Lower Middle Market

With 90% of all deals being in the $10 million to $250 million-size range.

Through constructive collaboration and information systems upgrading, team building, operations improvement practices in governance, management companies and focusing on best growth strategies that enhance the lower middle market? Implementing

What determines success for deals in the lower middle market? How would you define the lower middle market? What is financing like for smaller deals, and how does it differ from the larger middle market?

Mario Ippolito: What's deal flow like in this space?

Jeff Rosenkranz: It is huge across the entire deal spectrum. We read and hear about the multi-billion dollar deals all the time. However, the vast majority of deals are happening in this size range. While deals under $200 million might have accounted for less than 10 percent of deal value in 2006, they accounted for over 90 percent of the number of deals in 2006.

Ippolito: How would you contrast this market to the larger middle market, or the large cap markets?

Rosenkranz: Auctions involving small companies tend to be less sophisticated and less pressured than larger deals. They tend to have fewer parties involved. Lower middle market deals, though, are probably more hotly contested than larger deals. There are far fewer firms that can do $10 billion or $20 billion deals than there are firms that can do $150 million transactions.

Ippolito: What do lenders look for in financing smaller companies? What are their underwriting criteria?

Kevin Mohan: There are a lot of companies that are under $25 million and growing fast. It is easier to grow faster if you’re smaller. So we’ll make equity investments anywhere from $5 million to $450 million. The bulk of the investments are still in the $50-75 million range, so that puts us squarely in the lower middle market. We are happy to be minority or majority partners. That’s appealing to a lot of entrepreneurs who aren’t sure they really want to sell their business. We’ll buy anywhere from 10 percent to 80 percent of a business.

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Ippolito: You mentioned auctions. How are they conducted in this market?

Rosenkranz: Rosenkranz: You see a higher percentage of companies in the lower middle market represented by able bankers than you did ten or fifteen years ago. The processes are certainly more sophisticated than they were a decade ago. And clearly there’s more competition. There are literally hundreds of private equity firms today that can do deals in this size range.

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A low-beta business. Strong operating margins can tell you whether a company’s product or service is valued to the extent that they don’t just sell on price.

Other important attributes are a highly diversified customer base, recurring revenues, multiple products and markets so that if one of those products is challenged, the other products will help carry it. We also look for companies that are non-cyclical or at least structured for the cycle. Performance in the last cycle is important, serving as a precursor for how a company will do in the upcoming cycle.

Geographic diversity is also important. Although we do transactions that are regional, it’s certainly much better if you’ve got a national footprint so a company is not traumatized by a downturn in a regional market.

We’re always seeking a strong, deep, and tenured management team. What innovations have they accomplished over a number of years and how have they positioned the company? Can they clearly articulate a vision for the long term? And, of course, the sponsor’s experience in the business is key. If a sponsor has been driving healthcare deals very successfully over a number of years, they are obviously much better positioned to grow a company in that business.

Ippolito: Is the greater growth potential of these companies a factor in your underwriting analysis?

Kurteson: A lot of companies we see in the lower middle market are transitioning from being “entrepreneur-run” and need an experienced sponsor to help take them to the next level. We recently met with a company started from scratch by a very bright, young management team. They grew the company to about $70 million in sales. It was clear that the sponsor was able to bring additional expertise in a number of areas. Not only could you expand their share of the industry, but you could actually expand the industry based on the sponsor’s ideas to approach it.

Schwimmer: We also see in the middle market more “hockey stick” growth where the sponsors identify a management team with a promising product—often in the consumer-branded space—that really takes off.

But there’s a flip side to rapid growth. You could have a company that was $2 million in Ebitda two years ago and today it’s $30, going tomorrow to $80. If the bubble bursts, you could find yourself back to $2 million pretty quickly. While there can be huge upsides from an equity perspective for the sponsor, debt investors are very cautious about high-growth businesses. For them, the best case is getting paid back.

Ippolito: What are the positive and negative attributes of deals in this space compared to large and middle market?

Mohan: Many of these companies are run by easily unique entrepreneurs. In many cases, these entrepreneurs have been wearing three or four hats, and they’ve got to hire their first CFO or their first VP of marketing. I think that means there’s more dependence on flexible equity and debt investors.

Many of these companies may strive to reach real scale by making an acquisition. An acquisition is even more risky with small companies. There are also fewer options for liquidity, especially in today’s market where many of these companies are too small for near-term IPOs.

Cook: For every negative, there’s a positive. The opportunity to add value is what transcends everything. On the negative side, the management bench in these companies is usually not very deep. On the other hand, these companies typically have phenominal leaders at the top. They just haven’t gotten around to building depth. So that gives us an opportunity to go in and build world-class teams and add value that way.

Ippolito: After the sale of a company, how do you keep the founders and managers motivated once they cash out of all or part of their investment in the company?

Mohan: We get good self-selection on the investments we make because most of these founders could sell 100 percent and they choose not to. They choose to sell us 30 or 50 or 70 percent. That’s the first test on whether they’ll be motivated going forward. They’re trying to optimize the value of the stock they keep.

We also work with founders on their stock ownership and stock option plans for their lieutenants. Stock ownership upside is typically more important than any base pay or bonus program. It’s about ownership and the responsibility for running the company. They run the company. They’re going to keep running the company even if we own 70 percent.

Ippolito: Are there differences between the $5 million Ebitda companies and the $25 million Ebitda ones? Do these differences influence your approach?

Schwimmer: If a company has been around for 50 years and Ebitda is still only $5 million today, it makes you think, “What have they been doing for the last 49 years?” Business in the $5-$15 million Ebitda range are tougher to finance because there’s less cushion if things go wrong. What happens in a downturn? Or what if they have a major customer? Customer concentration becomes much more critical with smaller companies. And $5 million is a small number. We see Ebitda adjustments bigger than that.

Cook: You’ve also got to invest heavily in building management teams and systems that can support the company at the next level of growth. For example, $1-$2 million in additional overhead is required to build a world-class team that consists of all the functional areas: CFO, IT, strategic human resources, marketing, and COO. At a $25 million Ebitda level company, adding $1 million to $2 million of this kind of investment is a lot more digestible. There are also non-recurring costs of recruiting and upgrading systems, which can run between $1 million and $5 million or more. All of this must be justified by higher growth and profitability and does require more room to maneuver from a debt standpoint.

Ippolito: Are there strategic benefits that you employ to drive the growth of these companies besides improving management?

Cook: We’ve devised an approach that we call Insight-Flexibility-Enhancement. It involves using due diligence to gain insight into how we’re going to design and phase our enhancement initiatives. We go beyond the typical confirmatory finance, accounting and legal due diligence to understand facets of the companies like human capital and team-work, operational effectiveness and strategic opportunities that others may have missed.

On the enhancement side, we put in place an engine that’s comprised of six components: governance, strategic planning, operations improvement, IT systems, branding, and marketing, and most importantly, development of human capital. It starts with governance, which ensures a majority of outside directors and proper committees are in place to ensure a unified commitment to growing shareholder value. We want the boards to be a resource to management, so we always encourage the addition of independent outsiders who may provide industry insights, connections and an objective sounding board for the CEO. Strategic planning is now considered an element of best practices in governance as well as a healthy discipline and alignment mechanism. If it is not already in place, we initiate a strategic planning process.

Ippolito: Can you give us a sense of what kind of purchase price and lending multiples you’re seeing in this market?

Kurteson: Well, of course, the answer today is very different than it was even a month ago. Leverage multiples are down at least a full turn. I’m sure purchase multiples will fall flat. Right now, 3.5 times senior and 5.25 times total is probably the upper limit. We try to stay within a zone that we think is comfortable, where the company will be able to pay back a reasonable amount of debt over the six or seven-year term of the loan.

Ippolito: How do you work with the sponsor during the diligence process? Is there a lot of overlap or is it more collaborative?

Kurteson: It depends on the sponsor. We communicate a lot with their team, each sharing our insights. They’ve got a lot of questions for the management team, and we’ve got our list. We may have a slightly different angle. When you combine the two approaches, you should get a broader perspective on the company, and get a complete picture.

Mohan: One interesting thing about our approach is that we often will track companies for years. We’re calling on the CEOs, we get to know the companies, and we’ve seen them hit bumps. When it’s time to make an investment, it is good process to ask some basic of the diligence questions we asked three years ago. It is helpful to have folks like Churchill thinking about some of those questions.

Ippolito: Have you seen deals in this space where you think companies are being over paid for?

Rosenkranz: Yes, but that’s also always been true. It’s hard not to look at the lever-age multiples today and remember not that long ago that those were purchase price multiples. I’ve pitched more business in the last six months—deals with multiples over 10 times—than I have in the 20 years prior to that. These are all terrific companies, but it does make you wonder what that says about the market. If you’re talking about purchase price multiples of 10 plus times and leverage multiples of 6 plus times, the margin of error is just not very great.

It appears that the turmoil we have seen recently in the credit markets will put a damper on leverage multiples for some period of time. If that translates into reductions in purchase price multiples, we will see a much slower M&A market because many sellers today are selling opportunistically to take advantage of the historically high multiples. While we may see a slowdown from the recent frenzied pace, the middle market is still huge and will continue to be active in the years to come.

Schwimmer: We absolutely agree. All you know about the future is, you don’t know about the future. No one predicted that the loan market could turn the way it did. And no one knows for sure what the impact for middle-market sponsor financing will be. But smaller companies have historically been sheltered from the excesses of the broader markets. And more sponsors are figuring out the inherent value of those businesses. So we’re betting the middle market will continue to be a great place to be.