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Introduction to Lower Middle Market Investments in Private Equity

Simply put, private equity is an alternative strategy for providing capital to invest in companies not listed on a public exchange. Although broadly defined as simply assets minus liabilities, private equity as a business wasn't specifically defined until the early 1970s or the early 1980s, and because private investment is such a broad concept, some may even trace it back to the early 1900s. When Kohlberg Kravis Roberts & Co (KKR), one of the world's largest private equity firms, was initially founded in the 1970s, there wasn't yet a clear definition of private equity as a business strategy.

Private equity as a strategy has grown since that time and is now widely known and practiced globally. Private equity firms make their money in two main ways: a management fee from the fund—typically 2% annually—and the fund's return. The limited partners, the investors in the fund that provide capital, may attend certain management meetings, but are traditionally not responsible for the management of the fund and trust the general partners to handle the investment strategy. General partners—the sponsor—report back to the limited partners on certain investments. However, in a discretionary fund, general partners make most decisions based on a set of criteria. General partners may keep limited partners updated if they find that they need more time than originally anticipated to resolve a fund.

Lower middle market investments by financial firms and institutional firms are an important part of the private equity industry. Such funds will typically have different durations depending on the investment strategy and the management, but the normal lifespan—the timespan during which investors expect to receive their returns—of a closed-end fund is about ten years.

Targets in the lower middle market category tend to have an enterprise value of $25-100 million, therefore, larger private equity firms such as KKR, Blackstone, or Carlyle generally wouldn't target a company in the lower middle market category. This is because lower middle market investments generate a relatively lower quantity of dollars (because of the investments' lower enterprise value) than the very large deals that KKR, Blackstone, and Carlyle pursue. Instead, lower middle market investments may be the target of younger and smaller investment firms due to the lower price tag on possible investments and more limited competition. In the lower middle market, firms generally have ideal investment criteria. Ideal investment criteria may include a range of specific financials, market leadership, and/or niche industries.

Firms in the lower middle market space may employ different investment strategies. For example, certain private equity firms may be industry-focused, such as targeting the consumer, manufacturing, or health sector. Firms may also be focused on industry consolidation; this means a firm may target one major company, and then focus on buying and building upwards of 20 add-on companies to expand the revenues and margins of said company. Another strategy that might appeal to a firm is targeting companies with a leading position in a market or in an industry. Different methods and strategies are used in private equity to generate higher returns than that of the public markets, but without careful thinking, the investment can wind up worthless.

The Initial Investment Process

Once enough capital has been raised for the sponsor (the firm) to create a fund, the general partner will begin to seek out investments through different strategies. Strategies might consist of connections to investment bankers or another third party such as a consultant who contacts the sponsor on behalf of companies seeking new ownership. Target firms

could have all sorts of reasons to seek out a buyer to acquire their company: the current owners are preparing to retire, cash out, an entrepreneur may want more capital to build another business, or the firm is currently under the ownership of another sponsor that is looking to complete divestiture.

A phone call with an investment banker and the sponsor, or a document being sent to the sponsor from the investment banker, would consist of the investment banker providing information about what the target does, their market position, and other general information, but just enough so that the general partners become interested. This initial information is called a teaser and may include a couple of pages of information regarding the target, but often at this stage the name of the target and key information of the target is not disclosed. The teaser is just enough to hook the sponsor's interest.

Two outcomes are plausible after the teaser: the sponsor wants more information about the investment, in which they are attracted, or the sponsor is not interested in the investment because it doesn't fit their ideal investment criteria. If the sponsor decides that they want to know more about the potential target, they are typically required to sign a non-disclosure agreement (NDA) to get to the next step. The NDA is usually necessary because the next step includes disclosure regarding the target's strategies, financials, management, and other private information, all contained inside a confidential information memorandum (CIM), or an offering memorandum designed to build the buyer's interest. The CIM will usually contain several basic categories of information about the target. The CIM can vary in length, depending on how much information a target wants to provide, ranging from a couple of dozen pages to almost 100 pages. The CIM must contain the essential information about the target, which tends to be public information. This essential information includes current management and the product and or services that they provide to their customers.

A CIM might also provide the preferred timeline of the target and the robust financials. When investing in lower middle market companies, within $25-100 million in enterprise value, paying attention to their financial history is critical. Companies may only include up to two-three years back in their CIM, and then provide estimates on future financials based on specific compound annual growth rates (CAGR). Companies' future estimates may be based on estimated CAGRs and are often purely speculative, even overly optimistic. Essential information might include the historical financials of the target, as they tell a story of how successful they have been. Steady and strong cash flow, revenues, and growth in EBITDA margins compared to other companies in its sector may indicate a prominent leader in the industry. Lower financials, but higher CAGR point toward a target with a riskier but higher potential for future growth.

Startup companies that are significantly riskier and have lower earnings tend to be a target not for lower middle market private equity funds, but instead for venture capital. However, a sponsor might look in the CIM for growth opportunities for the target. For example, the company might be targeting other companies in their sector for a synergy strategy: combining multiple companies under one management team. All products being sold under one company, in general, creates a strong opportunity for growth.

Sponsors review countless CIMs and will pass on them if even one or two things seem out of touch. Once the sponsor reviews the company's CIM, if the sponsor is interested in the target, the next step is to send in an expression of interest (EoI) to the investment banker. The letter is usually non-binding, and although it contains an enterprise value for the target at close from the sponsor based on a debt-free, cash-free basis, nothing is legally binding the sponsor to the target, nor vice versa. The expression of interest simply lets the target know that the sponsor is interested in the acquisition of the target. If the target likes the enterprise value that the sponsor indicated, it may then allow the firm to attend a management presentation, and it typically gives them access to a virtual data room from the target.

Due Diligence

A management presentation allows the target to present information, some from the CIM, but in a way that can elucidate certain matters. The presentation is usually in-person, which allows the management to demonstrate their product(s) or service(s) and present the history and story of their company on a more personal level. The questions asked

by the sponsor depend on what the sponsor is looking for in a target. A sponsor normally has its acquisition criteria in mind before acting upon an investment opportunity, and in general, questions branch off those criteria. A general criterion, particularly for lower middle market investments, is that other than a general enterprise value, sponsors may target a certain EBITDA amount. EBITDA, being one of the key profiting benchmarks, usually ranges in the $3-15M for lower middle market investments. Items that were not included in the CIM but may be included in the presentation include previous acquisitions, the rationale for past acquisitions, certain margins not included in the CIM, problems they are dealing with, strengths of the target, and importantly, certain historical financials. During a management presentation, a drastic drop in revenue, for example, could be explained: COVID-19, shortage of materials, the CEO being fired, etc. Questions that may be centered around a sponsor's investment criteria such as a duopoly between two companies in their sector, how difficult barriers to entry into the target's industry could be (if they have a defensible market position), etc., may be asked during the management presentation. It is incredibly useful for the sponsor to be able to ask questions instead of merely receiving written information.

Especially in lower middle market private equity, asking questions about market share, competitors, the type of sales the target relies on (contracts, eCommerce, etc.), and purchasing frequency to determine their sustainability is essential. If an economic recession were to happen, would the target's sales drop 50%? Or would they drop 20%? These are all questions to ask to determine the strength of the target's industry and the bargaining power that they hold. If they relied on the supply of copper, and the price of copper increased 20%, would customers still rely on them for their product? Or would they simply turn to someone else? As previously mentioned, management presentations also consist of additional financial data, possibly a couple of years prior to what was included in the CIM. Those years might only be included in the management presentation, and not the CIM if it is difficult to justify the decrease in a certain year. A rigid dichotomy between private investment in general vs. public investment is that there is no public metric for determining a proper enterprise value for a target. Public securities have a market cap, a share price, and a share price history, whereas private companies have reported financials, management presentations, due diligence, and conversations with the target, making it complex to place a price tag on the target; despite this a major part of determining a price tag on a target is comparing said target to public companies, that do contain public price data. The entire process of determining the price tag is a long and broad concept called due diligence.

Due diligence is critical when determining the valuation of a target. Prior to signing the contract, sponsors will hire accountants, lawyers, and researchers, request data, research customers, assess the industry that the target operates in, and more. A good sponsor will also have been in contact with the investment banker connected to the target and will have constantly been engaging in meetings and discussing information they find important. Good sponsors will also dive into a target's legal history and debt history to assess any ongoing lawsuits, contingent liabilities, and determine if they are hiding anything. Sponsors will constantly be in contact with the target's investment bankers, and management in order to answer some of their questions.

A major part of due diligence could be a quality of earnings (QoE) report and/or a financial model. The financial model will use many different measurements: predicted growth, free cash flow, taxes, and importantly, debt repayment to determine the attractiveness of a target. The financial model could vary in specificity, but generally takes professionals at least several days to build. A QoE report is a thorough process conducted by the sponsor, but sometimes also by the target, in order to determine the validity of a target's earnings. A QoE report, usually conducted after the letter of intent is signed, by an accountant, consists of creating a data request list from the target, adjusting the future earnings projections, and the past transactions not included. The QoE report helps the sponsor understand the expenses, earnings stream, and reliability of data keeping, all ultimately leading to an evaluation of the target. The enterprise value and the value that a sponsor will ascribe to the target usually consists of a multiple of EBITDA. Certain sponsors may target different pricing, but in lower middle market private investments, three to ten times EBITDA is typical. Due diligence in valuing the target is vital; even if a target grows exponentially, if it was overvalued by the sponsor, negative to low returns or even complete loss is possible.

The Letter of Intent

In lower middle market private investing, determining how much to bid is without a doubt very difficult. Sponsors are frequently rejected by targets on which they place a low enterprise value, but because so many companies are constantly being brought to market, another opportunity often comes along relatively quickly. The bid placed upon a target in an expression of interest (EoI) or a letter of intent (LoI) isn't as final as one might think. Often unlike the actual contract, both letters (EoI and LoI) are completely non-binding, and the valuation of the target often changes throughout the acquisition process. The LoI includes the sources for the purchase proceeds (term loans, mezzanine debt, and equity from the fund), the uses for the purchase (cash to sellers, seller rollover equity, and estimated fees), and generally templated information stating that the valuation could change. The LoI also serves as an agreement between two parties that they intend on working with each other with the goal of completing a transaction. Although more of a moral agreement, depending on whether the LoI was structured to be legally binding or not (usually is not), the target is now exclusively working with the sponsor and granting them access to documents and the history of the target. After the LoI is signed, the sponsor is in its final and most important stage of due diligence before signing a contract, which means calls between the target and the sponsor will be even more frequent. During the final stages of due diligence, the contract negotiation of a live deal—the most intense phase of the acquisition—begins.

The Live Deal

Up to the live deal period, the sponsor has been conducting and evaluating the target's financials and gathering data. A good sponsor has been working day and night to assess the deal, ensuring that the target has legitimacy and value. A virtual data room provided by the target after the expression of interest will now contain several folders about the historical and current data and financial models of the target. Properly recorded transaction history, tax, legal, intellectual property, financials, and more are all crucial to ensure that the deal goes smoothly. Being able to trust the target's management also remains vital for the sponsor, as is ensuring that they have properly recorded past financial data in a proper manner as well. If a target's accountant has improperly reported the financials and given them an estimated $10M in EBITDA, and after due diligence, the sponsor discovers that the actual EBITDA is $8M, that can cause a deal to be renegotiated, or even fall apart. Suppose the target has been overly optimistic about its industry and has been emphasizing a significant pattern of growth long-term, and due diligence suggests that the industry is undergoing a steady decline, often, sponsors will drop out of the deal. Hundreds of hours, tens of thousands of dollars, and hard work will all then be sunken costs, and this is completely dependent on the sponsor's diligence. As previously discussed, proper due diligence cannot be "watered down". Good sponsors will lay out a schedule for their due diligence, and it will not be an easy process. The weeks spent conducting customer calls, analyzing the market, the legal aspect of the business, and ensuring that the sponsor has the type of target that they are looking for is a big part of the process. Finally, lawyers, accountants, management from both parties, and anyone involved, will gather when they are ready to close. Signatures will be released with confirmation from both parties, and then the wire transfers will be released, finalizing the deal.

The Capital Structure

Previous chapters consisted of basic information about the underwriting process, but the acquisition capital structure can be complex, involving many different metrics of accounting. The capital structure of a deal can be one of the biggest "make or break" aspects to ensure a respectable return. In general, a sponsor wants to put in less equity compared to lower-cost debt, which will be explained later in the chapter. The capital structure can be classified into three major categories: senior debt, mezzanine (also known as junior or subordinate) debt, and equity. Lenders typically size corporate acquisition loans on a multiple of EBITDA. This can be utilized by the private equity sponsors investing in lower middle market companies, as this means that for some loans, if they grow a target's EBITDA, then the amount the bank is willing to fund increases as well. For example, if a target was acquired by a sponsor with an initial EBITDA

of $8M, and a bank loaned the sponsor on a multiple of the EBITDA of the target, 4x EBITDA, the loan amount would be $32M. Two years later, the hypothetical target was able to raise the EBITDA amount to $10M, and if the bank lent funds based on a multiple of EBITDA, an additional $8M would be funded. Such EBITDA-based loans allow target firms to invest proceeds into add-on (bolt-on) targets(s), providing another opportunity for growth initiatives (mentioned in The Initial Process). The sponsor can do this with the approval of the bank because the money loaned is technically all under one institution: the initial target.

Within the debt structure, the senior lenders have the highest priority in the repayment of their debt and usually require some sort of financial tests and provisions from the target. Mezzanine debt has the second highest priority in the repayment of their debt and is hence subject to slightly more risk. Mezzanine debt consists of senior subordinated debt, convertible subordinated debt, and redeemable preferred stock. Mezzanine debt is relatively complex but can be generalized as higher risk debt. Mezzanine's role is to fill in the gaps between the senior debt and the equity if the senior lenders are not willing to lend adequate proceeds designed by borrowers—which could be because of all sorts of reasons.

The final category of funding sources is equity. Equity is essentially the investment from the sponsor, and in a lower middle market environment, will likely consist of about $20-70M. Debt is significantly more complicated than previously explained, but the important takeaway is that debt can be leveraged. A lower percentage of equity and a correspondingly higher level of debt (leverage), usually facilitates a higher return along with higher risk. Leveraged buyouts with a significantly higher percentage of debt compared to equity generate higher returns through debt repayment: despite annual free cash flow being reduced, the debt repayment at an exit, calculated based on the same exit sale price, will cause the total returns to be significantly higher, than if more equity was put in, assuming the annual rates of debt are the same.

The primary metrics used to calculate the total returns are (1) the internal rate of return (IRR), calculated using the idea that time is money (net present value), and (2) cash return—a lot more simple than IRR, but not factoring in time—calculated simply based on what multiple in which the investment was grown. An IRR of 20% is generally the target investor return, in comparison to a public market investment such as in the Standard & Poor's 500, is significantly higher. On a general, five-year basis, tripling equity value from $250-750M over a five-year basis is a 24.6% IRR. A 3x return would be almost five times as much as the S&P 500 has generated from the beginning of 2015 to the end of 2020. The capital structure is one of the most crucial choices investors make—no good private equity firm will be as successful if the capital structure is not optimal.

General Partner's Strategies

Once again, tactics vary depending on the sponsor's investment strategies, but some tactics are more common than others. A sponsor may sell a subsidiary, or borrow more money, but a general goal is to simply grow the profitability of the target. At least a couple of years is typical for a sponsor to hold and grow a target, and they'll be doing a lot of different things while holding that target. If a sponsor has a "hands-off" approach, it's usually because they have confidence in the target's management. A hands-off approach does not signify no intervention whatsoever, but instead, significantly less of such. Private equity could easily be compared to the investment of stock: if a passive consumer buys a stock, it's usually because they believe in the management, and product(s)/service(s) behind it. With that being said, not every sponsor has a hands-off approach.

Reducing general expenses including shipping, suppliance, payrolls, and capital expenditures overall may show a noticeable increase in earnings. Bolt-ons, or add-ons, as previously mentioned, provide an opportunity for synergy. Acquiring companies for synergies requires the same research and process that the initial buyout does and can sometimes be worth as much as the initial buyout, or more. Not every bolt-on target is initially for sale before being acquired. Proprietary deals, also known as direct solicitation, conducted without an intermediary, may include reaching out to another company, initiated by the sponsor, to inquire about said company's status. There's a factor of attempted familiarity when reaching out to someone (the owner of the company) who might have no interest in selling

their company. Researching what they like to do—surfing, golf, food, sports—can all be a part of a sponsor's job when trying to purchase an add-on. The recapitalization process of the target can also include a dividend recapitalization (dividend recap). As mentioned, when a sponsor grows a target's EBITDA, more debt is typically available from the bank, allowing the sponsor to have more money. In a dividend recapitalization, the additional debt being issued may be used by the sponsor to directly pay its limited partners. Another key strategy that private equity firms might use is a sale-leaseback. A sale-leaseback allows a sponsor to raise capital by selling an asset, particularly real estate, and then leasing said asset back from the lessor/owner. An example of this is as follows with fictional names and values.

Boot manufacturing company, "Company 123" was acquired by private equity firm, "Firm ABC", with an initial EBITDA of $1M. Firm ABC notices that Company 123 has an asset, "Asset 1", that is worth about $1M, and decides to pursue a sale-leaseback. Firm ABC sells Asset 1 for $1M to a lessor. The lease allows Company 123 to lease Asset 1 for $10,000 annually, giving Company 123 an additional $1M cash on their balance sheet in assets. Company 123 now has $10,000 less of EBITDA each year, but in turn, Company 123 can do what they wish with $1M and gets to retain Asset 1 [end of example]. Like a dividend recapitalization, a sponsor can directly use the proceeds of a sale-leaseback to pay their investors, but it must be pre-negotiated with the lenders.

Once a sponsor is pleased with the growth of their target, and they are ready to exit, it will take a couple of different routes. Because of the size of companies in a lower-middle market, an initial public offering (IPO) is not likely. If listed as stock on a public exchange, which might happen in larger private equity investments, the result would likely be a penny stock, and simply not worth it for a lower middle market sponsor. Traditional routes for a lower middle market sponsor would be selling its target to another private equity firm, selling to a larger company, or selling portions of the company to individuals, but they likely wouldn't hold it long-term. The exit from the target allows the sponsor to now distribute its returns to its investors.

Conclusion

Still relatively new to investing in general compared to public investing—which has been around for centuries—lower middle market private equity is not an easy field to understand. There are layers of details that all are part of the process of closing a deal in private equity. Valuation and placing a bid on a target can also be difficult to execute and make or break the deal. However, using financial modeling, QoE reports, and data rooms can ensure that a sponsor's process goes smoothly. To prevent the deal from falling apart, as nothing is definitive until a contract is signed, the employees of the sponsor must work tirelessly during due diligence, and during their capital structuring process to ensure that what they are doing was not for nothing. The sponsor will apply its knowledge about the industry that the target is in and take different routes in improving the state of its investment. Seeking out add-ons, executing a sale-leaseback, or a dividend recap, are all significant parts of a private equity firm's job. Each private equity firm is different, and each target is different, but proper diligence can ensure a smooth transaction.

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