

ASA Presentation

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Trends in the Private Capital Markets

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INTRODUCTION

We toss around the word “market” loosely, but what constitutes the “Middle Market” and how is it different from other markets? The middle market is distinguished by several features including: a dedicated system of capital providers, an industry of specialized service professionals, transfer mechanisms peculiar to the market, owners with different motivations than public market owners, all of which lead to different theories designed to understand the private middle market.

First, let’s discuss how the market fits into the American economy. According our research there are about:

- 26 million businesses in the United States
- 20 million have no employees
- 5.7 million have revenue less than \$5 mm
- **300,000 with revenue of \$5 mm or more**
- 4,000 have revenue above \$500 mm



Our focus here is on those mid-market businesses with revenue over \$5mm.

The goal is to provide a peek, through a series of snapshots, into a market that has all the visibility of the "Munster's House."

The single most striking snapshot of these private markets is that...

95% of all business never outgrow their segment wall.



Why? What accounts for this astounding lack of growth?

Walls

Our framework is structured around a wall metaphor: a series of significant obstacles that, together, or individually, impede growth for most business owners. The walls together with their components include:

- Motivational walls
 - The will to win
 - The risk barrier
 - Priority wall
 - Timing wall
- Capital walls
 - Sales and earnings
 - Access to capital
 - Cost of capital
- Operational walls
 - Management team walls
 - Productivity walls
 - That vision thing
 - Strategic planning wall



- Transfer walls
 - Wall of complexity
 - War of the world wall
 - Transfer segment wall
 - Timing wall

Market Trends

Overwhelming trends crash across the market from several directions at the same time. Each is pregnant with possibilities and loaded with peril. In broad terms the trends are:

- Capital Deluge and droughts
- Information insurgency
- Creating value
- Redefining risk
- Expanding/contracting market
- Regulatory change
- Transfer turbulence.



These trends are reshaping the middle market. They simultaneously wreak havoc while stimulating value creation. They have spawned one of the best economic environments in history – and one of the riskiest. The dilemma for those caught in the storm-tossed market is how to triangulate a winning strategy. We touch on each trend but focus primarily on Capital Deluge and Droughts and Transfer Turbulence.

Capital deluge and droughts

A mass of capital cascaded onto the middle market in the 1980s and early 1990s. It certainly did not leave the market unchanged. Total middle market capitalization rose from an estimated \$1.8 trillion in 1980 to \$4.2 trillion in 2010. Providing capital to this market was once the exclusive province of community banks. Now multiple funding sources compete to make massive amounts of capital available, even in down markets. Some observations about the change:



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- The market morphed from a lack of capital - to an excess of capital – and back to capital that is available - albeit allocated parsimoniously.
- The market operates like a cattle coral - the feed is capital.
- The market was effectively monetized i.e., illiquid assets were converted to cash.
- This led to major increases in business transfer volume.
- Private equity now control about 40% of mid-market capitalization, not numbers of business.
- Those businesses are now under the influence of the Wall Street economy.
- There is an established link between Prime Rate, the number of deals, and GDP.



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- In the last three recessions, mid-market and small business acted as flywheels providing momentum to the economy. Not so in the recent recession.
- In 1980 individual owners held about 91% of mid-market equity. In 2010 they held about 50%.
- Now there is good reason to think the Middle Market capitalization fluctuates in a pattern similar to, but not identical with, the public market.
- Individual shareholder's equity in 1980 estimated at \$579 billion. In 2010 it grew to \$900 billion. (Intrepid estimators strike again)
- Nearly nonexistent in 1980 mezzanine, financing rose to an estimated \$80 billion in 2010. It supports rapid growth without diluting control.
- Mid-market debt rose from \$1.2 trillion in 1980 of \$3.3 trillion in 2010



Information Insurgency

The mid-market is fully engaged in the rapidly developing information economy, at least those who survive will be. Winners have a growing intellectual capital component. The market worked differently when very few people had access to, or control of, information.

- Once information was limited. Now there is information overload.
- Once information was sequestered. Now it is open.

Creating Value

Business owners seldom talk about creating value. However, the record of growth and value creation belies the silence on the matter. In 1980, the middle market had an estimated \$635 billion in shareholder equity. We estimate it reached \$1.5 trillion in 2010.

- Once it was enough to improve operations and tactics.
- Now business strategy must be improved.



Redefining risk

With the introduction of more capital and greater competition, the market became much more risky. In fact, the very definition of risk is changing. Owners must deal head-on with risk.

- Winners manage risk and return, rather than avoiding risk.
- Once it was difficult to earn risk-adjusted returns. Now it is mandatory for success.
- Good economies conceal risk
- Bad economies highlight risk.

Regulation

All markets require regulation if they are to develop and thrive. Paradoxically, free markets have more forms of regulation than those that are not considered free. The middle market is shaped, encouraged, limited and informed by regulation of several types including:

- Government regulation
- Regulation by authorities
- Regulation by mutual adjustment and cooperation
- Regulation by competition



Expanding/Contracting Markets

The market for goods and services produced by mid-market companies is simultaneously expanding and contracting. Communication and technology allow companies to compete in larger markets by seeking smaller niches.

- The paradox is that as markets grow larger, niches become smaller.
- Winners carve out niches in all industries.

Transfer turbulence

The transfer market has more of everything. There now is a whole range of middle market transfer options that did not exist in 1980. The annual number of mid-market transfers doubled between 1980 and 2002. The percentage of business being sold also rose through this period. Selling a business today is an entirely different process than it was in 1980. There is more of everything.

- More deals
- More buyers
- More sellers
- More transfer methods
- More complexity



Long term trends

Long term trends also impact the mid-market, however they can be more difficult to spot and evaluate.

- The dot.com boom and bust
- Housing boom and bust.
 - 12 million homeowners with negative equity.
 - 2.5 million 30 – 90 days delinquent.
 - 4.1 million 90 days or in foreclosure.
 - 5.4 million of these are current.
 - Nearly half of all borrowers under 40 remain underwater in Aug 2012.
- Greater percentage of job losses in current recession than in the 10 previous recessions.
- Construction spending declined precipitously. Are we looking a cyclical adjustment or a long term trend?
- Business startups in the US private sector declined recently more than in any period since 1980. Where is the feeder lot?
- To match the GDP growth rates of the past 20 years, the US needs 34% acceleration in productivity growth. A rate not achieved since the 1960's.



A peek behind the trends

- According to the Wall Street Journal:
 - U.S. births fell again on weak economy for the third year in a row. How is this for a long term trend or prediction?
 - As many as 80% of the nation's small businesses haven't applied for a bank loan in the past five years.
- U.S. high school graduation rates have dropped in the past 20 years.
 - Unemployment rate is vastly different by levels of education.
 - Is this a cyclical adjustment?
- The Global competitiveness report from the World Economic Forum reports:
 - The US falls two places to fourth position.
 - America now ranks 27th on the ease of getting construction permits, behind Saudi Arabia.



A peek behind the trends

- The US economy has taken major hits:
 - US debt downgrade August 2011.
 - Ten years, ten increases to the debt limit.
 - Unofficial problem bank list **declines** to 891 institutions.
 - Per Capita US debt is higher than other OECD countries.
 - Personal savings rate has declined since 1982.
- These factors among others lead to changing rules that redefine market behavior:
 - Owners goals are still obtainable
 - Financial capital was hoarded. Intellectual capital is shared.
 - Intellectual capital trumps financial capital.
 - Once traditional business models won. Now conceptual business models win.



Welcome to the conceptual age

Where the core economic conflict is not between Main Street and Wall Street – or between the government and the private sector – it is between established business models and new forms of wealth creation. A creativity explosion is coming.

- Snap quiz. When did the information economy begin?
- August 15, 1971, when President Nixon dropped the Gold Standard in favor of the **Information standard**.



Longer term trends

A good argument can be made that we are caught up in longer term trends that will play out over many years to come. What do you think?

- Waves of innovation
 - **19th – 20th century**
 - We changed from an agricultural to a manufacturing economy.
 - Farm jobs, as a percentage of total jobs, declined from 85% in 1790 - to 2.6 % in 2000.
 - **20th – 21st century**
 - Changing from a manufacturing to a conceptual economy.
 - Productivity per manufacturing worker increase many times.
 - News flash: Harvard cracks DNA storage, crams 700 terabytes of information into a single gram of DNA. (Sebastian Anthony, August 17, 2012)
 - What can your people produce?
 - Examples of yearly profit per employee are dated but powerful.

There are many simultaneous business cycles occurring in long term waves, it is easy to mistake one for the other



**Are we experiencing a long term shift
in the nature of our economy
rather than merely a cyclical recession?**

Why is winning the Middle Market important? Without the Middle Market, the U.S. economy, its businesses, and its workers would suffer a declining standard of living...something few of us would want.

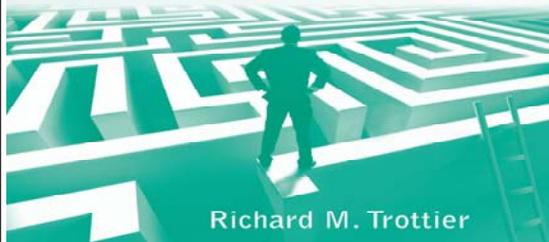
This is all well and good - but there's a big problem. Ninety-five percent of all firms will never outgrow their segment. Some overcome huge walls using effective middle market middle strategies.

Strong middle market businesses are what America needs to grow.



Middle Market Strategies

**How Private Companies
Use the Markets to Create Value**



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Thank you
for your attention

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