PART One

The Middle Market

CHAPTER 1

Private Capital Markets

A fundamental premise in this handbook is that there is a difference between the deals, transactions, and financings in the middle market and those in the large-company, traditional-corporate-finance public market. As indicated in the preface, the focus of this book is the middle market, primarily composed of private businesses. This chapter sets the stage for the balance of the discussion in this handbook by providing an overview and perspective of the middle market and private capital market activity.

A *capital market* is a market for securities (debt or equity) where businesses can raise long-term funds. Since the 1970s, public capital markets[1] have received much of the attention from academics in the literature and press. Since that time it has been assumed that the public and private markets are substitutes, but in recent years this assumption has been challenged by research studies showing that the two markets are different in many meaningful ways.*

Merger and acquisition (M&A) activity is mainly driven by capital availability, liquidity, and motives of the players, which vary in each market. Regardless of the purview of the buyer, seller, M&A advisor, investor, or lender in the middle market, it is important to understand the market differences and dynamics.

A number of factors differentiate the public and private markets:

- Risk and return are unique to each market.
- Liquidity within each market is different.

*Examples of middle market research and studies: (1) multiple industry surveys of middle market advisors by the Alliance of M&A Advisors, 2008–2011; (2) *Private Capital Markets: Valuation, Capitalization, and Transfer of Private Business Interests* (John Wiley & Sons, 2011), by Robert T. Slee; (3) *Handbook of Financing Growth: Strategies, Capital Structure and M&A Transactions, 2nd Edition* (John Wiley & Sons, 2009), by Kenneth H Marks et al.; and (4) the Pepperdine Private Capital Markets Project.

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- Motives of private owners are different from those of professional managers.
- Underlying capital market theories that explain the behavior of players in each market are different.
- Private companies are priced at a point in time, while public companies are continuously priced.
- Public markets allow ready access to capital, whereas private capital is difficult to arrange.
- Public shareholders can diversify their holdings, whereas shareholders of closely held businesses have few opportunities to create liquidity or to reallocate their ownership in a private company.
- Private markets are inefficient, whereas public markets are fairly efficient.
- Market mechanisms have differing effects on each market.
- Costs of capital are substantially different for each market.
- The expected holding period for investors is different.
- The transaction costs of buying versus selling a business are different.

So, why does it matter whether large public and middle markets are different? It is important because acquisition pricing and behavior vary by market, or more specifically, by market segment. Further, much of what is taught in traditional corporate finance is not easily applied, nor appropriate to apply, to the private capital markets and to many middle market deals. And lastly, a clearer understanding of market behaviors, drivers, processes, and dynamics will ideally enable those on all sides of a transaction to put greater focus on meeting strategic objectives, creating value, and achieving owner and shareholder objectives.

SEGMENTED MARKETS

The private markets actually contain numerous marketplaces. For example, there are different submarkets for raising debt and equity and for transferring business interests. This handbook consistently uses the collective term *markets* to describe activity within the private capital markets, rather than attempting to describe particular submarkets with a confusing array of terminology. While there are no definitive size boundaries, Figure 1.1 depicts market segmentation by size of business.[2]

Small businesses with annual sales of less than $5 million are at the bottom of the ladder. There are more than 5 million small businesses in the United States and together this group generates approximately 15 percent of the U.S. gross domestic product. These businesses generally are handled

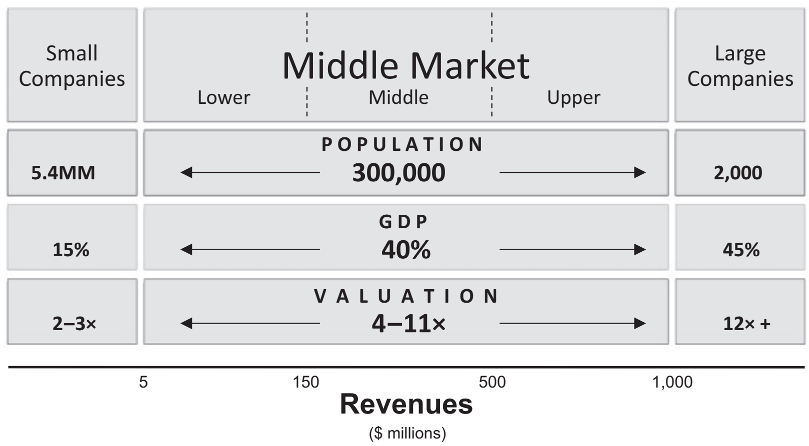

FIGURE 1.1 Segmented Capital Markets

by the business banking group of community or smaller regional banks and are almost always owner-managed. These businesses have limited access to the private capital markets beyond assistance from the Small Business Administration (SBA) and business brokers. Capital access improves as the business moves into the upper segments.

The entire middle market generates roughly 40 percent of the U.S. gross domestic product (GDP). The *lower-middle* market segment includes companies with annual sales of $5 million to $150 million. The lower-middle market is the main province of the private capital markets as described in this book. Companies in this segment have a number of unique characteristics:

- There is owner management.
- Owners have virtually unlimited liability and personally guarantee the debt.
- Owners typically have most of their personal wealth tied to the business.
- A vast majority of these businesses will not transfer to the next generation.
- Access to capital varies greatly, is situation dependent, and is difficult to prescribe.
- The enterprise value of the company can vary widely from year to year.

The *middle-middle* market includes companies with annual sales of $150 million to $500 million. They are serviced by regional investment banks and draw the attention of the bank's top lenders—their corporate bankers. Generally, capital market access and efficiency improve at this level as the sophistication and robustness of the business increase. Companies with sales over $150 million begin to have access to nearly all capital market alternatives in some form, though selective.

The *upper-middle* market is comprised of companies with sales of between $500 million and $1 billion. These companies have access to most of the capital market alternatives available to the largest public companies. This group of companies, which tend to be publicly held, attracts the secondary attention of the largest Wall Street investment banking firms; the largest regional bankers also take notice. In this tier, capital is accessible and priced to reflect the riskiness of the borrower.

The *large-company* market, which is almost entirely composed of public companies, is estimated to generate about 45 percent of the U.S. GDP. Large companies have the complete arsenal of capital alternatives at their disposal. Many use discounted-cash-flow techniques to make capital decisions because they can fund projects at their marginal cost of capital. Almost all are public, and the few that are private have most of the financial capabilities of public companies. Wall Street bankers focus primarily on these companies. This segment of the market is where the finance theory, research, and rules of traditional capital markets were developed and typically applied.

Each market segment yields information and liquidity, which form the basis for particular investor return expectations manifested by acquisition multiples paid for companies within it. Acquisition multiples based on *EBITDA* (earnings before interest, taxes, depreciation and amortization) represent capital structure decisions. The reciprocal of EBITDA multiples yields an expected return on total capital. For instance, equity investors *ordinarily* require 30 to 40 percent compounded returns from investments in the middle market, and 10 to 20 percent from investments in large companies.[3]

Markets segment by investor return expectations because players within a segment view valuation parochially. The relationship between investor return expectations and valuation is straightforward: Greater perceived risk requires greater returns to compensate for the risk. Using a capital market–determined discount rate is another way of looking at this risk/return relationship. The discount rate then is the expected rate of return required to attract capital to an investment, taking into account the rate of return available from other investments of comparable risk.

Calculating the reciprocal of a selling multiple is a shorthand method for determining the capitalization rate or, once we account for assumed long-term growth, the discount rate. EBITDA acquisition multiples for the lower-middle market typically fall between four and seven times. Expressed as a reciprocal, this roughly corresponds to a 14 to 25 percent capitalization rate, or assuming a long-term EBITDA growth rate of 2 percent, a discount rate (investor return expectation) of 16 to 27 percent. Return expectations can be expressed as discount rates and tested. Assume a buyer uses a

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capital structure in an acquisition with 30 percent equity, carrying 30 percent return expectation, and 70 percent debt, which costs 9 percent. The discount rate implied in this capital structure is about 15 percent, within the return range cited above. Thus, as Figure 1.1 indicates, there is a correlation between investor return expectations and pricing. Although much of Figure 1.1 is definitional, support for these findings can be found in several private company transactional databases.[4]

Since a number of factors form boundaries in the capital markets, appraisers must correctly identify the segment within which the subject will be viewed. Characteristics need to be weighed in their totality. For example, some companies have annual sales of $3 million, but meet other criteria that may allow them to be viewed as lower-middle market entities. On the contrary, companies with sales over $5 million may be viewed by the markets as small businesses if they don't have certain characteristics. An incorrect assessment will lead to improper valuation. Table 1.1 provides criteria appraisers can use to define the segment within which their subject should be viewed.[5]

Some criteria warrant further explanation. Owners significantly influence the segment in which their company will be viewed. For instance, if an owner decides to personally manage every aspect of the business and desires to achieve only a good lifestyle from the business, the market will probably view it as a small business. Conversely, owners who strive to create company value and build a functional organization may induce the markets to view the company as a lower-middle market entity.

Market players also help decide how a subject will be viewed. For example, business bankers and business brokers work with small businesses; commercial bankers and private investment bankers work with lower-middle market businesses.

Once again, market segmentation matters in M&A because segmentation (how a company is viewed by the capital markets) determines several critical issues: how that company will be valued, capital access and costs, transfer options or exit alternatives, and which professionals are likely to engage and support the business. Therefore, one element of a strategy to maximize a company's value is for management to get the company viewed in a more advantageous segment based on their objectives.

WHY ARE MARKETS SEGMENTED?

Markets, like individual firms, have a cost of capital that reflects the return expectations of capital providers in that market. But, how do capital providers determine risk and return within a market? Capital markets are

TABLE 1.1 Defining Characteristics by Segment

Characteristic	Small Market	Lower-Middle Market	Middle-Middle Market and Up
Revenue Size	<$5 million	$5–$150 million	$150–$500 million
EBITDA Size	<$500,000	$500,000–$15 million	$15–50 million
Ownership Profile	Owner-managed	Owner-managed, professionally managed	Professionally managed
Owner or Manager Capital Motives	To manage cash in business, not balance sheet	To manage the business, not the balance sheet	To manage net assets on the balance sheet
Ownership Goal	Lifestyle	Lifestyle—entity wealth creation	Entity wealth creation
Role of Key Manager	Wears all hats	Wears few hats—functional management	Functional management
Market Orientation	Service	Service—market maker	Market maker—service
Capital Access			
Debt	Business banking	Commercial banking	Corporate banking
Equity	Personal/family	Personal/private equity	Private equity
Intermediation	Business brokers	M&A advisors and local investment bankers	Regional/national investment bankers

segmented for two primary reasons. First, capital providers are the authorities that set rules and parameters. Second, owners and managers view and define risk and return differently in each market.

Capital Providers

Capital providers use what may be thought of as *credit boxes*, which depict the criteria necessary to access the specific capital. Many institutional capital providers use portfolio theory to diversify risk while optimizing return. Portfolio theory is built on the premise that the risk inherent in any single asset, when held in a group of assets, is different from the inherent risk of that asset in isolation. It is unlikely that even investments in a class, like senior middle market debt, will experience returns that co-vary. Credit boxes help capital providers filter asset quality and set return expectations. Loans or investments that meet the terms of the credit box should promise risk-adjusted returns that meet a provider's goals.

Providers also use other devices to manage portfolio risk and return. Techniques such as advance rates and loan terms enable providers to hedge risks. They manage risk with interest rate matching and hedges, and diversify investments across geography and industries. Loan covenants are a major risk/return management tool; by setting behavioral boundaries around the borrower, capital providers are better able to manage portfolios. Providers constantly monitor their portfolios, feeding back information through their credit boxes to adjust the characteristics of assets in their portfolios.

Debt providers' use of loan covenants further segments capital markets. For example, the range of senior debt multiples and the ratio of senior debt to EBITDA, is different for each segment. Small market debt providers usually will not lend more than two times EBITDA; middle market lending usually occurs in the three-to-five-times range; finally, middle-middle and large-company lenders often lend beyond five times EBITDA.

It is possible to get a general idea of acquisition multiples by knowing just a few variables. These variables are equity investment and senior lending multiples. According to recent surveys by Pepperdine University, the typical private equity group (PEG) deal employs about 48 percent equity in the capital structure.[6] This percentage, by the way, represents an all-time-high equity investment level by PEGs. The most recent Pepperdine survey indicates that senior lenders use a financial covenant of 2.5 run-rate EBITDA on total debt. This combination of debt and equity yields an equation that derives acquisition multiples as follows:

$$\begin{aligned}\text{Acquisition multiple} &= \text{Senior lending multiple}/(1 - \%\ \text{Equity investment})\\ &= 2.5/(1 - 0.48) = 4.8\end{aligned}$$

Thus, when senior lenders employ a 2.5 lending multiple and equity represents almost half the capital structure, acquisition multiples fall to below 5. Many middle market owners resist selling for less than a 5 acquisition multiple, primarily because net proceeds after closing fees and taxes do not enable them to meet their financial needs. In an attempt to overcome low multiples, advisors may craft economic bridges (earnouts, seller notes) to boost purchase prices.

Markets are further segmented by the ability to accommodate perceived risk differences. In the middle market there is a distinct difference between the portfolio risk experienced by equity providers and that of debt providers. Equity risk is generally greater, due to its legal structure, and it is likely to be a larger portion of a smaller portfolio, further increasing risk. Debt tends to be less risky, due to its substantial bundle of legal rights, and it is usually a smaller portion of a larger investment portfolio, diminishing the impact of risk. Middle market equity investors generally spread their risk among relatively few investments contained in a given fund or portfolio. In contrast, debt investors spread the risk among a larger pool of investments in the portfolio. *Mezzanine investors* can assemble blended portfolios with an entirely different risk profile since they tend to make relatively smaller investments in a greater number of companies. Moreover, the debt portion of their investments diminishes mezzanine investors' risk, while the equity portion improves their return. Rounding out this discussion of the impact of portfolio risk, pity the poor business owner who has a portfolio of one company to absorb all risk.

Lenders' and investors' portfolios define the limits of their expected returns, and managing these limits creates market fluctuations. Similarly, owners manage a balance sheet with a blend of equity and debt. In other words, owners manage a portfolio of equity and debt in order to maximize utilization of capital and control exposure to risk. It is the day-to-day operation of these portfolios of investments working through market mechanisms that *defines* the market at any point in time.

Owners' and Managers' Views of Risk/Return

Appraisal attempts to estimate the balance between risk and return. The foregoing illustrates that risk and return balance by market segment. Behavior of parties in the markets reinforces this premise. For instance, when a large public company, whose stock may be trading at 30 times earnings, acquires a lower-middle market company, why does the larger company pay 4 to 7 times earnings, and not 20? Paying any multiple less than 30 would be accretive, thus adding value to the shareholders. The reason is that the

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larger company views investments in the lower-middle market as riskier, and therefore needs to pay less to balance risk and return.

Here is the key insight: Risk and return are viewed and defined differently by owners and managers in each market. At a minimum, both risk and return are comprised of financial, behavioral, and psychological elements. Financial risk/return indicates that the monetary results of an action must compensate for the risk of taking the action. Behavioral risk/return describes the fact that actions occur within a set of social expectations. For example, loss of face in a community may be viewed as a behavioral risk. Psychological risk/return is personal to the decision maker and accounts for an individual's or an institution's emotional investment in a course of action.

Owners of small companies view risk/return more from a personal perspective, unlike shareholders in larger-market firms. Many small and lower-middle market company owners view the business as a means to a desirable lifestyle, rather than an entity that creates purely financial value. Most small firm owners do not measure investments in the business with the tools of corporate finance. They are more likely to use a gut-feel approach in making an investment decision.

Middle-middle market owner-managers tend to balance the financial and psychological elements of risk/return. They understand that cost of capital is relatively high, so financial returns must compensate for investment risk. However, personal pride and community standing still have great importance. Middle-middle and larger-company managers are driven to realize risk-adjusted returns. This drives economic value–added approaches to managing, which have taken root only in larger companies. Behavioral and psychological decision making are less important to large-company managers, or at least they take different forms.

The combination of capital providers that balance risk/return through portfolio management and owner-managers who view risk/return differently leads to market segmentation. The behavior and perceptions of players are unique in each market. Therefore, making proper financing, appraisal, and investment decisions requires using theories and methods appropriate to the subject's market.

Buyers

Once the market segment in which a company will be viewed is ascertained, the next step is to determine which of the four types of buyers is likely to be interested in the subject company. Table 1.2 offers a brief description of each.

Many owners of mid-size companies think there is one *value* for their firm, when in fact every company has a range of values, depending on the

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TABLE 1.2 Four Types of Buyers

Buyer Profile	Description
Individual	Most individual buyers are acquiring a job (or source of income) when they purchase a business. Purchase prices tend to be constrained, and are typically comprised of a relatively small down payment with the balance coming from bank financing and seller notes.
Financial	Private equity groups are the main financial buyers in the market. They typically cannot bring synergies to a deal. An institutional buyer that does not currently participate in the subject's industry or cannot leverage the subject's business is probably a financial buyer. This group includes some holding companies.
Strategic	Corporate buyers are usually the strategic buyers. They can extract or create value beyond what a financial buyer can enable, resulting in synergies. These synergies can result from a variety of acquisition scenarios. Perhaps the most quantifiable group of synergies emanate from *horizontal integrations*. A horizontal integrator can realize substantial synergies by cutting duplicate overhead and other expenses. Some of these savings *may* be shared with the seller. *Vertical integrations* also can create substantial synergies. These tend to be strategic, in that the target company helps the acquirer achieve some business goal. Synergies also can result from the different financial structures of the parties. For instance, the target may realize interest expense savings due to adopting the cheaper borrowing costs of the acquirer.
Value Investor	These acquirers seek assets or franchises that may be thought of as distressed or turnaround companies. They may seek to acquire a target company that has no defensible current or future earnings prospects, or is in an industry that does not give credit for value beyond the fair market value of its assets.

appraisal purpose and who does the valuation. For example, a perfect-fit strategic buyer will value a company one way, while a nonstrategic individual buyer will value it another.

Mid-size companies can sell to one of these four types of buyers. Each of these alternatives normally represents a different value range.

Each prospective buyer-type brings something different to the table, which directly affects its valuation. Individual buyers can use only the seller's financial statements as a basis for value. Typically, this group has a return expectation of 30 to 40 percent on its investment in the company. This means that individual buyers operate mainly in the small business segment. This

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was confirmed by one study comprising 10 years of data that showed that the selling price/earnings (P/E) multiples of small companies (transactions of less than $1 million) have averaged in the 2.5-to-3.0-times range. This study used the Institute of Business Appraisers database, which houses selling data for more than 10,000 small companies. Interestingly, one of the conclusions of the study was that even with inflation and varying interest costs, the average selling P/E stayed within a fairly tight range.

PEGs are financial buyers that tend to make direct investments in middle market companies and tend to pay four to seven times EBITDA for companies. They normally make control investments; however, many groups will take a minority position in the most promising deals. Private equity groups provide strategic capital for a number of activities, including recapitalizations, leveraged buildups, management buyouts, and management buy-ins. PEGs are opportunistic investors and look at many deals before making an investment. Frequently, PEGs will create investment opportunities by sponsoring an executive team to target an industry in which the team has relevant experience and a strong track record. Many PEGs are comfortable investing in family businesses.

The current view is that the optimum available alternative for most mid-sized companies is to sell to strategic corporate acquirers. The best corporate buyers are normally in the same line of business, but need the subject company's market share or production capability. These buyers use what we call the *second-spreadsheet rule* to determine value. First, they forecast the numbers for the target acquisition with no change in ownership (i.e., the stand-alone value). Next, they add the difference for the change in ownership, which should be increased investment, new business, and so on. The second spreadsheet is different for every acquirer, and this difference explains why five different corporate acquirers will value a company five different ways (six if one of the CEOs gets involved).

It should be noted that strategic buyers typically pay similar acquisition multiples as financial buyers (4–7 times) for middle market companies. The valuation may be higher than a financial buyer because the second spreadsheet increases adjusted EBITDA by the amount of synergies the strategic buyer credits to the seller. For example, if the buyer decides to "share" $500,000 in synergies with the seller, but still uses a *5* acquisition multiple, the resulting valuation will be increased by $2.5 million beyond what a financial buyer would pay.

Value investors (sometimes referred to as buyers of distressed companies) acquire the assets of the seller and value them accordingly. Earnings are not really used as the basis for the valuation. Rather, the assets are valued on either a liquidation basis or other appropriate premise of value depending on the circumstances and underlying assets.

While we have provided the foregoing as an indication of what historical multiples have been for each buyer group, it should be noted that valuation multiples vary tremendously in actuality. Differences in risk profiles, expected growth rates (particularly in the years following the one used in valuing the company), and the strategic significance of the company to the buyer all play huge roles in establishing value. What's more, there are certain industries, technology being one, where it would be highly unusual for a successful company to trade within these multiples. This is not to say that these multiples cannot be used as general guidelines, but instead, is an admonition not to take anything for granted, and that nothing takes the place of good homework, thoughtful analysis, and due diligence when establishing a company's value.

MARKET ACTIVITY

The middle market can be viewed by the sizes and quantities of transactions. Figures 1.2, 1.3, and 1.4 provide a historical context for understanding the market, particularly as it relates to M&A activity. The data in Figures 1.2 and 1.3 has been segmented by revenue of the target company in synchronization with those segments in Figure 1.1. To some degree, there is a

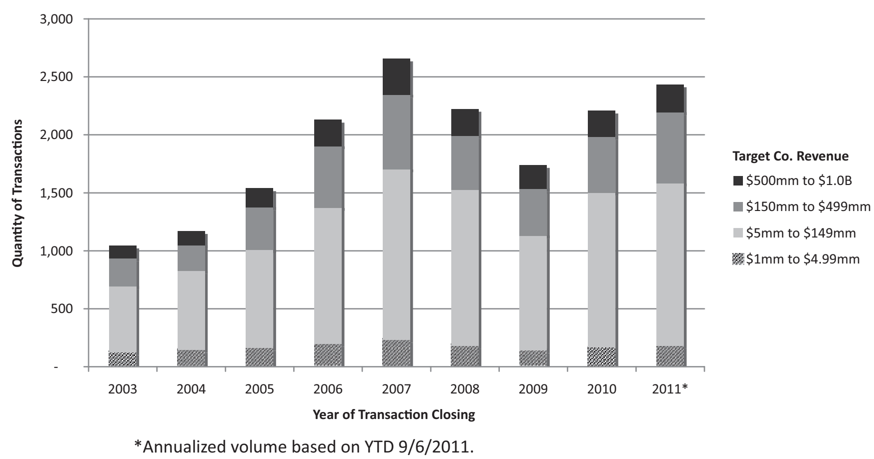

FIGURE 1.2 Global Middle Market M&A Activity-Transaction Volumes
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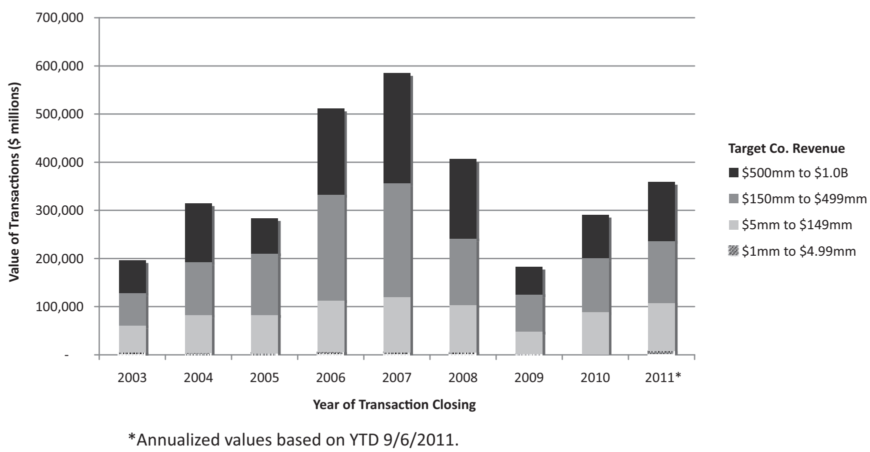

FIGURE 1.3 Global Middle Market M&A Activity-Transaction Values
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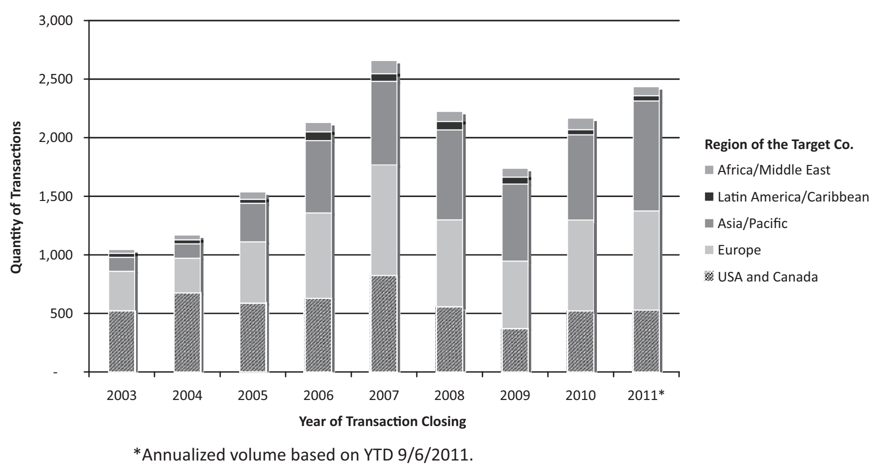

FIGURE 1.4 Global Middle Market M&A Activity-Transactions by Region
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blurring of definitions of private and public deals on a global basis at the company size on which this handbook focuses. The data supporting these charts includes both private and public information as appropriate. It does not include growth equity or recapitalizations, which would increase the quantity and value of the transactions significantly. These charts are meant to illustrate the pure M&A deals.

As shown in Figure 1.2, the quantity of transactions has nearly doubled over the past eight years, particularly in the lower-middle market.

Figure 1.3 highlights the escalation of investment in the middle market just prior to the Great Recession, as values and investment by private equity peaked. Note that the total value of transactions in the segment below the lower-middle market is negligible. The information on this segment in Figures 1.2, 1.3, and 1.4 is included for reported transactions that likely included institutional buyers or investors; not included are the thousands of main-street brokerage deals.

The value of global middle market transactions reached over $585 billion in 2007. About 57 percent of the target companies were privately held, representing 80 percent of the transaction dollar values. In 2011, it is estimated that about 47 percent of the target companies are privately held, representing 77 percent of the transaction dollar values. Thus the estimated global dollar value of private middle market transactions in 2011 is $276 billion.

Figure 1.4 highlights the global nature of the middle market. In 2003, the target middle market companies were primarily in the United States, Canada, and Europe, representing 82 percent of the volume. Today, the majority of the targets are in Asia, the Pacific Rim, and Europe, with the quantity of deals in the United States and Canada remaining relatively flat.

The middle market is global, vibrant and active.