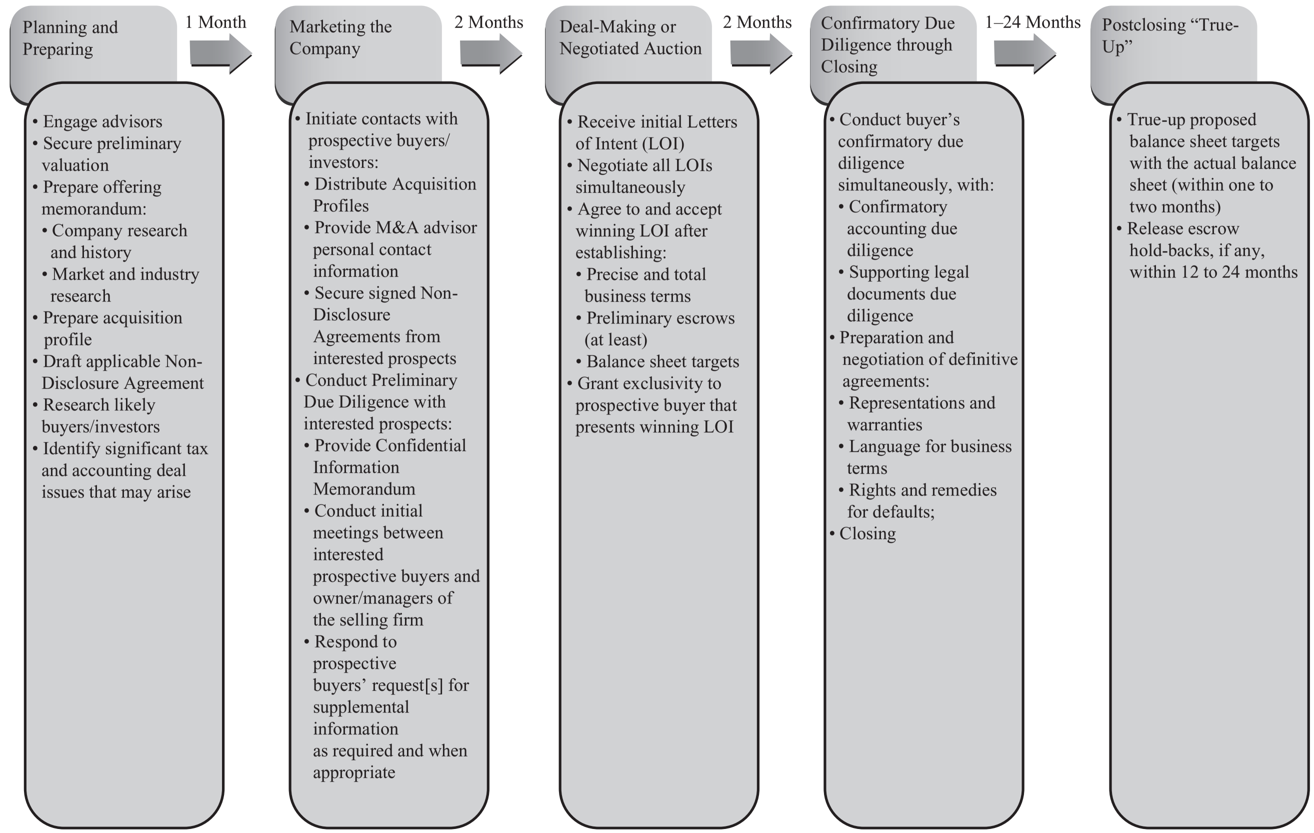

EXHIBIT 1.1 The M&A Process from Start to Finish

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- Mom-and-Pops are sold with the assistance of business brokers who develop stables of buyers for these smaller firms.
- Sales of Middle Market and Upper Market firms are transacted by boutique or large investment banks.
- Middle Market businesses are usually represented by investment bankers who are more concerned with sellers, inasmuch as buyers for these attractive business are usually not that difficult to locate.

Exhibit 1.1 gives an overview of the M&A process.

Notes

1. In point of fact, there is really no consensus agreement on where the Middle Market ends and the Upper Market begins. I do not think anyone would argue though with an upper limit on the former of $1 billion in sales (which in turn suggests about $500 million in value). As a practical matter between $500 million in value and $1 billion is a rarified area and most Middle Market transactions in the M&A world are substantially under even $500 million in value.
2. This excludes some 17,600,000 "businesses" that have no employees.
3. For a basis for this assumption, see Chapter 23, the Rules of Five and Ten.