

CHAPTER 1

Capital Markets

This book explores private capital markets, the last major uncharted financial markets. Private markets contain millions of companies, which generate more than half of the gross domestic product (GDP) of the United States and the world. Yet these markets are largely ignored, partly because of the difficulty obtaining information and partly because of the lack of a unified structure to approach them. This work offers such an approach. It provides a theoretical and practical framework that enables readers to make sound investment and financing decisions in the private capital markets.

A capital market is one in which businesses can raise debt and equity funds. Since the 1970s, public capital markets have received almost all of the attention from academics in the literature.¹ In 2004, the first edition of this book challenged the assumption that public and private capital markets are substitutes, showing instead that the two markets were different in most meaningful ways. Specifically, 12 factors differentiate public and private markets:²

1. Risk and return are unique to each market.
2. Liquidity within each market is different.
3. Motives of private owners are different from those of professional managers.
4. Underlying capital market theories that explain the behavior of players in each market are different.
5. Private companies are priced at a point in time, while public companies are continuously priced.
6. Public markets allow ready access to capital, while private capital is difficult to arrange.
7. Public shareholders can diversify their holdings, whereas private shareholders cannot diversify.
8. Private markets are inefficient, whereas public markets are fairly efficient.
9. Market mechanisms have differing effects on each market.
10. Capital market lines (costs of capital) are substantially different for each market.
11. The expected holding period for investors is different.
12. The transaction cost of either buying or selling the interest is different.

Several of the major differences between public and private markets require further discussion. Specifically, public and private markets differ in structure and

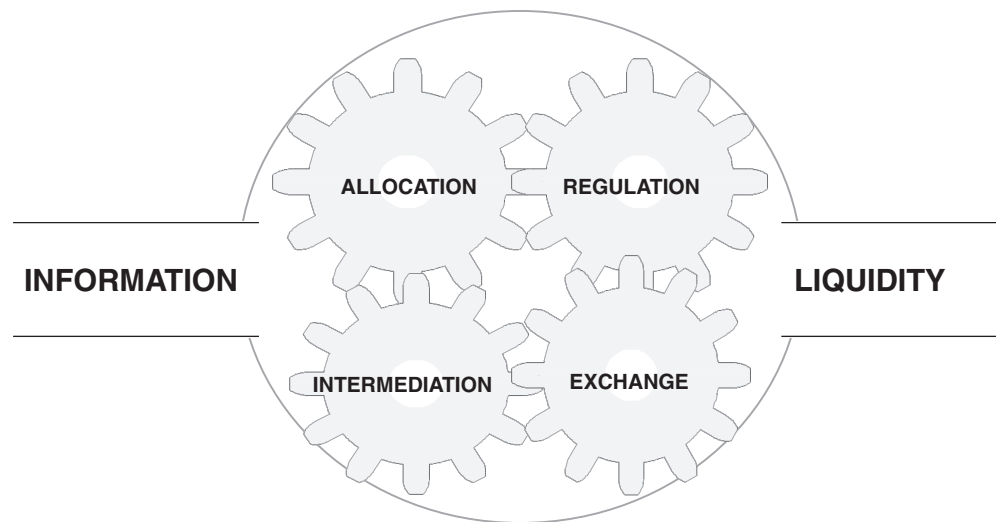


EXHIBIT 1.1 Mechanisms that Structure a Market

behavior, which necessitates unique capital market theories to better organize and predict behavior.

MARKET STRUCTURE

All markets are comprised of commercial activity where parties undertake an exchange because each expects to gain. In a free market, participants are able to meet and exchange for a mutually agreed price. Markets mechanisms are organized sets of activities enabling people to exchange or invest. Exhibit 1.1 depicts several market mechanisms as gears in a market that is greased by information and liquidity.

INFORMATION

The role of information is central in both public and private capital markets. Availability, accuracy, and access to information lubricate all market mechanisms. Information availability in public markets renders them more efficient. Theoretically, they are less likely to produce deals where one party takes advantage of another because of asymmetrical information. It takes government regulation and enforcement to ensure that public information is accurate and available to all.

Availability, accuracy, and access to information are significantly different in the private markets. Financial statements are the basic building blocks of information. Most private companies lack audited financial statements and are less likely to prepare their financial statements in compliance with generally accepted accounting principles. Even this lesser-quality information is not made publicly available. The absence of real-time, readily available information is a major difference between the markets.

Liquidity

Liquidity is the central value proposition of any market. Consider it as capital in motion, a necessary lubricant for movement between asset classes. The term refers to the amount of capital in a market and the flow of that capital internally as well as into and out of the market.

Markets are described as more or less liquid. For example, real estate and privately held businesses are typically illiquid investments, while investments in publicly held businesses are considered liquid. Public companies largely transfer fractional interests. Conversely, since there is no market to sell private minority interests, most private transfers involve enterprise sales. While an enterprise transfer of a private company can easily take a year or more, public enterprise sales normally require only six months. Investors in private companies factor a liquidity premium in their return expectations because they recognize that these investments are not easily exited.

Market Mechanisms

Market structure is comprised of several mechanisms; among them are:

- Allocation mechanism
- Regulatory mechanisms
- Intermediation mechanisms
- Exchange mechanisms

Market mechanisms provide a structured way to understand complex markets. These mechanisms are the activities or gears that enable a market to operate. Synchronization is possible because each mechanism contains elements of other mechanisms, all operate in a similar information environment, and all mechanisms tend toward equilibrium.

In equilibrium, the supply of companies for sale equals the demand for those companies. More sellers in a market lead to greater competition enabling buyers to get better value in the exchange. Fewer sellers mean less value for buyers. In short, a market is in equilibrium when supply equals demand.

Market mechanisms operate in an environment lubricated with information and liquidity, and one that tends toward equilibrium. This occurs, for example, in allocating scarce resources.

Allocation

Allocation is the market mechanism of rationing resources. Because resources are finite, markets allocate money, resources, effort, authority, and cooperation as well as tangible and intangible assets. Allocation decisions may be arrived at using a variety of criteria. For example, a first-come, first-served process benefits the fleet of foot. A political process, however, allocates benefits based on the ability to manipulate that process.

Resource allocation in the public markets is relatively efficient as demonstrated by both pricing and access to capital by public companies and investors. This is a distinct contrast with the relative inefficiency found in the private capital markets, as demonstrated by the inefficiency surrounding the Pepperdine Private Capital Market Line introduced in Chapter 2.

Regulation

“Regulation” refers to attempts to bring the market under the control of an authority. Regulation is provided by a number of sources, including government and competition.

Government regulation is pervasive, typically expressed as restrictions on behavior. It provides adjudication of disputes as well as rules for eligibility and participation. Governments may attempt to control all elements of the market. Yet in a free market system, governmental control itself operates under restrictions, which introduces competing authorities. Public companies are exposed to more extensive governmental regulation than are private companies.

Markets are also regulated through a severe discipline imposed by competition. Firms are not free to raise prices or salaries without facing economic consequences. Nor can a company pay its employees whatever it wants. Competition forces efficiency and ultimately causes supply and demand to balance. Competition regulates the market.

Intermediation

Specialization creates a need for intermediaries to serve as agents of exchange. This leads to increased efficiency based on developing expertise in disparate areas; however, it also breeds inefficiency through isolation. Specialization creates the need for information and trading expertise. Intermediaries act as *infomediaries* where information opacity exists.

Intermediaries add efficiency to a market in three ways:

1. They provide a communication system between parties.
2. They work to establish prices that often serve as the starting point in exchange discussions.
3. They might act as market makers by actually participating in the market as sellers or buyers in order to create a liquid market.

The public transfer market functions with agents *and* market makers. Public investment bankers are agents who advise on public enterprise transfers. Market makers are firms that stand ready to buy and sell a particular stock on a regular and continuous basis at a publicly quoted price. Public agents and market makers provide liquidity and efficiency to the public market. The private transfer market has agents, such as business brokers, merger and acquisitions (M&A) intermediaries, and private investment bankers. Yet none of these groups performs all the functions of public market makers.

Exchange

Market participants in a supply and demand economy are free to exchange something for an agreed price. Supply and demand in a market is affected by a host of factors. Shifts in supply or demand cause price increases and decreases. Changes in customer preferences or the cost of money may alter demand. Equilibrium is reached at the point where the greatest number of consumers and producers is satisfied.

An exchange is an institutionalizing mechanism. Institutionalized exchanges take many forms, including business-to-business, business-to-consumer, intermediated, and direct exchanges. The nature of the exchange mechanism is the most obvious difference between public and private markets. There is no single place or entity where an owner or investor might exchange an interest in a private company.

Comparison of the Markets

Market mechanisms explain the structure of the private capital markets. Exhibit 1.2 compares and contrasts transfer issues in the public and private capital markets. The private capital markets are a complex interacting network of discrete exchanges rather than a unified structure. They differ greatly from the unified structure of the public markets. For example, institutionalization in the public markets is developed more than in the private markets. In the public market, the players are licensed, highly regulated, and larger in size, and they tend to offer a wide range of financial services. In the private market, there is a host of smaller transfer players who provide discrete services. While these services are largely unregulated, the Securities and Exchange Commission and various state authorities provide some regulation.

Private markets are less mature than the public markets. They are considered emerging markets. While there are certain truths in the private–public comparison, there is more to private markets than the comparison implies. Private markets are driven by a wide variety of unique motives, and the markets have developed mechanisms enabling those unique objectives to be accomplished.

EXHIBIT 1.2 Comparison of the Capital Markets

Market Mechanism	The Public Market Enjoys	The Private Market Exhibits
Information	Symmetrical information Transparent information on the subject	Asymmetrical information Opaque information on the subject
Liquidity	Transfers of mainly minority interests Instant trading	Transfers of mainly enterprise interests Long-term planned exits
Allocation	Efficient allocation	Fairly inefficient allocation
Regulation	A regulated market	A mainly nonregulated market
Intermediation	An industry of agents and market makers	A segmented industry of agents
Exchange	Continuous pricing	Point-in-time pricing

Private capital markets are understandable in terms that apply to all markets. They are a collection of mechanisms, located in a free market system. No authority controls the overall structure and function of the market. Rather there are multiple authorities, with various levels of influence and control, operating in certain areas of the market.

So far this discussion describes markets from a high-level, monolithic viewpoint. Capital markets are not monolithic; rather, they are segmented based on a number of factors.

Segmented Markets

Private markets actually contain numerous marketplaces. For example, there are submarkets for raising debt or equity and for transferring business interests. This book consistently uses the collective term “markets” to describe activity within the private capital markets rather than attempting to describe particular submarkets with a confusing array of terminology. While there are no definitive size boundaries, Exhibit 1.3 depicts the market segmentation by size of business.³

Small businesses—those with annual sales of less than \$5 million—are at the bottom of the ladder. There are more than 5 million small businesses that report having at least one employee in the United States. This group generates approximately 15% of the U.S. GDP. Lending to these businesses is generally handled by the business banking group of community or smaller regional banks. Small businesses are almost always owner managed. These businesses have limited access to the private capital markets beyond assistance from the Small Business Administration and business brokers. Capital access improves as the business moves into the upper segments.

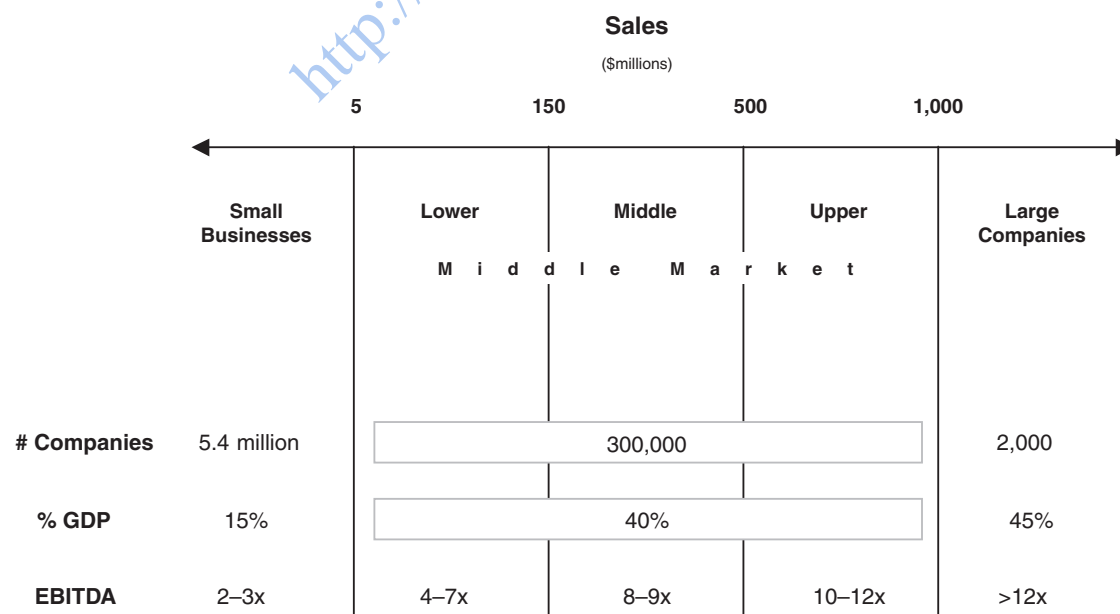


EXHIBIT 1.3 Segmented Capital Markets

EXHIBIT 1.4 Characteristics of the Lower Middle Market

- Owner management.
- Owner has unlimited liability and personally guarantees debt.
- Company has evolved from bookkeeper to controller or chief financial officer.
- Owner typically has more than 80% of personal wealth tied to business.
- About 80% of the businesses will not transfer to the next generation.
- Company has uncertain access to capital.
- Market value of the company can vary widely from year to year.

The entire U.S. middle market contains approximately 300,000 companies that generate roughly 40% of the U.S. GDP. The lower middle market includes companies with annual sales of \$5 million to \$150 million; and so on. The lower middle market is the main focus of this book. As Exhibit 1.4 portrays, companies in this segment have a number of unique characteristics.

The “middle” middle market includes companies with annual sales of \$150 million to \$500 million. They are serviced by regional investment banks and draw the attention of the banks’ top lenders, their corporate bankers. Capital market access and efficiency improve at this level. Companies with sales over \$150 million begin to have access to nearly all capital market alternatives.

The upper middle market is comprised of companies with sales of between \$500 million to \$1 billion. These companies have access to most of the capital market alternatives available to the largest public companies. This group of companies, which tends to be publicly held, attracts the secondary attention of the largest Wall Street investment banking firms. The largest regional bankers also take notice. In this tier, capital is accessible and priced to reflect the riskiness of the borrower.

Finally, the large-company market, which is comprised of about 2,000 mostly public companies, generates about 45% of the U.S. GDP. Large companies have the complete arsenal of capital alternatives at their disposal. They use discounted cash-flow techniques to make capital decisions because they can fund projects at their marginal cost of capital. Almost all are public. The few that are private have most of the financial capabilities of public companies. Wall Street bankers focus primarily on these companies, which flourish under the rules of corporate finance theory.

Each market segment yields information and liquidity, which form the basis for peculiar investor return expectations manifested by acquisition multiples paid for companies within it. Acquisition multiples based on earnings before interest, taxes, depreciation, and amortization (EBITDA) represent capital structure decisions. The reciprocal of EBITDA multiples yields a shorthand for expected return on total capital. For instance, equity investors *ordinarily* require 30% to 40% compounded returns from investments in the middle market and 10% to 20% from investments in large companies.⁴

Markets segment by investor return expectations because players within a segment view valuation parochially. The relationship between investor return expectations and valuation is straightforward: Greater perceived risk requires greater returns to compensate for the risk. Using a capital market-determined discount

EXHIBIT 1.5 Defining Characteristics by Segment

Characteristic	Small Market	Lower Middle Market	Middle Middle Market and Up
Revenue size	<\$5 million	\$5 million–\$150 million	\$150 million–\$500 million
EBITDA size	<\$500,000	\$500,000–\$15 million	\$15 million–\$50 million
Ownership profile	Owner managed	Owner managed–professionally managed	Professionally managed
Owner or manager capital motives	To manage cash in the business, not the balance sheet	To manage the business, not the balance sheet	To manage net assets on the balance sheet
Ownership goal	Lifestyle	Lifestyle–entity value creation	Entity value creation
Role of key manager	Wears all hats	Wears few hats—functional management	Functional management
Market orientation	Service	Service–market maker	Market maker–service
Capital access			
Debt	Business banking	Commercial banking	Corporate banking
Equity	Personal/family	Personal/private equity	Private equity
Intermediation	Business brokers	Local investment bankers	Regional/national investment bankers

rate is another way of looking at this risk/return relationship. The discount rate then is the expected rate of return required to attract capital to an investment, taking into account the rate of return available from other investments of comparable risk.

Since a number of factors form boundaries in the capital markets, observers must correctly identify the segment within which the subject will be viewed. Characteristics need to be weighed in their totality. For instance, some companies have annual sales of \$3 million but meet other criteria that may allow them to be viewed as lower-middle-market entities. Companies with sales over \$5 million may be viewed by the markets as small businesses, if they do not have the proper characteristics. An incorrect assessment will lead to improper valuation assessment. Exhibit 1.5 provides criteria appraisers can use to define the segment within which their subject should be viewed.⁵

Owners mainly decide the segment in which their company will be viewed. For instance, if an owner decides to personally manage every aspect of the business and desires to achieve only a good lifestyle from it, the market will probably view it as a small business. Conversely, owners who strive to create company value and build a functional organization may induce the markets to view the company as a lower-middle-market entity.

WHY ARE MARKETS SEGMENTED?

Markets, like individual firms, have a cost of capital that reflects the return expectations of capital providers in that market. But how do capital providers determine

risk and return within a market? Capital markets are segmented for two primary reasons.

1. Capital providers are the authorities that set rules and parameters.
2. Owners and managers view and define risk and return differently in each market.

Capital Providers

Capital providers use credit boxes to define the criteria necessary to access capital. Credit boxes help capital providers filter asset quality and set return expectations. Loans or investments that meet the terms of the credit box should promise risk-adjusted returns that meets a provider's goal. Institutional capital providers use portfolio theory to diversify risk while optimizing return. Portfolio theory is built on the premise that the risk inherent in any single asset, when held in a group of assets, is different from the inherent risk of that asset in isolation. It is unlikely that even investments in a class, such as senior midmarket debt, will experience returns that covary.

Providers also use other devices to manage portfolio risk and return. Techniques like advance rates and loan terms enable providers to hedge risks. These techniques manage risk with interest rate matching and hedges and diversify investments across geography and industries. Loan covenants are a major risk/return management tool; by setting behavioral boundaries around the borrower, capital providers are better able to manage portfolios. Providers constantly monitor their portfolios, feeding back information through their credit boxes to adjust the characteristics of assets in their portfolios.

Debt providers' use of loan covenants further creates capital market segmentation. For example, as Exhibit 1.6 shows, the range of senior debt multiples and the ratio of senior debt to earnings before EBITDA are different for each segment. It is instructive to note a positive correlation between senior debt lending multiples and middle-market private acquisition multiples between 2003 and 2010.⁶ During that period, lending multiples ranged from 2.1 to 3.3. During periods of restricted lending, M&A activity was depressed. In those deals, multiples

EXHIBIT 1.6 Correlation of Senior Lending and Acquisition Multiples

	2003– 2005	2006	2007	2008	2009	2010
Senior Debt/EBITDA						
\$10 million–\$25 million	2.1	2.3	2.4	2.1	1.3	1.9
\$25 million–\$50 million	2.5	2.7	2.9	2.2	1.7	2.1
\$50 million–\$100 million	2.6	3.3	3.1	2.8	2.0	2.4
Total Enterprise Value/EBITDA						
\$10 million–\$25 million	5.5	5.7	5.4	5.3	5.1	4.8
\$25 million–\$50 million	6.0	6.0	6.2	5.9	6.1	6.3
\$50 million–\$100 million	6.1	6.5	6.6	6.4	6.1	6.2

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tended to be lower. By comparison, in the late 2000s, both lending and acquisition multiples moved up together. There is a significant correlation between senior debt lending multiples and business transfer values, especially in larger transactions.

Markets are further segmented by the ability to accommodate perceived risk differences. In the middle market, there is a distinct difference between the portfolio risk experienced by equity providers and that of debt providers. Equity risk is generally greater, due to its legal structure; and it is likely to be a larger portion of a smaller portfolio, further increasing risk. Debt tends to be less risky, due to its substantial bundle of legal rights; and it is usually a smaller portion of a larger investment portfolio, diminishing the impact of risk. Middle-market equity investors generally spread their risk among relatively few investments contained in a given fund or portfolio. In contrast, debt investors spread the risk among a larger pool of investments in the portfolio. Mezzanine investors can assemble blended portfolios with an entirely different risk profile since they tend to make relatively smaller investments in a greater number of companies. Moreover, the debt portion of their investments diminishes mezzanine investors' risk, while the equity portion improves their return. Rounding out this discussion of the impact of portfolio risk, pity the poor business owner who has a portfolio of one company to absorb all risk.

Lenders' and investors' portfolios define the limit of their expected returns, and managing this limit creates market fluctuations. Similarly, owners manage a balance sheet with a blend of equity and debt. In other words, owners manage a portfolio of equity and debt in order to maximize utilization of capital and manage exposure to risk. It is the day-to-day operation of these portfolios of investments working through market mechanisms that defines the market at any point in time.

Owners' and Managers' View of Risk/Return

Business appraisal attempts to estimate the balance between risk and return, specifically the risk or likelihood of achieving a certain benefit stream. The preceding text illustrates that risk and return balance by market segment. Behavior of parties in the markets reinforces this premise. For instance, when a large public company, whose stock may be trading at 30 times earnings, acquires a lower-middle-market company, why does the larger company pay 4 to 7 times earnings and not 20? Paying any multiple less than 30 would be accretive, thus adding value to the shareholders. The reason is that the larger company views investments in the lower-middle market as riskier and therefore needs to pay less to balance risk and return.

Here is the key insight: Risk and return are viewed and defined differently by owners and managers in each market segment. At a minimum, both risk and return are comprised of financial, behavioral, and psychic elements. Financial risk/return indicates that the monetary results of an action must compensate for the risk of taking the action. Behavioral risk/return describes the fact that actions occur within a set of social expectations. For instance, loss of face in a community may be viewed as a behavioral risk. Psychic risk/return is personal to the decision maker and accounts for an individual's or an institution's emotional investment in a course of action.

Unlike shareholders in firms in larger markets, owners of small companies view risk/return more from a personal perspective. Many small and lower-midmarket company owners view the business as a means to a desirable lifestyle rather than an entity that creates purely financial value. Most small-firm owners do not measure investments in the business with the tools of corporate finance. They are more likely to use a “gut feel” approach to make an investment decision.

Mid-middle-market owner-managers tend to balance the financial and psychic elements of risk/return. They understand that cost of capital is relatively high, so financial returns must compensate for investment risk. However, personal pride and community standing still have great importance. Mid-middle- and larger-company managers are driven to realize risk-adjusted returns. This drives economic value-added approaches to managing, which have taken root only in larger companies. Behavioral and psychic decision making is less important to large-company managers, or at least it takes different forms.

The combination of capital providers that balance risk/return through portfolio management and owners-managers who view risk/return differently leads to market segmentation. The behavior and perceptions of players are unique in each market. Therefore, making proper financing, appraisal, and investment decisions requires using theories and methods appropriate to the subject’s market. The next section discusses the ramifications of borrowing theories, tools, and data from a market other than the subject’s.

Behavior of Players and Capital Market Theories

Studying the behavior of players in a system often begins with understanding their motives or goals. Motives of owners and managers are different in each market segment. Exhibit 1.7 illustrates behavioral differences, relating to capital and transfer motives, to help observers decide which market segment a company is likely to be viewed in.⁷

EXHIBIT 1.7 Owner and Management Motives

Motive	Small Market Owners Want:	Lower Middle Market Owners Want:	Middle-Middle Market and Up Managers Want:
Capital	No partners To remove equity from the business To manage cash in business, not balance sheet	As few shareholders as possible To minimize equity in the business To stretch required equity To borrow without personal guarantees To manage the business, not the balance sheet	To build equity in the business To optimize the firm’s capital structure To borrow at the firm’s marginal cost of capital To manage “net assets” on the balance sheet
Transfer	Simple transfer motives To create lifestyle business To use the business to create a job	To meet personal motives To diversify the estate To create a family legacy To use transfer to create wealth	To meet entity motives To diversify the business To create a business legacy

Motives of small- and middle-market company owners are different from those of large-company managers. While most business owners want to maximize earnings, they differ in how they define and derive those earnings. Small-business owners want no partners; middle-company owners want few partners; large-company managers are motivated to increase the number of shareholders to build equity and reduce risk. Private owners want control and don't want to share equity. This limits growth because debt providers are reluctant to account for a company's total capitalization.

From the midrange of the middle market and up, managers are motivated to maximize earnings, thereby building the equity base. Smaller-business owners are motivated to reduce reported earnings to reduce taxes, which dilutes equity. Moreover, most private companies employ pass-through entities, such as limited liability companies and S corporations, to distribute money out of the company and further reduce equity.

Beginning in the mid-middle market, company managers seek to borrow at the firm's marginal cost of capital, thus optimizing the company's capital structure by always employing the least expensive capital. Private lower-middle-market and small-company owners want to avoid providing personal guarantees and are less concerned by the incremental cost of capital. Many gladly pay hundreds of extra basis points in interest to be relieved from the responsibility of personally guaranteeing a loan.

From the mid-middle market on up, managers are strongly motivated to manage the net assets of the business because companies have bonus systems tied to return on net assets. The more effectively a manager controls net assets, the bigger the bonus. On the contrary, small- and lower-middle-market private owners are compensated out of cash flow, not on a balance sheet metric. Therefore, they are motivated to manage the income statement, not the balance sheet.

There are distinct differences between transfer motives of players in various markets. Large-company managers have a corporate perspective; small-company owners have a personal perspective. Most small-firm owners have limited ability to build value in their business; therefore, they have limited transfer expectations. Most middle-market owners sell out because they are burned out. Large public companies do not get tired. Lower-middle-market owners cannot easily replace themselves because they tend to wear so many hats that no single person can replace them. Mid-middle-market and larger companies are organized functionally, so any one executive can be replaced without forcing a sale. Large companies can last a long time; small companies frequently do not outlast the current owner.

Large-company motives are different from personal owner motives relative to diversification, legacy building, and likely retirement vehicles. Most large-company managers seek to diversify their businesses because diversification reduces ownership risk and increases job security. As a result, a large-firm manager is more likely to diversify the business into unfamiliar territory. In contrast, lower-middle-market owners usually wish to diversify their estates, the majority of which are vested in the business. Therefore, a lower-middle-market owner is more likely to employ sophisticated estate planning techniques to transfer the business to children as a family legacy. Finally, lower-middle-market owners typically forgo

some compensation to reinvest in the business, anticipating a major capital event. Professional managers look to maximize ordinary income and use 401(k) type plans or stock options to build retirement nest eggs.

Capital Market Theories

Until the first edition of this book was published in 2004, private market players had only corporate finance theories to explain the behavior of private capital markets.⁸ They were left to assume that corporate finance theories explain and predict actions in the private markets. *Private Capital Markets* showed that corporate finance theories explain and organize the public capital markets but were never intended to explain nonpublic capital markets. Private markets must be explained using theories tailored to experience in those markets. Employing powerful theories in the wrong context leads to frustration and a loss of utility. For example, assessing risk using a theoretical structure applicable to one market while expecting a return in another market causes a serious disconnect.

At least three capital markets theories are needed to explain the broader capital markets. Exhibit 1.8 shows the linkage between each market and theory.

Small-company market theory does not yet exist in the literature. Elements of this emerging theory are extant, such as valuation standards for appraising small-business interests, capital-raising constructs such as the use of the Small Business Administration's programs, and various articles and writings on transferring small businesses. The behavior of many of the players at this end of the market relies more on psychology than on economics. At some point in the near future,

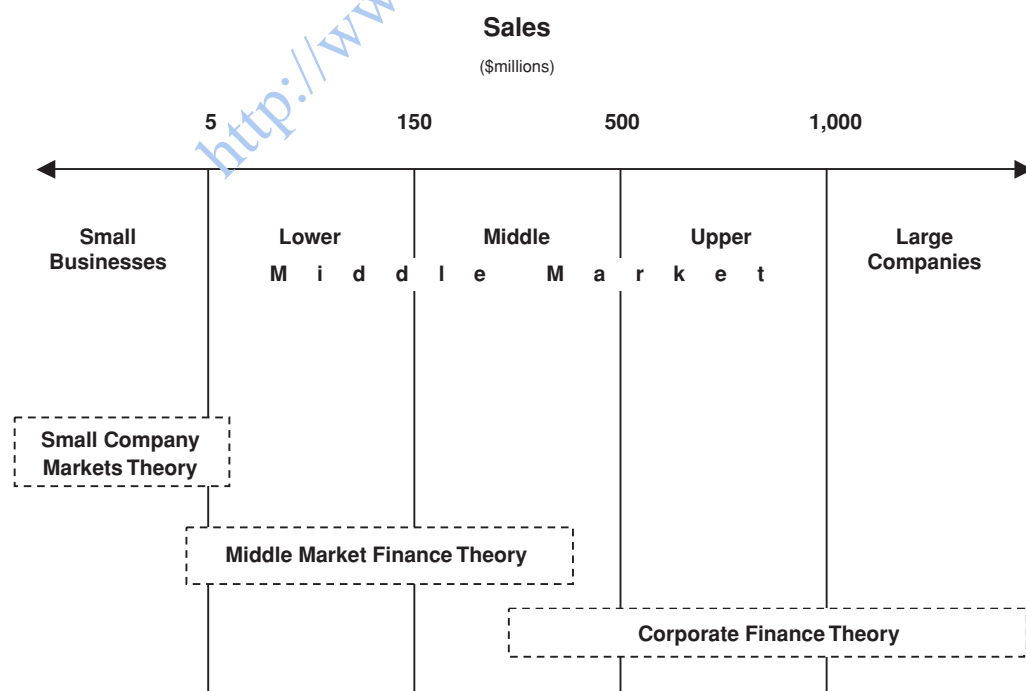


EXHIBIT 1.8 Capital Markets and Theories

EXHIBIT 1.9 Assumptions behind Corporate Finance Theory and Middle-Market Finance Theory

Corporate Finance Theory	Middle-Market Finance Theory
Use of a C corporation	Can be any type entity (S, limited liability corporation, etc.)
Value is established by a market	Value is established at a point in time
Ready access to public capital markets	No access to public capital markets
Owners have limited liability	Owners have unlimited liability
Owners are well diversified	Owners have one primary asset
Professional management	Owner management
Company has infinite life	Typical company life of one generation
Liquid securities efficiently traded	Illiquid securities inefficiently traded
Profit maximization as goal	Personal wealth creation as goal

institutions within the small-business market will mature sufficiently to enable a holistic theory to develop.

Middle-market finance theory is the integrated capital market theory unique to middle-market private companies, especially those with annual sales of \$5 million to \$350 million. This theory describes the valuation, capitalization, and transfer of private business interests. These three interrelated areas rely on each other in a triangular fashion. This interrelation not only provides strength to market architecture, but it also requires users of the body of knowledge to understand all three legs of the triangle. Just understanding valuation or capital structure or transfer will not get the job done in the marketplace. Employing triad logic generates what the private companies need most: holistic solutions. Typically a private business owner is faced with a financial problem that can be solved only by drawing information from throughout the body of capital knowledge.

Finally, corporate finance theory was developed in the 1960s to explain the behavior of large companies in public capital markets. These theories include capital asset pricing theory, efficient market theory, option pricing theory, agency theory, net present value, portfolio theory, and others. Exhibit 1.9 describes the various corporate finance theories and their application (or lack thereof) to private markets.

Theories are useful only if they are predictive. Corporate finance theory does not predict behavior in the private capital markets; likewise, middle-market finance theory is not predictive of large-company behavior in the public markets. The starkness of this contrast is shown by the assumptions behind corporate finance theory and middle-market finance theory.

Many underlying assumptions between corporate and middle-market finance theory are different and at odds with each other. Several characteristics are particularly noteworthy:

- A market establishes value for public companies, whereas private companies must rely on a point-in-time appraisal or a transaction to determine value. This is a startling contrast. In one case, it is possible to use the Internet to obtain *real-time* pricing of a security. In the other case, much work is required

to ascertain the value of a security at a particular point in time, probably in the past. If there were no other differences between public and private markets, this one issue would suffice to separate them.

- Public companies have ready access to capital, but private companies must create capital solutions one deal at a time, with little certainty of success. Think of it as if public companies have access to a supermarket of securities. Within aisles of the supermarket can be found all of the available capital alternatives. The riskiness of the particular financing determines which aisle the public company can access. Private companies, however, have no access to the supermarket. Instead, they must visit a flea market of capital each time they need to access capital.
- Shareholders in public companies are able to diversify, because of the high liquidity available in the public capital markets. They do not have all their eggs in one basket. Private owners have nearly all of their wealth tied up in one asset: the stock of their business. Increased risk is the main ramification of this lack of diversification. Both public and private capital markets treat risk similarly: The greater the risk of owning an asset, the greater the return required to compensate for the added risk.

The different assumptions that underlie corporate finance ultimately limit the utility of these theories to private markets, especially to the middle market.

Middle-Market Finance

Middle-market finance is the study of how managers of middle-market companies make investment and financing decisions. Chapter 2 describes this capital market theory.

NOTES

1. Unless otherwise stated, public companies are defined herein as those entities that trade on a public exchange and have a float of more than \$500 million.
2. Robert T. Slee, "Public and Private Capital Markets Are Not Substitutes," *Business Appraisal Practice* (Spring 2005), p. 29.
3. Richard M. Trottier, *Middle Market Strategies: How Private Companies Use the Markets to Create Value* (Hoboken, NJ: John Wiley & Sons, 2009), Chapter 1.
4. John K. Paglia, Pepperdine Private Capital Markets Project Survey Report, April 2010, bschool.pepperdine.edu/privatecapital.
5. Robert T. Slee and Richard M. Trottier, "Capital Market Segmentation Matters," *Business Appraisal Practice* (Summer 2006), p. 46.
6. Correlations between senior lending multiples and acquisition multiples are: \$10 million–\$25 million category: .60; \$25 million–\$50 million category: –.05; \$50 million–\$100 million: .87.
7. Slee and Trottier, "Capital Market Segmentation Matters," p. 49.
8. Robert T. Slee, *Private Capital Markets: Valuation, Capitalization, and Transfer of Private Business Interests*, 1st ed. (Hoboken, NJ: John Wiley & Sons, 2004).

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