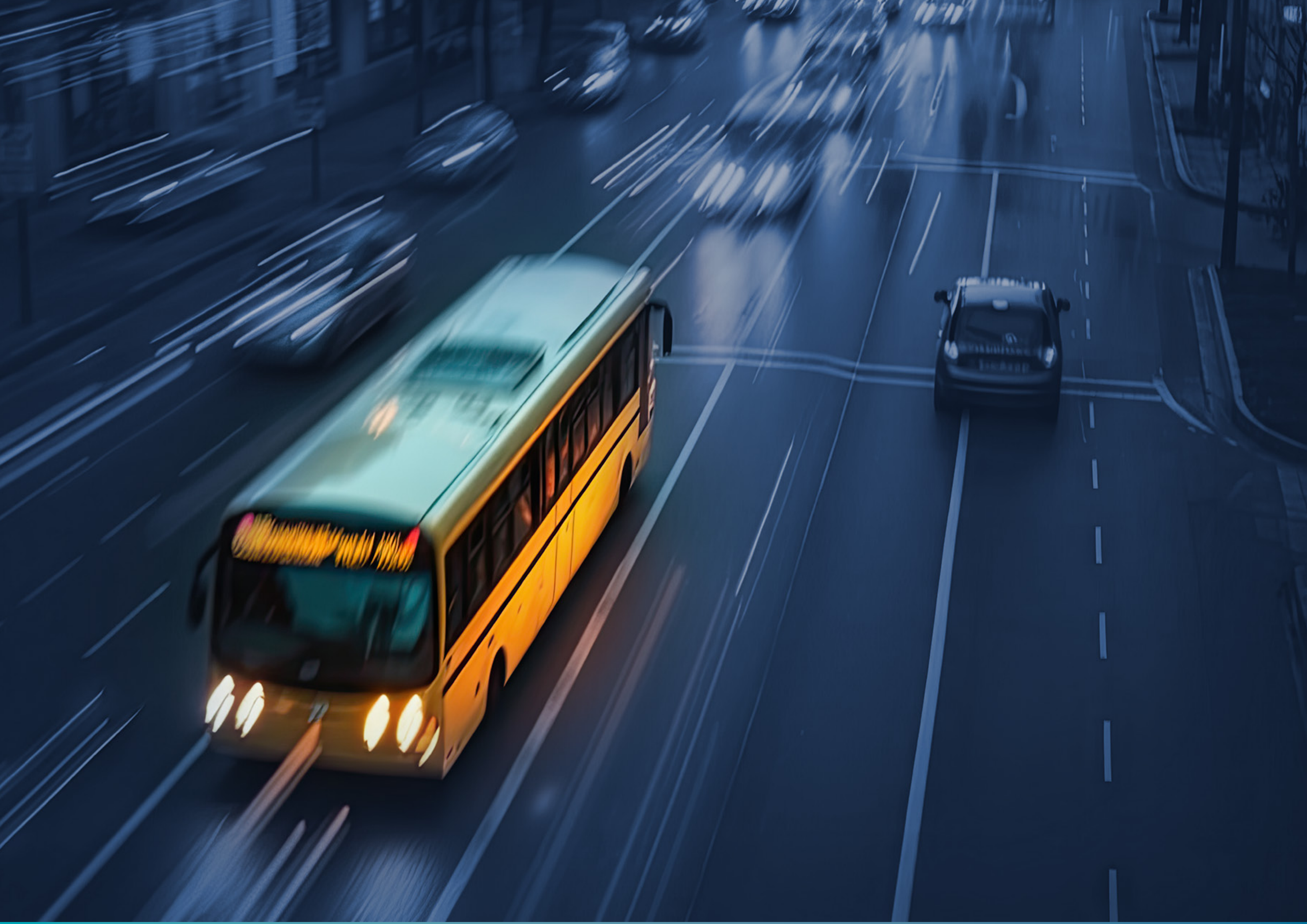

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Get on the Bus or Get Run Over!

How competition is fundamentally changing for lower middle-market business owners

The Competitive Landscape

The competitive landscape is quickly and fundamentally changing, and lower middle-market business owners are largely unprepared and ill-equipped to adapt to the changing dynamic. While owning and operating a lower middle-market business has never been easy, the last 12 years of economic expansion have made growing a business relatively easier. With that said, there is an evolving threat to lower middle-market businesses that is completely changing the competitive landscape and will force business owners to take one of three paths: Get on the bus, build a better bus, or get run over by the bus.

This "bus," which is transforming the competitive landscape, is known as private equity. While fifteen years ago there was little interest in sub-$100 million companies from private equity investors, we now have a perfect storm that is making lower middle-market companies much more attractive.

The primary factors driving this movement by private equity firms to invest in $5 million to $100 million revenue companies are:

- ✓ More targets available in the <$100 million revenue range
- ✓ More private equity funds and more firms
- ✓ Lower valuations in companies with lower revenues
- ✓ Greater opportunity for growth and returns
- ✓ An aging demographic of business owners looking for exit opportunities

While it was not uncommon in the first ten years of this century for a company with $80mm in revenue not to get much interest from private equity because it fell below their typical threshold for investment, both the number of private equity firms and the amount of capital they need to deploy has forced many of them down-market looking for returns. A study by Preqin indicated there was nearly $2.5 trillion in dry powder by 2020 held by private equity firms with pressure to deploy this capital in a way that produced returns. With the traditional sweet spot of private equity being companies with $100-500 million in revenue, the sheer number of targets in that revenue range is not sufficient to deploy that level of capital. **According to Forbes, there are 350,000 lower middle-market ($5mm - $50mm in revenue) companies in the U.S., and this is where private equity is shifting its focus.**

In addition to broadening the target base, the lower middle-market tends to carry lower multiples and provide a greater opportunity to produce higher returns. However, the risk profile tends to be higher as well. The expansion of potential private equity buyers creates a potentially substantial opportunity for lower middle-market business owners and will serve as a lifeline for those who are prepared for the exit.

That’s the good news for lower middle-market business owners. Now for the bad news...

For those lower middle-market business owners used to competing with other businesses lacking strategy, fiscal discipline, a skilled management bench and/or cash, all getting their fair share of the market, business owners are increasingly finding former stand-alone competitors being purchased by private equity firms. Industries that have been immune to the influence of private equity are quickly being overrun with private equity firms. In fact, Riverside was just named the private equity firm of the year by the Association for Corporate Growth (ACG), and their strategy is almost exclusively lower middle-market. There are firms with specific investment platforms for HVAC businesses, die casters, and the like. Because private equity firms build structure, create accountability, improve operational processes and efficiency, develop and execute strategy, and provide an infusion of capital, business owners comfortable competing with other Single A teams are now finding themselves competing with Major League franchises.

The bar has been raised, and business owners are faced with one of three choices they must make:

- ✓ Professionalize their business and re-level the competitive playing field
- ✓ Professionalize their business and make it a target for private equity or a family office
- ✓ Continue to run the business as it has always been run and watch the business atrophy and die

The Key Take-Away

Business owners must professionalize their businesses to survive and have any option to exit.
That means business owners must become much more focused on investing in tools to create efficiency, becoming highly intentional about making decisions based on value creation, building platforms that will facilitate scaling the company, and running their business with a high level of fiscal discipline.

According to a KeyBank study, 250,000 U.S. business owners will desire to transition their businesses between now and 2030. Of those, only 50,000 will be market ready, meaning 200,000 of these businesses will not be sellable in any form. Of the 50,000 businesses with a higher likelihood of transitioning, only 14,000 will transition for the value the business owner believes the business to be worth.

That means if all businesses continue to operate as they are today and don't adapt to make themselves market ready, **there is a 6% probability of a successful exit.**

Additionally, unsolicited Letters of Intent (LOI's) are coming from private equity firms to business owners who have not previously contemplated an exit. Because the numbers are often attractive, business owners engage in discussions with a lack of full appreciation for the fact they are about to be overwhelmed by a diligence process that will ultimately result in a significantly lower offer than the original LOI. Private equity firms will take advantage of the unlevel playing field created as a result of most business owners lacking the experience or sophistication in the transaction process. Preparation is the key, and that involves surrounding yourself with capable advisors well before a transaction is in process!

For those fortunate enough to exit, one of two parties will derive value from the business; 1.) you, as the business owner, running a strategically focused, high growth, profitable, operationally efficient business, or 2.) the private equity firm or strategic buyer taking advantage of the fact that value could be extracted from your business because you didn't build a well-run business and a platform for growth. While multiples have been trending down over the past twelve months, a study by BizEquity indicates there is still an above market premium being paid for those companies who have a strong operating model and an optimized growth engine.

Summary

Based on many macroeconomic factors, the M&A market is quickly shifting from a sellers' market to a buyers' market, and most business owners are not well positioned to transition their businesses in any form. However, there is still a premium being paid for well-run businesses that have a level of financial stability, operational efficiency, and most of all, a platform for growth. Every business owner will exit their businesses at some point, and building a highly effective revenue function and ensuring your financial house is in order will provide meaningful options not otherwise available.

Jeff Saturday, the long-time center for the Indianapolis Colts, was out of football after his college career. He took a job as a manager at an electrical supply store. However, he continued to train, workout and prepare in the event he got "the call." Because he was prepared when the call came, he was able to play for 14 years in the NFL and was invited to six Pro Bowls. Similarly, business owners never know when the opportunity for a meaningful exit will occur. They need to prepare by engaging advisors, professionalizing their businesses, and preparing an exit plan. This is not to say an exit needs to be imminent, only that they need to be fully prepared for "the call."

About the Author

Greg Stanley is the founder and president of Accelerant Consultants, a firm that helps small and mid-sized business owners optimize their revenue functions in a way that maximizes valuation, creating more, and more meaningful options to exit. Prior to launching Accelerant Consultants in 2017, Mr. Stanley spent over 25 years building marketing and sales organizations, developing and executing organizational strategy, and serving in executive leadership roles for both small and large organizations. Accelerant Consultants has helped dozens of companies build more effective go-to-market strategies and align company resources to drive growth, profitability, new account acquisition, and prepare for exit events. Contact Accelerant Consultants at info@accelerantconsultants.com or visit the website at accelerantconsultants.com