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APRIL, 2018 CAPITAL MARKETS UPDATE “THE LOWER MIDDLE MARKET”

This **Capital Markets Update** is directed to busy people. We are making an effort to keep this narrative short, in the hope that you will take the time to read it

It is apparent that most middle market business owners continue to do well. Many companies are paying down or reducing debt, and strengthening their Balance Sheets. This bodes well as the recovery, which began in 2010, enters its 8th year.

The good news: **Middle market funded debt remains at manageable levels.**

Locally, residential real estate prices are at or above the levels of 2007 before the downturn. In some markets, values have surpassed that level. In downtown Detroit residential prices are up 300 to 400 percent from 4 or 5 years ago. In Birmingham MI, new condominiums are being built with asking prices comparable to those in east and west coast metros. Are these anomalies, or an indication of things to come in the broader market? Today's prices are partially a result of the low interest rate environment. Will an increase in interest rates, which has already begun, lead to a softening of the market? Offsetting the rate increase are higher levels of employment, rising wages, and the recently enacted tax cut. The collapse of prices which began in 2007 was largely the result of problems in the sub-prime mortgage market, occasioned by the failure of Lehman Brothers. Today's mortgage markets are very different; sub-prime mortgages, while increasingly available, are still a much reduced portion of the market. **Is there a residential real estate bubble? We don't think so, not yet, but the reader will have to decide for him or herself.**

Since we began this Update over 20 years ago, we have warned in almost every issue of the difficult problems that would result if Washington and the Federal Reserve continue to embrace policies that encourage, justify, or even allow the twin deficits, balance of payments and budget. It appears that the Trump administration is attempting to address the former, even if it means beginning a trade war with mercantile economies like China, Japan and Germany. Will there be a Trade War? Not likely, but if there is, domestically there will be winners and losers, but **overall it is hard to see how a nation with a \$800 billion trade deficit can lose!**

Unfortunately, irrespective of which political party holds office, the budget deficit continues to grow.

The increase in the worldwide production of oil and natural gas is once again being managed by the producers, led by Saudi Arabia and Russia. Crude oil prices have risen. Free market pricing in the International market is once again no longer the order of the day. We have returned to cartel pricing.

Today the Capital Markets continue to be defined by the **Abundance of Liquidity** created by the Federal Reserve System's open market and low interest rate policies. There is still simply too much money competing for attractive returns. Increased regulatory burdens create obstacles to efficiently putting this liquidity to work where it will do the most good for the economy. Although the Administration is attempting to remove these obstacles to economic growth, those affecting Banks, Broker-dealers, and Investment Advisors are largely still in place. Ostensibly put into effect as a reaction to the Great Recession of 2008-2010, they have an out of proportion impact on smaller banks that had little or no role in that Wall Street debacle! Consolidation continues and institutions "Too Big to Fail" are becoming larger and more entrenched, because they can afford to deal with the increased regulatory burden.

Anti-trust policy? So badly needed, but Wall Street rules the day. Forget it!

WHAT ARE THE MIDDLE MARKET CAPITAL MARKETS

The Capital Market serving Middle Market Businesses, loosely defined by us as those with sales of between \$5 Million and \$500 Million, consists primarily of Commercial Banks, Asset Based Lenders, Factors, and a small but growing number of Mezzanine, Equity, Opportunity, and Venture Capital Funds. Largely gone from the scene are the many local and regional Broker-Dealers who once served as a source of equity to growing local companies. It is hard to visualize America returning to its former dominance as a manufacturing center without a significantly expanded local Capital Markets community serving middle market businesses. The Obama Administration recognized this fact, and supported the passing of the JOBS Act which allows access to the capital markets without the need of raising money through a broker dealer. When fully implemented, it has the potential to make capital much more available to early stage businesses and to middle market companies in non-money market cities.

BUSINESS BROKERAGE AND M & A

Today, buyers of middle market companies are more likely to be a Private Equity Fund or one of a very few successful entrepreneurial acquirers who are continually in the market. For good companies it is a Seller's market. While demand still exceeds supply, the market is no longer as dynamic as it was several years ago. Buyers are rational and disciplined. Sellers are in short supply in this segment of the market. Thorough analysis and skillful financial modeling can often result in a higher selling price.

Senior Debt lenders drive the transaction market and are financing acquisitions at higher multiples of historical EBITDA. Earnings improvement has largely leveled out. Buyers remain disciplined, and pricing multiples for stable lower middle market businesses seem to be holding, **maxing at 4 to 5 times historical cash flows averaged over a three year period. A strategic buyer will pay more.** Our transaction size is \$2 Million to \$25 Million, and market conditions differ for the upper middle market. Equity Fund buyers tell us that sale multiples can be significantly higher, with 6 to 10 times EBITDA not unusual.

SENIOR DEBT MARKETS

Lenders compete hard for the better credits. Due to the abundance of liquidity, there is intense competition for the business of profitable companies. Increased regulation of the lending function has led to most lenders structuring loan facilities in a similar manner. **"Creativity" in transaction structuring is frowned upon.**

We have seen a tightening of credit criteria at all levels, with even some factors, lenders that purchase accounts receivables, doing credit analysis not dissimilar from that of a commercial lender!

Transactions with any degree of difficulty or in industries that are out-of-favor, are usually rejected, often without serious consideration. Formerly bankable companies are forced to deal with finance companies and factors. A growing number of these lenders are offering a variety of new products, very responsive to the market need. But the end result is that many smaller businesses must pay a higher cost for money.

Cash Flows and a successful operating history have surpassed Balance Sheets in importance to most lenders. Collateral, while still important, must be supported by long-term cash flow both historical and projected.

As we noted earlier, corporate Balance Sheets have strengthened which is finally triggering increased spending on plant and equipment. **Recent equipment appraisals are definitely showing higher values.**

The Midwest is blessed by a growing number of middle market lenders, both Community Banks and Asset Based Lenders. But...consolidation, particularly among the community banks, is once again taking its toll.

The Community Banks provide smaller middle market businesses with additional sources of lower cost financing. We routinely include them in our Client credit offerings for loans that are in their geographic area.

We have seen a rapid growth in the number of **Merchant Finance Lenders.** Merchant Finance credit analysis is based on the credit card model. Conventional credit analysis is dispensed with in favor of a review of cash inflows or collections. These lenders control all incoming cash and pay themselves as money is received. There is nothing new about this form of funding. The credit card companies have been doing it for many years, but as a service to their customers. Rates have been reasonable, under 10% on an annual basis. What is new, is the emergence of Merchant Finance Lenders, entities created solely to provide “loans” using this model and at very high cost, usually in excess of twenty percent (20%) per annum. They charge a “fee” in lieu of interest, thus escaping the usury laws. **Borrowers that do not have unusually high margins run the risk of not surviving their experience with the Merchant Finance Lenders.**

We have seen a sharp decrease in requests for assistance in locating financing from companies that have been asked by their existing bank to find a new lender. Other requests come from businesses under pressure to expand capacity.

We are being asked to fund real estate transactions, both construction and end-financing. This reflects today’s market, and we are looking for additional opportunities to serve this market.

TRANCHE B, SUBORDINATED, OR MEZZANINE DEBT

There is an increase in requests for locating subordinated debt. These lenders rely on the cash flow of the borrower. They normally limit their funding to a stated multiple of **Earnings Before Interest, Taxes, Depreciation and Amortization or EBITDA.** Second Lien Lenders, a subset, whose loans are generally limited by the amount of collateral, charge significantly lower rates, and do not require equity “kickers”, a dilutive practice that many owners prefer to avoid.

Acquirers that cannot qualify for bank over lines, loans in excess of the amount that can be justified solely by the collateral, can replace these facilities with Subordinated Debt. While more expensive, it can make the difference in successfully completing a profitable transaction.

Because of the cyclical nature of our local economy, Michigan has relatively few subordinated debt lenders. Several of those that are located here, invest heavily in other parts of the country. **This class of lender requires predictable cash flow to assure the repayment of their loans. They focus on competent managements that are able to earn a return year in and year out.** Mid-States has relationships with both local and out-of-state institutions interested in providing Mezzanine financing of between \$2,000,000 and \$20,000,000. Except for the two small funds that have been heavily seeded with startup money from the Strategic Fund of the State of Michigan, they are seeking returns of between 12% and 20 %, with about one-half of that payable on a deferred basis. Depending on the lender, these loans can be non-amortizing for a period of from one to five years.

Uni-tranche financing is a hybrid loan structure that usually combines senior and subordinated debt into one facility with an interest rate that falls between the rates for the two types of debt. If necessary, the uni-tranche lender will consider a minority equity investment in the borrower. This is a particularly useful tool in acquisition financing. **Transaction size to qualify for this funding must be \$7,500,000 or more.**

MIDDLE MARKET EQUITY AND EARLY STAGE VENTURE CAPITAL

There are three sources for middle market or venture capital equity: high net worth individuals, angel funds or investors, and institutions such as Equity and Venture Capital Funds. Compared to other major metropolitan areas, there are relatively few of these funds located in Michigan. Given the enormous amount of technology in the area, there should be many more. There are a growing number, in Ann Arbor, Detroit, and Oakland County. Kalamazoo and Grand Rapids have their own Venture and Equity fund communities. By national standards, Michigan Funds are small. Several are developing some size and it is possible to syndicate a Six to Ten Million Dollar round, using only local money. Several years ago, I read that **Michigan is second only to California in the number of new patents issued.** Is that still the case? Irrespective of whether we are second or third, **worthwhile technology businesses have a good chance of locating investment capital locally.**

In the past, few of the Michigan venture funds gave a preference to local opportunities. Due to a combination of factors, including an improving infrastructure to support early stage businesses, that is changing. **There are a growing number of funds and investors willing to invest in Michigan based technology businesses.**

There are many investors anxious to invest in and support **Management Buy-Outs** of successful businesses. **Consumer Product Companies** are another area of intense investor interest.

Please contact either Joseph Alam at 313-670-5713 or jp3@midstatescapital.com, or myself, Joe, at 313-215-1700 or jpa@midstatescapital.com, if you, or someone you know would like to discuss a Funding or Business Brokerage engagement. Thanks,

JPA/jp3

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