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MID-STATES ADVISORS
A Private Placement and Business Brokerage Firm
Newsletter

Mid-States Advisors, Inc.
Monthly Article & Updates

Good Morning,

Outside of a quick warm streak this week the remnants of summer are officially fading here in Michigan. Leaves are changing and falling, it's dark early in the evening, and I hate to admit this but we've already had to drive through snow flurries.

But, the world keeps spinning and our business activity is staying strong. We continue to see lots of M&A activity and will be bringing a new sell side engagement to market before the end of the month. Financing activity continues to be slow but we are starting to hear rumblings from business leaders and lenders that they expect activity to pick up in early 2022.

As we prepare to head into the beginning of the holiday season and shortly thereafter the end of the year, we thought this as good a time as any to release our annual Capital Markets Update. We release our Capital Markets Update once a year because the capital markets do not typically swing so wildly that an update would be relevant without repeating ourselves. After skipping the 2020 Capital Markets Update because of the sheer uncertainty in the markets, we've gained our bearings and put our thoughts together. This is a combination of input from the entire Mid-States team and not the voice of any one member. We always attempt to keep the conversation balanced regardless of political or social leanings.

We hope we provide some good insights to our readers. This is a long issue of our newsletter but we've included convenient headers so that the reader can jump wherever they find their interests.

As always, if you are interested in learning more about this volume's content or if we can help you or a client in any way, please feel free to reach out to one of our team members.

Best Regards,
The Mid-States Team

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2021 CAPITAL MARKETS UPDATE "THE LOWER MIDDLE MARKET"

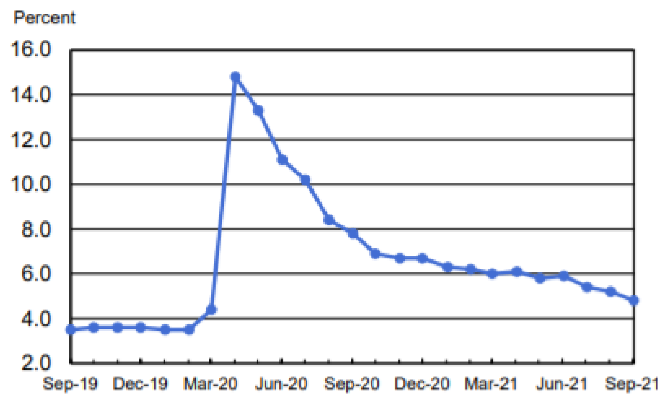
We live in interesting times! This is a long read, but we urge you to take the time to read it.

Covid-19, the resulting shutdown of much of the economy, and federal and state governments' actions to offset the retraction of and prevent a complete collapse of the economy have, at least temporarily, completely remade the capital markets for lower middle market companies.

The Payroll Protection Program or PPP loans (forgivable), the Main Street Loan program, Economic Injury Disaster Loans, Employee Retention Tax Credits, and other government funding mechanisms, have supplied the capital to enable lower middle market businesses to survive the turmoil. Industry leaders we talk to believe these efforts often masked the issues for companies that were struggling pre-pandemic and provided a short reprieve from the inevitable. The trillions of dollars of stimulus of which these programs are a part is, as expected, having a positive impact on the economy. But there will be a price to pay, in the form of higher inflation rates, and the efforts needed to contain it, a disrupted labor market and a poorly functioning supply chain for goods and services. We are already experiencing a far greater effect than the Fed initially projected and we see continued disruption into 2022 and beyond. A trip to your local grocery store will provide some idea of the impact of certain of these factors.

Today, the capital markets continue to be defined by the **Abundance of Liquidity,** created not only by the previously mentioned government funding programs, but also by the Federal Reserve System's long standing Open Market Committee actions and low interest rate policies. There is simply too much money competing for attractive returns.

We draw attention to the unemployment rate graph in the US which we have all seen too many times. Old news for sure but focus again on the slope of that trend line in late March 2020. It's almost vertical. It was impossible for any free-market economy to overcome the sudden effect of Covid without disastrous results. Remember too that this is a global problem, not just the US. Bold governmental action was required and the massive influx of liquidity through global government interventions generally worked to avoid a global economic collapse.



Many lower middle market businesses survived 2020 and even showed profits due, in part, to their taking advantage of the government funding programs. This continues into 2021. The PPP loans and Employee Retention Tax Credits are essentially government subsidies and as the economy shows signs of rebounding, we see that underwriters are not including these "subsidies" as legitimate income and are subtracting them from cash flow when reviewing loan applications. What will be the impact on these businesses when these programs end? As mentioned above, we believe lenders will see a significant increase in bad loans and workout situations will increase as the "free money" disappears. The programs were needed to bridge to a reopened economy but are perceived as sometimes masking major problems in operations and in the supply chain. Some of that is true, but most of the "subsidies" truly were used to bridge to better times. But whatever your view, remember RISK is not something an underwriter appreciates!

So, what's ahead?

The economic restart is proving to be painful. We are only four or five months into the recovery process. The restart will drive the capital markets. We have to accept, or at least realize, that we do not have a free market right now. The laws of supply and demand are absent and will be for some time. Look at the goods piled up at the LA/Long Beach port. There are eight miles of cargo ships lined up and by our calculation two million containers offshore waiting entry to USA ports. And more on their way. Think of the time it will take to unload those and get to their US destination! Realizing that there are only 3.5 million Class 8 truck drivers across the US and the dimension of the problem becomes clearer. It's the dreaded "no solution" high school algebra teachers thought was an answer. OEMs must reverse the off shoring and "low-cost country" purchasing policies for higher priced local sources. They have become used to low cost Asian and Latin goods, and unfortunately, it is not at all clear that purchasing agents have the foresight to refrain from choosing the lowest piece price. Will we start ignoring just-in-time inventory for higher cost safety stock, etc., etc., etc.? This will cost more in the short run, require funding and contribute to inflation, higher interest rates, but minimize the chance of disruption in the delivery of goods and services.

If supply chain is not problematic enough, then consider our labor force. Unemployment is at reasonable levels yet basic labor, including restaurant staffs, and shop floor laborers are in short supply. Portions of the work force seems to have disappeared! Some of it can be attributed to the stay-at-home effect from Covid, and some is our aging population taking the opportunity to

move into retirement. Nevertheless, the reasons are beyond our purpose in writing this Capital Markets Update, but the effect is certainly a major factor on the state of the Capital Markets for lower middle market businesses.

Capital markets will be forced to adjust to a new set of funding policies as the liquidity must find a home and the economy will demand cash. We trudge into complex uncharted waters, and we're only in the early stages of the recovery process.

The capital markets will be disrupted for some time. We have addressed the reason for the excess of liquidity earlier in this commentary. Large corporations, hedge funds, family offices, and private equity funds amassed $1.6 trillion of cash in 2019 compared to $2.2 trillion today. A significant increase but those are enormous amounts of cash, which suggests there has not been a lack of liquidity for many years. This liquidity is not in the accounts of lower middle market businesses, the audience we are addressing. The government is going to be more involved in the capital markets and not less. At the moment we just don't have a free-market economy. It will all settle down over time and the capital markets will fund transactions as they have always done.

What advice can we offer? As we know the simple EBITDA multiple is no longer the only way to evaluate investment decisions. A longer-term view is required with an eye to bargain hunting. "Buy low" rings truer than ever. Even though multiples of EBITDA are at high levels right now, they largely have to be ignored as irrelevant. Historic EBITDA multiples are not the singular benchmark to measure enterprise value. The capital markets will fund the solid, well thought through transaction looking out, strategically, over several years. The Liquidity we see today is illusionary due to underlying cause of government intervention but that's not necessarily a bad thing. It provides stability.

Be cautious of forecasting cash flows by simply targeting the "pre-pandemic levels" as the normal level to expect going forward. There's no rational explanation that says a company's revenue will go back to pre-pandemic activity with the passage of time. The devil is in the details, forecast strategically and realistically but forecast what you know, not what you hope. There will be opportunities abounding, but assumptions must be challenged. It is best to start with a blank sheet of paper. The classic financial analyst's best friend, the trend line, is subject to doubt.

THE LOWER MIDDLE MARKET ("LMM") CAPITAL MARKETS

The capital market serving Middle Market Businesses, loosely defined by us as those business with sales between $5 Million and $500 Million, consists primarily of Commercial Banks, Asset Based Lenders, Factors, and a 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 but are now replaced by private equity funds. They do not fund entrepreneurs; they buy their businesses. It is hard to visualize America returning to a manufacturing center as the restart continues without a significantly expanded local capital markets community serving lower middle market businesses. We believe there will be a greater focus on the LMM in all the market sectors outlined in more detail below.

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 and awash in cash. Sellers are in short supply in this segment of the market. More buyers are willing to look to the lower middle market as they seek financial returns.

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 by the regulators but lenders continue to be inventive for stronger credits.** Middle Market Bank loan officers we are in regular contact with report very low loan demand except for acquisition financing. While they formerly required new borrowers to open accounts with them, that is no longer the case. The excess liquidity is ending up on the balance sheets of the commercial banks, and they simply cannot put it to work earning returns. We hesitate to predict the dimensions of the problems that result from this condition.

Asset Based Lenders are having another strong year and anticipate 2022 to be the same. Cash flow covenants typical in middle market commercial bank cash flow loans tend to be difficult and the ABL model just supports the credit better. But the collateral monitoring cost of such loans can be significant and time consuming.

TRANCHE B, SUBORDINATED, OR MEZZANINE DEBT

There is an increase in requests for locating subordinated debt. Again, we believe this is another funding vehicle that is evolving due to the available liquidity and the difficulty in typical cash flow financing. Subordinated debt lenders, standing second in line to the first secured lender, rely on the cash flow of the borrower. Much like an investor, they are depending on consistently good management to repay their loans. They normally limit their funding to a stated multiple of EBITDA. Debt coverage ratios are a key consideration to these lenders. They are often very creative and flexible in structuring their loan product, offering principal payment deferrals and other tools to qualify the credit. 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.

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, even though Michigan is increasingly moving up the list of states receiving early-stage investment, topping out at $3.1 billion in 2020. Due to a combination of factors, including an improving infrastructure to support early-stage businesses, we see a growing number of funds and investors willing to invest in Michigan based technology businesses.

OUR CONCLUSION – LOTS OF AVAILABLE CAPITAL BUT NEW RULES…

The capital markets in the Lower Middle Market are evolving quickly in the chaos of the economic post pandemic restart. Rules of supply and demand have changed, and markets are adapting. Capital is abundantly available, but it takes knowledgeable and skillful efforts to the ever-changing environment to complete a successful funding.

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