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# Permanent Equity: Successfully Finding and Buying a Small Business

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# PERMANENT EQUITY: SUCCESSFULLY FINDING AND BUYING A SMALL BUSINESS

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## Acknowledgments

This paper would not be possible without the help of many people. I am extremely grateful as the information provided to me was critical to writing this thesis. The information that was provided included general industry knowledge and the ways that each of their firms implements this way of investing in the real world.

I would first like to thank Robbie Walters, my first boss, for introducing me to the world of permanent equity within the small business space. He took a chance on me as a freshman with little to no financial knowledge and offering me an internship. He spent many hours correcting my mistakes and helping me build a foundation of understanding businesses and valuation. Outside of the internship, he also pushed me to learn about other funds and their styles through the *Invest Like the Best* podcast hosted by Patrick O'Shaughnessy and reading books and papers on value investing.

Secondly, I would like to thank both my thesis mentor Dr. Ozgur Ince and my second reader, Mills Snell. Dr. Ince was an invaluable adviser providing me with research, guidance, and structure for this paper. Mills also was a tremendous resource as an industry practitioner giving me insights into not only how his firm operates, but also potential leads to follow up on to learn about some of the different options available to permanent equity investors.

Finally, I would like to thank my family. Especially my father, Hsin, and mother, Su, for their support and guidance. Not only have they both helped me in writing and editing this thesis, but their biggest contributions have been instilling a natural curiosity in me that led me to pursue the unpaid internship at Bluegrass Equity as well as funding my college education. Without them, none of this would have been possible.

# Abstract

This thesis aims to build off the existing research on the advantages of permanent equity within the micro-cap market space. This strategy combines many advantages from private equity, venture capital, small-cap, and value / quality investing in order to generate a differentiated return. While the pros and cons of these various strategies have been explored by previous academic research, not much has been written on the actual implementation and choices practitioners must make when they decide how to deploy capital. In order to dive deeper into implementation, this thesis presents several anecdotes of various firms that invest in this space according to different risk appetites and objectives. It will walk through some of the considerations that investors take into account when making each of these decisions.

My introduction to this niche corner of investing came from a freshman year internship working at a firm called Bluegrass Equity based in Lexington, Kentucky. There I got some first-hand experience working alongside the founder to learn how to identify quality businesses efficiently and how much true value-add an investor can provide small business owners, while still maintaining the opportunity to earn a sizable return. The alignment of incentives allows both parties to benefit. However, as I became more familiar with the space, I began to realize that the firm I was working at made some active choices that had different risks and benefits than other firms within the industry. Therefore, this thesis will represent a culmination of interviews from various industry professionals, personal experience, news articles, and prior research papers / professional publications that examines all the choices investors make that can potentially lead to outsized alpha generation, or excess return on an investment relative public markets.

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# Methodology / Approach

This thesis utilizes a variety of sources to identify the potential opportunity set that permanent equity offers. Permanent equity presents a particularly challenging field to conduct research on because it is firstly, hard to define, and secondly, difficult to gather private market data. In addition, as investors move even further down the private market universe to the small businesses, data is even more difficult to find because these companies often have varying accounting capabilities – anything from QuickBooks financials to S-Corp tax returns to rough Excel spreadsheet estimates.

The background / literature review identifies the opportunity set available to potential investors. It is broken up into the following sections: Current Investment Landscape, Private Equity, Small Business Market, Venture Capital, and Value / Quality Investing. The Current Investment Landscape section examines current market trends towards private markets investing and the "democratization of finance." It aggregates news reports with studies conducted by firms like Wilshire, McKinsey, and Meketa. After analyzing the current market trends, the subsequent section explores the influences of private equity as an asset class and how permanent equity can draw from the strengths of the model while mitigating the risks and weaknesses. It draws from various papers that examine the value creation levers and interprets the data of the current private equity landscape to find the best investment opportunities within the space.

Continuing to focus on the scope of what permanent equity is, the small business market section examines the advantages of investing in this space as well as the total addressable market size. It relies heavily on the research from the Pepperdine Graziadio Business School's Private Capital Markets reports. The most recent report was conducted in January 2019 and aggregates "the behavior of senior lenders, asset-based lenders, mezzanine funds, private equity groups, venture capital firms, angel investors, privately-held businesses, investment bankers, business brokers, limited partners, and business appraisers" (Pepperdine). The scope of this section will focus primarily on the trading multiples and leverage levels of small businesses. Pepperdine partners with reputable organizations such as Dun &

Bradstreet, Angel Capital Association, the Alliance of Merger & Acquisition Advisors, and Venture Capital/Private Equity Roundtable to produce this report.

In the small business market, permanent equity funds can learn a lot from how venture capitalists source and structure deals. Oftentimes, the investor is required to educate the seller, who probably has not gone through the process before. Fit and strategic alignment can often matter just as much to the business owner as price. The final section of the background before it is all put together focuses on incorporating some of the principles from value and quality factor investing that have historically outperformed the public market and creating a methodical, repeatable way of screening through prospective investment opportunities.

Once the parameters of permanent equity in the small business market are established, this thesis explores four potential areas for alpha, an active return on investment, generation: sourcing / process, negotiations, differentiation, and structuring. These sections will aggregate interviews from multiple perspectives in the space and will be backed with empirical data if possible. It is important to understand that investors have different risk and reward tolerances, as well as the negotiating incentives of every party involved in the acquisition process.

Below is a list of people and a brief background on their respective firms that were gracious enough to lend their time and expertise in writing this research:

1. Mills Shore is a Vice President at Permanent Equity (the firm will be differentiated from the asset class by its capitalization), formerly known as Adventur.es, and leads their Columbia, South Carolina office. Permanent Equity is one of the leading funds in the permanent equity space with $280 million committed capital, a 27-year time horizon, and 8 portfolio companies under management. Their founder, Brent Beshore, is one of the most influential figures in the space and is often featured on the popular podcast *Invest Like the Best.*

2. Ted Crosson is a Vice President and SBA Lending Officer at Business Development Corporation (BDC) in Columbia, South Carolina. BDC has been financing small businesses in South Carolina for over 60 years and has approved more than 2,850 loans totaling in excess of $1.71 billion. He lent his knowledge and expertise on SBA loans and small business financing that helped provide some more color on leverage options in the small business permanent equity space.
3. David Yezbak is the President of Sunbelt Business Brokers in Columbia, South Carolina. Sunbelt helps the owners of established businesses prepare for retirement or to move on to their next business venture. Sunbelt Business Brokers is the largest business brokerage company with over 300 offices worldwide. Before Sunbelt, David was the President of his own small business, Codalex Imaging. He exited his business as part of a roll-up IPO. In this thesis, David helped provide some crucial insights into the business brokers' perspective in the sale process.
4. Patrick Weston, CFA, is a Partner at Route 2 Capital Partners and has been in this space for more than 20 years. Route 2 is a private investment firm providing $3 – 15 million of flexible mezzanine debt and equity capital solutions to lower middle-market companies, primarily in the southern United States. The firm has offices in Charleston and Greenville, South Carolina.
5. Robbie Walters is a University of South Carolina alumni whose previous career includes being an investment banking analyst in the Energy and Power Group at Barclays Capital and an Associate at Citadel LLC. I had the great opportunity to work and learn from him at Bluegrass Equity in Lexington, Kentucky until he was able to close on his first acquisition. Bluegrass Equity had a unique style of permanent equity which required Robbie to run the initial portfolio company until he was able to find a successor to continue running it for him while he moves on to his next search.

# Introduction

According to a Financial Times article, private equity and hedge fund managers consider "permanent capital… as a new holy grail" (Foley). Permanent capital allows investors to have a theoretically unlimited time horizon to deploy capital and implement their investment strategies throughout different economic cycles. At the same time, they don't have to worry too much about investor redemptions, raising new funds, or deployment deadlines. It allows investors to stay disciplined and start thinking more about long-term investing by positioning them as owners of assets rather than trying to buy and flip within a short timeframe. However, the idea of permanent equity is not necessarily a novel one. The most successful example of permanent equity is Warren Buffett's Berkshire Hathaway, the fourth largest public company in the United States. For the past 50 years, Buffett has been successfully reinvesting the profits from his businesses and the premiums from his insurance operations and generating market-beating returns by buying and building a large portfolio of companies. His investments include big names such as Dairy Queen, GEICO, and Fruit of the Loom and maintain diversity over a variety of sectors including energy, finance, defense, and consumer, just to name a few. This style of investing is also more common in real asset markets such as real estate and infrastructure.

This thesis presents some background and conducts a literary review on the market and different investing styles that can be combined. It begins by examining the current investing landscape by providing a brief introduction to the evolution of financial markets and how permanent equity can be applied to withstand a variety of market conditions. Then it investigates the small-business market and the advantages of investing in that space. The following sections dive into the background and some of the strengths and weaknesses of private equity and venture capital. The final part of the background section covers value investing, one of the most prominent and well-researched factors within style-based investing. Therefore, if combined correctly, this style of investing combines the skills necessary to run a private equity firm and venture capital fund with a value-investing mindset in a market with 800,000+

companies and only 20 – 50 active searchers at a time. This presents a fantastic opportunity to generate alpha.

The majority of this paper focuses on the actual implementation of this style of investing by compiling all the research and interviews that have been conducted. Sourcing / process, negotiations, differentiation, and structuring are the primary areas to focus on potential alpha generation. In each one of these categories, investors must weigh their risk vs. return preferences and have a humble amount of introspection / understanding of their strengths and weakness. As with any sort of investing and especially in the small business universe, what worked for one investor on a particular investment does not guarantee future success for both them and other investors.

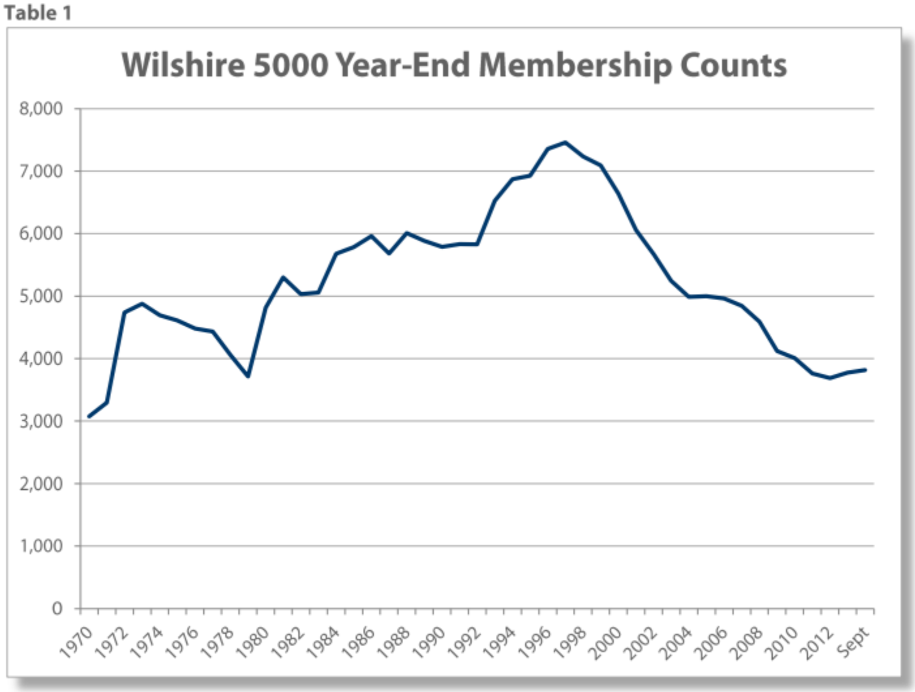
# Background and Literature Review

## Current Investment Landscape

In 2017, the *Wall Street Journal* published an article stating that there are only 3,671 domestic listings, almost half of the 7,322 available in 1996 on the Wilshire 5000, an index that tracks the entire US equity market (WSJ). The graph below (Figure 1.1) provides an even longer timeframe from *Wilshire* that monitors the number of public companies the index tracks. In that same period, investor access increased greatly with the emergence of low-cost index funds, zero-fee financial technology brokerage firms, and growing middle classes in emerging countries. With the "democratization" of finance from the aforementioned innovations and developments, competition has increased significantly and the opportunities for finding alpha in the public markets has become much harder.

Figure 1.1

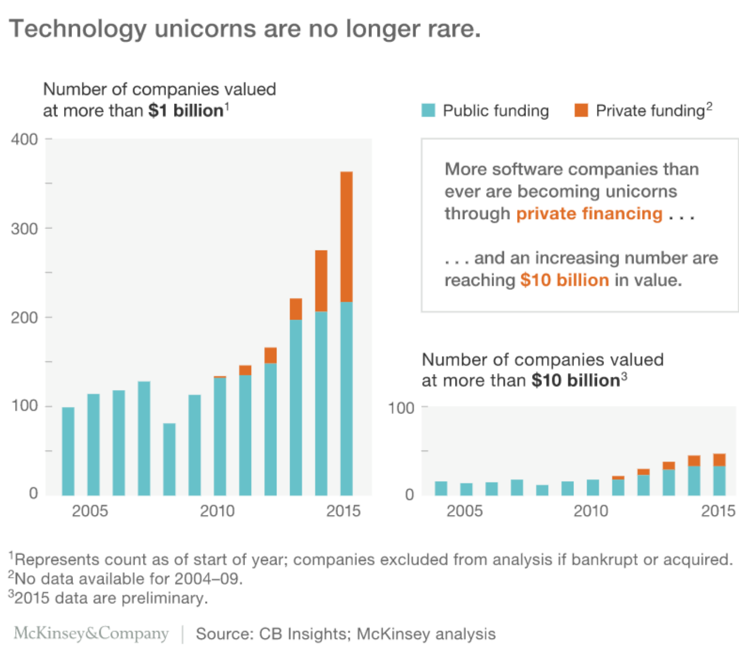
Table 1




Source: Wilshire 5000

On the other hand, more and more companies have gone private, or they have stayed private for longer if they are a start-up. According to a Bloomberg article, "new businesses have been offering shares to the public at less than half the rate of the 1980s and 1990s. Mergers and acquisitions have eliminated hundreds more" in industry consolidations (Bloomberg). In addition to staying private longer, many businesses are also electing to participate in larger and more rounds of venture / growth funding. A recent CNBC report found that "the average tech company age in a public debut rose from three years in 2001 to 13 years in 2018" (CNBC). As a result, there are many more private "unicorns" or companies that reach a valuation of over $1 billion. A McKinsey study attributes this trend to the "US Jumpstart Our Business Startups (JOBS) Act, which was passed into law in 2012, increased fourfold the maximum number of shareholders a company can have before it must disclose financial statements" and "the acceleration of capital invested in private companies" (McKinsey). Figure 1.2 shows that while the number of technology unicorns in the public markets has been growing at a fairly steady rate since the financial crisis, private funding has greatly increased the total number and is becoming a larger and larger percentage of the total.

Figure 1.2



It is important to understand the differences between how public and private companies are valued. For publicly traded companies, public market investors determine the enterprise value on a nearly second by second basis. To simplify, one can assume a company's enterprise value is determined primarily as common equity value plus the net debt of the company (in more complex capital structures we would also include non-core assets, long-term investments, non-controlling interest, and preferred stock). The common equity value is calculated by multiplying the number of shares outstanding by the share price. The share price is the outcome of supply and demand and is, therefore, the average of all of the market participants' expectations for the value of the company.

On the other hand, a private company has the advantage of being valued by only the most bullish investors. For example, if a tech start-up like WeWork is trying to raise money for an equity fundraise, they will probably run a robust fundraising process and reach out to a lot of investors. The more investors that are interested, the more they have to compete with each other over price and valuation. As the valuation rises, investors must turn more and more to the bullish case of their valuation until the most bullish investor(s) emerge and complete that round of fundraising. However, bearish investors have pointed out that the valuations in the private markets are not always justified as seen with WeWork, Uber, and Peloton's 2019 IPO experiences. Public market investors often demand profitability, simple corporate structures, and lower levels of leverage than private markets are willing to tolerate. This mismatch is the reason why companies such as WeWork see their valuation fall from $47 billion to $8 billion during its IPO process.

In summary, the public markets are getting increasingly more competitive because of a smaller investable universe that decreases the chances of mispricing and differentiation. On the other side of the equation, the number of retail investors is increasing through the "democratization" of finance and the emergence of the low-cost index funds. Additionally, some extremely sophisticated active institutional investors are starting to specialize in distressed scenarios, algorithmic trading, deep industry specialization, etc. that are also competing within this space. As a result, it can be hard to differentiate and find alpha in the public markets.

The number of private market companies is increasing, and they are staying private for longer. While there are significant opportunities and more price dislocations within the private market, it presents its own set of risks. The illiquidity risk and information disparity can potentially lead to unrealistic valuations and numerous years before realizing the loss. Additionally, the private market is still an extensive marketplace with companies of varying sizes. According to Meketa, "the aggregate market value of privately held companies is comparable to that of publicly-traded company shares… Historical studies have shown that the ratio of U.S. private companies to public companies is 100:1" (Meketa). The next section will discuss the role of private equity and its advantages within the private market space.

**Private Equity**

The prominence of private equity has been increasing as more and more money is devoted to this asset class, and their successes and failures are becoming more public as well. Meketa Investment Group, an investment consulting and advisory firm commonly hired by pension funds, states in their primer that "private equity investments are simply investments in privately held companies. Private equity investments are generally structured in the form of partnerships that usually consist of ten to twenty equity investments in individual companies" (Meketa). Private equity strategies can come in a variety of forms as well. These can include buyout / LBO (Leveraged Buyout) funds, distressed, growth, real estate, fund of funds, infrastructure, and mezzanine funds. Each of these fund types reflects a unique strategy and investment thesis. For the purpose of this thesis, we will be focusing on the traditional buyout / LBO strategy.

A leveraged buyout is a type of financial engineering used by specialized investment firms in which they acquire a target company using a relatively small portion of equity and a significant amount of debt (this can vary by industry, business cycle, etc.). "In a typical leveraged-buyout transaction, the private equity firm buys the majority control of an existing or mature firm" (Kaplan, 2009). The private equity firm then will then deploy a variety of strategies such as cost-cutting, marketing initiatives, bolt-on acquisitions, divestitures, etc. At the same time, they will be paying down the debt with the operating company's cash flow which will increase their equity proportion over a five to eight-year hold period (Kaplan, 2009). Then, the private equity firm will exit their investment through a sale of the company to another private equity firm or strategic buyout, enter the public markets through an IPO, or have the management team buy back the business. Figure 2.1 details types of exits and hold periods using a CapitalIQ buyout sample.

Figure 2.1

**Exit Characteristics of Leveraged Buyouts across Time**

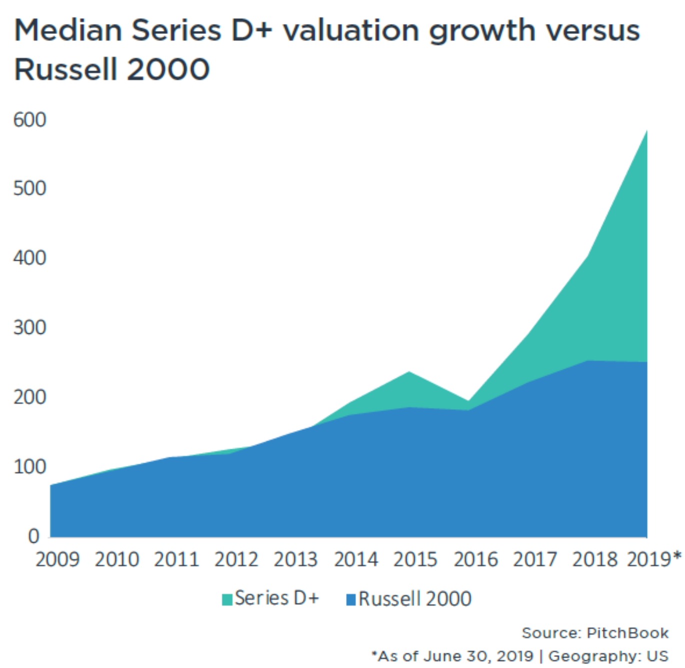
| *Year of original LBO* | *1970–1984* | *1985–1989* | *1990–1994* | *1995–1999* | *2000–2002* | *2003–2005* | *2006–2007* | *Whole period* |
|---|---|---|---|---|---|---|---|---|
| **Type of exit:** | | | | | | | | |
| Bankruptcy | 7% | 6% | 5% | 8% | 6% | 3% | 3% | 6% |
| IPO | 28% | 25% | 23% | 11% | 9% | 11% | 1% | 14% |
| Sold to strategic buyer | 31% | 35% | 38% | 40% | 37% | 40% | 35% | 38% |
| Sold to financial buyer | 5% | 13% | 17% | 23% | 31% | 31% | 17% | 24% |
| Sold to LBO-backed firm | 2% | 3% | 3% | 5% | 6% | 7% | 19% | 5% |
| Sold to management | 1% | 1% | 1% | 2% | 2% | 1% | 1% | 1% |
| Other/unknown | 26% | 18% | 12% | 11% | 10% | 7% | 24% | 11% |
| **No exit by Nov. 2007** | 3% | 5% | 9% | 27% | 43% | 74% | 98% | 54% |
| **% of deals exited within** | | | | | | | | |
| 24 months (2 years) | 14% | 12% | 14% | 13% | 9% | 13% | | 12% |
| 60 months (5 years) | 47% | 40% | 53% | 41% | 40% | | | 42% |
| 72 months (6 years) | 53% | 48% | 63% | 49% | 49% | | | 51% |
| 84 months (7 years) | 61% | 58% | 70% | 56% | 55% | | | 58% |
| 120 months (10 years) | 70% | 75% | 82% | 73% | | | | 76% |

*Note:* The table reports exit information for 17,171 worldwide leveraged buyout transactions that include every transaction with a financial sponsor in the CapitalIQ database announced between 1/1/1970 and 6/30/2007. The numbers are expressed as a percentage of transactions, on an equally-weighted basis. Exit status is determined using various databases, including CapitalIQ, SDC, Worldscope, Amadeus, Cao and Lerner (2007), as well as company and LBO firm web sites. See Strömberg (2008) for a more detailed description of the methodology.

Historically, public-to-private deals, or take-privates, accounted for over 50% of the LBO transactions of mature businesses such as manufacturing and retail (Kaplan, 2009). That number fell to around 10% of transactions corresponding to the 1980 fall of the junk bond market. However, middle-market buyouts and carveouts of individual divisions within larger corporations began to increase significantly. In addition, firms expanded into different industries such as technology, energy, financial services, and telecom, to name a few.

So why do people invest in private equity firms? At the company-level, private equity has been proven to outperform their respective public market peers adjusted by industry and market as seen in Figure 2.2 from Pitchbook comparing the valuation of late-stage Series D funded companies compared to the small-cap benchmark Russell 2000.

Figure 2.2




Private equity firms have three main levers to drive returns: governance, financial, and operational engineering. The first of which is governance. Private equity firms focus a lot on aligning the interest of their management teams. Studies have found that they give the management teams more upside opportunity through stocks and options than the public markets (Kaplan). The increased equity stake helps align interests because not only does the management team have the opportunity for a large upside, but they could have a significant downside risk as well. "Moreover, because the companies are private, management's equity is illiquid—that is, management cannot sell its equity or exercise its options until the value is proved by an exit transaction. This illiquidity reduces management's incentive to manipulate short-term performance" (Kaplan). Also, private equity firms are often taking a very active position in the company's board and are involved in the governance of the company. If a company is not performing up to standard, private equity investors do not hesitate to replace the CEO and other company managers.

The second potential value creation lever that private equity firms employ in buyouts is financial engineering. As stated earlier, LBOs employ a significant amount of debt as a percentage of the transaction. This debt has two advantages. The first is that it helps make the management team more accountable because they have to be disciplined enough to meet all of the interest and principal payments instead of investing in potentially unprofitable endeavors that some public companies face. The second reason is that the interest on the debt is often tax-deductible, which can potentially increase firm value. Additionally, if a company is performing exceptionally well, the private equity firm can pay itself with additional debt in a dividend recapitalization which will help them boost their internal rate of return (IRR) because they begin to receive positive inflows earlier.

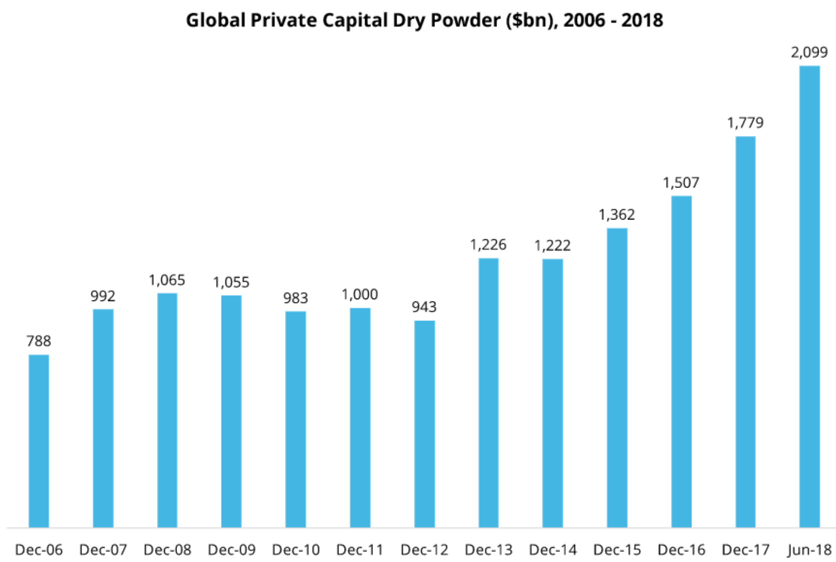
The final value creation lever employed by private equity firms is operation improvements. Many firms now employ large teams of "operators" and include a value creation plan in their investment theses. These operators often have deep industry knowledge and could be former CEOs of large Fortune 500 companies, former public officials to help navigate public policy or internal and external consultants. Their plans "might include elements of cost-cutting opportunities and productivity improvements, strategic changes or repositioning, acquisition opportunities, as well as management changes and upgrades" (Acharya and Kehoe, 2008; Gadiesh and MacArthur, 2008).

As with any sort of investment, it is important to understand the potential risk and reward profile of each. For private equity as an asset class, the biggest areas of risk are leverage, reputational, political, and competition. The largest of these is leverage risk because of how much debt is deployed in a buyout transaction. With any sort of debt, it is important to be able to meet all of the debt covenants associated with the debt and to produce enough steady cash flows to be able to regularly pay off the interest and slowly reduce the proportion of the principal debt of the total enterprise value. From the sample of transactions tracked by CapitalIQ, only 6 – 7% of companies have ended in bankruptcy or reorganization. "Assuming an average holding period of six years, this works out to an annual default rate of 1.2 percent per year. Perhaps surprisingly, this is lower than the average annual default rate of 1.6 percent that Moody's reports bond issuers from 1980 – 2002" (Kaplan, 2009). The caveat to this statistic is that the number of distressed companies within the "Other / unknown" category could contain "hidden" defaults.

There is also the reputational and political risk associated with private equity that should be considered. Private equity transactions often employ aggressive cost-cutting strategies on their portfolio companies in order to increase efficiency and productivity. Critics of private equity cite job loss and lack of innovation as the negative effects of private equity. Recently in a *Medium* post, former Democratic presidential candidate and senator from Massachusetts Elizabeth Warren called private equity firms "vampires – bleeding the company dry and walking away enriched even as the company succumbs" (Warren). Politicians are painting the industry as a whole with a broad brush and blaming it for the shutdown of prominent businesses such as Toys-R-Us and Sears. It is becoming increasingly more important for funds to consider not just shareholder interest but also stakeholder interest.

The final area of risk is from competition. In the past few years, private equity has been receiving a record amount of cash inflow in its fundraising. To better understand this, we will analyze the data collected and published by Prequin, a data provider for alternative assets professionals that covers private equity, venture capital, hedge funds, real estate, infrastructure, private debt, natural resources, and secondaries. According to their research, "at the end of June 2018, private capital dry powder – the capital available for fund managers to deploy – surpassed the $2tn mark to reach $2.10tn" (Feliz, 2019). And of that $2.1tn, private equity dry powder accounts for the bulk of that number at $1.2tn. This "accounts for 58% of all available capital in the industry, the highest proportion seen since 2012" (Feliz, 2019). Figure 2.3 represents the data gathered about private capital dry powder reserves since December of 2006.

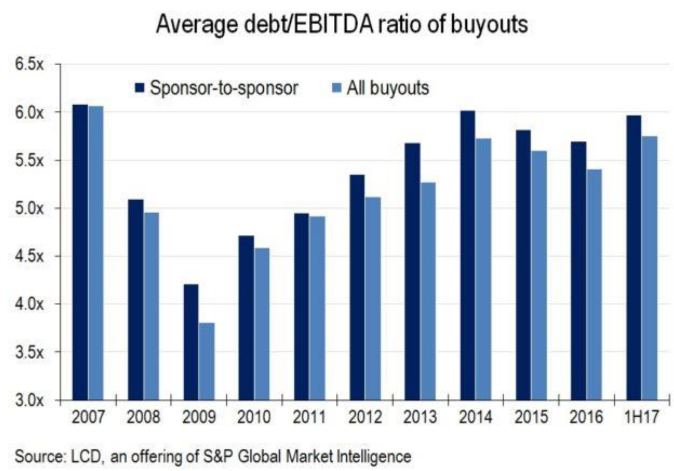
<u>Figure 2.3</u>




This increased level of dry powder is indicative of the increase in the number of firms and funds participating in this asset class. This can contribute to firms paying higher prices than before because each sale process is much more competitive. It is hard to differentiate because every single firm is looking for companies to purchase with stable cash flows, industry leaders, low capital expenditures, and / or areas for improvements. With higher prices, there is a smaller margin of safety when using a lot of debt and decreases returns.  Figures 2.4 and 2.5 from S&P Global Market Intelligence that show average EV / EBITDA multiples and Debt / EBITDA ratio of buyouts since 2007.

<u>Figure 2.4</u>


Figure 2.5




While private equity has strong value creation levers that it can use to generate alpha versus the public market, the need for differentiation is becoming more and more important. As a result, firms are turning to a variety of different strategies from specialization (i.e. KSL Capital Partners Specializes in Leisure and TPG has recently raised a healthcare-focused investment vehicle) to changing market size up to megafunds or down to smaller lower middle market companies. As a result, we are seeing the emergence of more and more “mega-funds,” which is an investment vehicle with a pooled capital of $5bn or more. However, the next section will focus on a more underappreciated part of the market, the small business market. It will analyze the current small business market conditions as well as some of the advantages and risks.

**Small Business Market**

In the United States, the small business investable universe for the purpose of this thesis is defined as businesses with revenues greater than $2.5mn and less than $100.0mn. NAICS's September 2019 data estimates that there are roughly 523,970 businesses that fall within this range.

Figure 3.1

| Annual Sales Ranges | Number of Businesses |
|---|---|
| **Under 500,000** | 12,723,110 |
| **500,000 – 999,999** | 789,466 |
| **1,000,000 – 2,499,999** | 555,399 |
| **2,500,000 – 4,999,999** | 220,032 |
| **5,000,000 – 9,999,999** | 141,160 |
| **10,000,000 – 99,999,999** | 162,778 |
| **100,000,000 – 499,999,999** | 19,459 |
| **500,000,000 – 999,999,999** | 3,068 |
| **1,000,000,000+** | 3,874 |
| **Uncoded records** | 1,747,539 |
| **Grand Total** | 16,365,885 |

This is the ideal range to target because companies with over $100mn in revenue are targets of private equity firms that can often pay a higher price because of their access to cheap debt. However, as it gets smaller, there is less and less of a private equity / institutional presence because sourcing in this area can be very time consuming and might be too small of a check size for the private equity funds which have to deploy all of their capital within a set timeframe. Generally, the more competitive a sales process is, the higher the purchase price. On the smaller end, investors are still looking for a company that can generate a sufficient financial return to reward the amount of time spent on diligence.

Now, other than having less competition from other institutional investors there are several other advantages for focusing on the small business market. First, prices are generally cheaper. In the private equity section, the average purchase price multiple for companies was around 10x EV / EBITDA. In contrast within the small business market, the deal multiples are smaller and directly correlated with the size of the company. Using the research from the 2019 Pepperdine Private Capital Markets Report, Figure 3.2 shows the median deal multiples by EBITDA size of company:

Figure 3.2

| EBITDA | Manufacturing | Construction & engineering | Consumer goods & services | Wholesale & distribution | Busines s services | Basic materials & energy | Healthcare & biotech | Information technology | Financial services | Media & entertainment | Average |
|---|---|---|---|---|---|---|---|---|---|---|---|
| $0K - $999K EBITDA | 5.0 | 3.5 | 4.3 | 5.5 | 3.0 | 5.0 | 4.3 | 7.0 | 5.5 | 4.0 | 4.7 |
| $1M - $4.99M EBITDA | 5.5 | 4.5 | 5.5 | 5.5 | 4.8 | 5.5 | 5.5 | 7.5 | 6.0 | 5.5 | 5.6 |
| $5M - $9.99M EBITDA | 6.5 | 5.0 | 5.8 | 5.8 | 5.3 | 6.0 | 7.3 | 8.0 | 7.5 | 6.0 | 6.3 |
| $10M - $24.99M EBITDA | 7.5 | 6.5 | 6.5 | 7.5 | 6.0 | 6.0 | 7.5 | 8.5 | 7.8 | 6.5 | 7.0 |
| $25M - $49.99M EBITDA | 7.5 | 9.0 | 8.0 | 7.5 | 7.0 | 6.5 | 8.0 | 9.0 | 8.0 | 8.3 | 7.9 |
| $50M+ EBITDA | 8.0 | n/a | 8.0 | N/A | 7.0 | 7.0 | 10.0 | 10.0 | 8.0 | n/a | 8.3 |

In this space, disciplined investors are able to pay 3.0x – 5.0x EV / EBITDA for a company. To put this in context, if that investor is able to keep the cash flows of the company steady for 4 years on a company they paid 4.0x for, they would be able to make their initial investment back, corresponding to an implied annual return of 25%, which is much higher than most well-diversified public market mutual funds. The lower the initial purchase price paid, the larger the margin of safety that exists for the investor.

**Venture Capital**

In private capital, there is often a distinction between venture capital, growth equity, and private equity based on where a company is in its life cycle. Venture capital is generally associated with investing in startups and companies with high growth potentials in contrast to the mature companies and industries that private equity focuses on. Therefore, it requires a vastly different skill set to be successful and has a different business model with higher risk and return investments. As a result, the venture capital model is sometimes referred to as “moonshot investing,” or investing in a basket of companies with most failing, but a few big winners that dictate the success of the fund.

Permanent equity is inherently the opposite of many core aspects of venture capital because rather than the high growth and exciting businesses targeted by venture capital, permanent equity prefers to focus on much more steady cash flow positive businesses. However, there are some positive aspects of venture capital that can improve the performance of permanent equity funds. The most important of these positive aspects is sourcing and deal origination.

Deal sourcing or deal origination is how many potential investment opportunities an investor is able to find. For investing, venture capital sourcing is the most similar to permanent equity. Both asset classes are working in a more opaque corner of the market where information is not readily available like in public markets. In many cases, the founder / owner of the business has also never experienced an equity transaction and could require some handholding throughout the investment process.

Investors can source deals through a variety of channels. These can include, but are not limited to, proprietary interactions, brokered transaction, industry conferences, partner referrals, and reputation. Proprietary interactions are often initiated by the investor or fund. This can range anywhere from a cold call to an opportunity through an acquaintance. Most investors prefer proprietary sourcing because it generally means less competitive bidding processes. The second channel is a brokered transaction. Brokered transactions can come from a third-party middleman such as investment banks, broker-dealers, or in some cases, lawyers and accountants. These processes are often a little more competitive because the brokers generally want to get their clients the highest possible price. Industry conferences are often cited as sources of deal generation. At these conferences, investors often go to meet with founders and CEOs to learn about the industry trends and network for potential investment opportunities. The fourth channel is partner referrals. Unlike brokered transactions, partner referrals are more of a warm introduction. It could be from a friend, accountant, lawyer, etc. but oftentimes is not as competitive of a bidding process. The final channel mentioned above was reputation. Reputation allows firms such as Sequoia, Kleiner Perkins, Andreessen Horowitz, and Bessemer Ventures to not have to do much of the sourcing themselves. Instead, they have established themselves as such industry leaders that top startups have to compete against each other for the opportunity to pitch their ideas to these marquee funds. In many of these cases, receiving money from these funds represents a validation of their ideas.

Now bringing it back to permanent equity, all of these sourcing techniques can be used to generate deal flow except for reputation which will take time to build before that channel begins to pay off. How an investor or fund does the pitch is a potential source of alpha generation and differentiation which will be examined later.

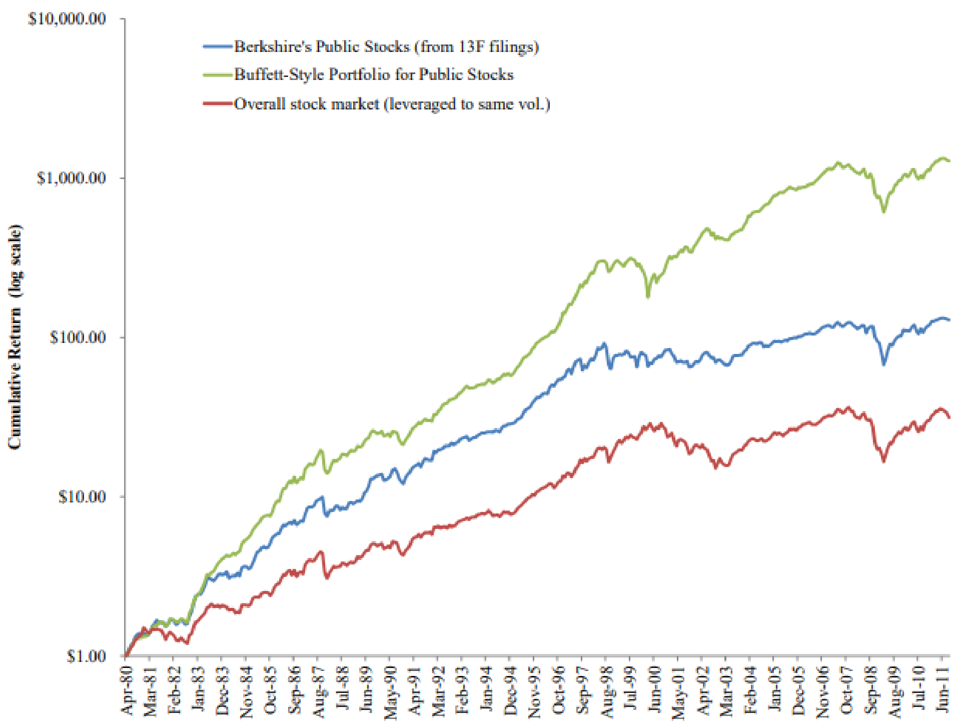
**Value / Quality Investing**

Over the past few years, factor or style-based investing has gained prominence and popularity in the markets. While the amount of publicly available research has played a large role in the rise in popularity, Warren Buffett's track record at Berkshire Hathaway has garnered an almost cult-like following which led students of his investing style to study the basic ideas of value investing and diving into the works of his mentor, Benjamin Graham. Graham is widely referred to as the "father of value investing." His books such as *Security Analysis* and *The Intelligent Investor* have become almost mandatory readings for value investing.

In order to understand value investing, it is first important to understand the debate on the efficient market theory. Proponents of the theory suggest that anyone who is able to outperform the general markets cannot do so in the long-term. Their short-term success is attributed to simple luck. However, the performance of Buffett's Berkshire Hathaway and other people who invest in a similar style seem to counter this argument. Between 1980 and 2011, Berkshire Hathaway was able to significantly outperform the overall stock market in the same period of ups and downs. In their paper titled "Buffett's

Alpha," Frazzini, Kabiller, and Pedersen attribute Buffett's long-term alpha to buying "stocks that are "safe" (with low beta and low volatility), "cheap" (i.e., value stocks with low price-to-book ratios), and high-quality (meaning stocks that profitable, stable, growing, and with high payout ratios)" (Frazzini, et al., 2013). When paired with some leverage, Figure 4.1 illustrates how much combining these two forms of investing can outperform the public market and in turn generate significant alpha.

Figure 4.1




**Summary**

In today's market, it is becoming harder and harder to differentiate and generate alpha. However, by combining some of the best attributes of private equity, venture capital, and factor investing in the small business market with an unlimited investment time horizon, permanent equity has the opportunity to outperform significantly. So, what exactly does permanent equity in the small business market look like in the context of this thesis?

Depending on the amount of capital that is able to be raised, funds target businesses that generate anywhere between $2.5mn and $100.0mn in revenue and use many sourcing techniques employed by venture capital or some search funds. Many of these businesses have attributes that are associated with the quality factor that many larger private equity funds and public market investors focus on, such as low betas and volatility, profitable, stable revenue growth, moderate growth, and high payout ratios. Given the size of the business, they often trade at very low multiples and have the same qualities that are important to the value factor such as low price-to-book and a large margin of safety. Investors often have the choice to use leverage during their deal structuring that can improve their returns, but also increase the risk. Once the fund has acquired a business, it has a theoretically indefinite holding period. When perfectly applied, it is entrepreneurship through acquisition, and then the underlying cash flows are used to fund future acquisitions until a diverse portfolio is created.

The rest of this thesis aims to explore the different areas and choices that could lead to outside returns and the risks associated with making these choices. It will not discuss the search process as in-depth as prior literature on the subject such as the *Stanford Search Primer* and *The HBR Guide to Buying a Small Business*, which cover this topic.

Specifically, the following sections will dive into four different areas: sourcing / process, negotiations, differentiation, and structuring. Each section will examine the various choices that an investor must make within that category. It will combine anecdotal examples from some industry practitioners as well as draw on the expertise of various bankers, accountants, and lawyers. When possible, some additional data will be provided to supplement the interviews.

# Alpha Generation

### Sourcing / Process

The first area of potential alpha generation is sourcing / process. This section is an area where differentiation such as relationship building, investment discipline, and efficiency has an outsized impact on investment performance. During the search process, an investor must decide how much of their time is split between brokered and proprietary searching. Both styles have their respective advantages and disadvantages that investors must take into consideration. In addition, their screening process adds another layer of differentiation and reflects their investment acumen and discipline.

During an active search, the first question that an investor must weigh is how much time they want to allocate between brokered and proprietary searching. This thesis defines a brokered search as one that is facilitated by an intermediary such as a business broker, investment bank, or professional referral of an accountant, lawyer, or other industry professionals. Oftentimes in the small business market segment, the owners of the business are first time sellers and hire the professional intermediary for their expertise and experience. According to *HBR*, “the brokers typically manage all aspects of the process, including negotiating terms and price for their client. The broker also puts together documentation about the company; the information can help you as a buyer identify early on if the purchase isn’t for you.” (Ruback, 2017).

A brokered search is often a quicker process than proprietary search. This is because the sellers are generally more motivated and committed to the process, especially if they retain a business broker or investment banker to facilitate the sale of their business. In addition, the intermediary is usually experienced in the process and generally knows what potential acquirers look for in a business and what could potentially be a sticking point that could prevent a deal. They will usually bring forth any strong qualities of the business without asking and prepare mitigants for any potential issues / points of contention.

The two types of brokers that an investor will most likely encounter are a business broker and some small investment banks / M&A advisors. The primary difference between the two is that business brokers generally do not hold any securities licenses and their suite of services do not include capital raises or valuation advisory. In addition, business brokers do not need any certifications in many states such as South Carolina. In the US, only 13 states require a business broker to have a real estate license. These states are Arkansas, California, Colorado, Florida, Georgia, Idaho, Illinois, Michigan, Minnesota, Nebraska, Nevada, Oregon, South Dakota, Utah, Wisconsin, and Wyoming.

There are several advantages to using business brokers including alignment of interest with the seller and a narrow process. Small business owners are often first-time sellers and will hire a business broker to assist them throughout the process. The business broker is responsible for the marketing of the business, estimating the value of the business, vetting potential acquirers, negotiating the purchase price and terms, and assisting through the due diligence and final close. Business brokers help ensure that the seller is motivated because their services could include a fee of $500 - $25,000 to create a Confidential Information Memorandum (CIM) for the small business. This cost is not insignificant for small business owners who tend to scrutinize all expenses.

Figure 5.1 is the table of contents of a sample CIM from online – the link to the entire CIM is found below the figure. It highlights the most important aspects of the business and can include samples of financials, industry background, company business model, and potential risks to the business. CIMs can range from 20 pages to 100+ depending on the complexity of the business. Therefore, it is essential for the investor to develop a methodical way to understand the most important information and quickly decide if this is a business that warrants a deeper dive or not.

Figure 5.1

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http://biws-support.s3.amazonaws.com/CIM/CIM-07-Sample-Template.pdf

In addition to having a more motivated seller, business brokers are incentivized to close the deal. According to the *Business Broker Journal*, brokers are generally compensated through a success fee. This fee ranges from 8 – 12% of the total purchase price, or for smaller transactions, there will be a minimum commission fee of $10,000 - $20,000. Therefore, business brokers are incentivized to close as many deals as possible. In an interview with David Yezbak, the president of Sunbelt Business Brokers in Columbia, South Carolina, he said that his average engagement will take around 9 months.

Brokers often operate like real estate agents when selling businesses. In many cases, they will not run a competitive selling process; however, this can vary on a per-company basis. But when the broker is not running a traditional process, there is often only a single buyer which means that there will not be a bidding war to drive up the price and the broker is solely focused on getting the deal over the finish line. “Of course, there are exceptions to this with larger and more established business brokers that can run a more competitive process” (Mills). In addition, an experienced broker will try and address any potential questions or concerns that the buyer will have ahead of time in their CIMs such as customer concentration, competitive advantages, and reliance on the owner. They will also include reviewed financials, if available, and condense the tax returns into a digestible format too. Despite this, how much an investor decides to believe in the projections depends on their risk tolerance, quality of the broker, and seller optimism. It is important to remember that the CIM is ultimately a marketing material produced by the broker to help sell the business to investors. Even with a more transparent broker, they are still just an intermediary and are taking the information that is given to them by the owners of the business, who might not be able to see the risks from an investor’s point of view. These can include owner dependency or asset intensity.

While searching through business brokers can be a quicker process, there are several important risks to consider. First, not all business brokers are the same quality. Because typically there are no license requirements, some brokers could ask for an extremely high or unreasonable valuation for a cyclical business like a restaurant. One potential way to screen is to check if they are a part of a reputable business broker association. The four largest ones are Alliance of Merger & Acquisition Advisors (AMAA), American Business Brokers Association, Association of Professional Merger & Acquisition Advisors (APMAA), and International Business Broker Association (IBBA). Each of these organizations holds conferences that update business brokers on market trends and potential new valuation methods. In addition, the networking aspect of these organizations allows for the brokers to trade war stories and share ways they sold potentially similar businesses. However, this simple screen will not guarantee that an investor will not engage and spend time working with a broker that asks for unreasonable prices. It can take quite a lot of time making introductions, building and maintaining relationships with brokers, and sifting through all of the teasers and CIMs.

In addition, using brokers could limit your potential ability to run across a good business that is up for sale. Firstly, brokers will often use websites such as Axial, a private network that helps middle-market companies and advisors find the right buyers and investors, or Bizbuysellbiz, the largest and most heavily trafficked business for sale marketplace on the Internet, to list their clients. Anyone who is in the market could find that business and because the business broker model is first come first serve, an investor might miss out on potential investments. Also, not every business owner that is interested in selling use business brokers. Exclusively sourcing through a business broker would narrow the total addressable market.

Business brokers are not the only potential source of brokered deals. Deals can also come from investment banks or through professional referrals such as accountants, C-suite executives of other companies, or lawyers. Investment banks become more and more prevalent as the businesses get larger (usually $3 million + in EBITDA). These deals can often be much more competitive during negotiations, which will be discussed in greater detail in the negotiations section because bankers can often run a robust process due to the larger amount of buyers (small middle-market private equity shops, strategic buyers, etc.).

As funds become more established and get more deal exposure, they can sometimes begin to receive leads from accountants, corporate lawyers, or other business owners to potential deals. Professional referrals have aspects of both proprietary and brokered sourcing because the relationship and referral are unique to each investor, but the transaction is still facilitated by an intermediary. This goodwill can be built upon by helping and providing advice and referrals to businesses that are too small or big for an investor’s check size. For example, Bluegrass Equity would refer company owners who were too large for to buy to some of the smaller investment bankers that they had established relationships with. In return, these banks and also some of the owners would refer smaller business owners trying to sell to Bluegrass Equity. Another example was quoted by Irena Blind of TSG Consumer Partners in an interview with Axial. She said "If they're not in need of capital right now, we stay in close contact and help provide feedback and guidance. From a size point of view, the transaction can become right within 12 months" (Daniels). These sorts of relationships take time to build but can be a source of significant sourcing differentiation. While a deal might not pan out immediately, it could happen in as little as a few months as circumstances change or years later after an investor has made other acquisitions.

Permanent Equity was able to build a formal referral network because of its record of being able to close deals with simple deal structures. Their "Scout Network" program incentivizes individuals to refer deals to them by compensating them with a "Big Check: $100,000 + $25,000 Adventure of a Lifetime Vacation" (Scout). On top of the compensation, Permanent Equity also offers deal coaching, events and training, and gear.

The other type of sourcing is proprietary sourcing. A proprietary deal allows a buyer to have an initial look and opportunity to do an investment before the deal is presented to other potential buyers. These are usually outside of any formal process ran by an intermediary like an auction. Proprietary sourcing presents a significant investment opportunity for buyers at lower prices and a larger pool of opportunities. However, it also has some disadvantages that are important for investors to keep in mind.

As the founder of Axial Peter Lehrman states, "Proprietary deal flow isn't dead, but it is rare" (Daniels). As noted earlier, proprietary deal flow can come from an existing relationship, or it can come from direct sourcing. Direct sourcing can be through cold contacting business leaders, or through them proactively searching for an investor. With both methods of direct sourcing, it is important for the investor to first understand their own identity. This requires a great deal of self-introspection of their value proposition and being able to not only identify but also clearly articulate their differentiation from other potential investors. Axial recommends that investors "clearly lay out your investment focus and value-add on your website and other channels (social media, deal sourcing networks like Axial, etc.). Highlight closed transactions and include industries of interest and what size deals are in your strike zone to show new contacts how they might work with your firm" (Daniels). These recommendations help establish professionalism and credibility. Especially, closed deals can help reaffirm how serious a buyer is and that they are truly willing to spend money according to their investment criteria.

Direct cold outreaches can provide investors some flexibility including geographical preference, competitive bidding processes, a larger total addressable market, increased personal relationships with potential sellers, and the opportunity for more thesis-driven investing. Unfortunately, this method is extremely time-consuming because it adds a few important layers of screening to an investor's search process. As Ruback and Yudkoff point out in their HBR report, "direct sourcing requires that you communicate with thousands – yes, thousands – of companies' owners to find those who are interested in selling their businesses" (Ruback). Therefore, maximizing response rate and efficiency can greatly increase the odds of an investor finding a strong business with a unique niche at a good price.

Earlier in the small business background section, it is estimated that there are roughly 500,000 small businesses that fit this investment criterion. Ruback and Yudkoff estimate that only 5 – 10% of business owners are interested and willing to have an initial conversation about the sale of their business. Using these estimates, that 500,000 is then narrowed to somewhere between 25,000 – 50,000 businesses. Paired with the naturally low response rate of cold emails or calls, potential investors should employ various strategies to increase their total number of outreaches, improve their response rate, and streamline their investment pipelines.

There are various strategies that can be employed to increase the total number of cold outreaches. The first of which is team capacity. The investor must decide if they want to do an individual search or a partnered search. Partnered searches can increase the capacity and can be extremely beneficial if the partners' skills complement each other (i.e. one who is better at operations and the other who is better at negotiations). Partnered searches can also provide investors with a support system throughout the acquisition process which can sometimes last for two years. However, partnered searches increase the cost of the search (forgone salaries, increase office expenses, increased travel expenses, etc.). In addition, investors should consider the more partners they have, the smaller share of equity they receive.

Once the number of primary partners is determined, the investor can build out their team through interns initially and then transition to full-time staff as they become more established and have completed multiple acquisitions.

Interns can be used to help source and screen for investment opportunities. The investors can decide if they want the interns to be salaried, paid on a stipend, commission-based, or unpaid. Each of these options has a potential trade-off. For example, salaried interns can be an expensive option, but already have some industry experience or unique skills such as coding. In contrast, unpaid interns need a strong incentive to do quality work and will probably require more time to get trained. Some potential options are more one-on-one training, professional development, professional introductions to whatever career they are ultimately pursuing, research opportunities, and being tasked with more important responsibilities. Unpaid interns will likely limit investors to the local talent pool and students with the family means to support an unpaid internship, because they will not have to pay any additional rent. Some additional incentives to consider are some universities will offer course credits for internships or provide research grants if a meaningful research topic can be applied. There are also a few firms that offer remote deal sourcing interns a percentage if the deal is closed. There is a lot of flexibility available to the investor, but each has its own set of trade-offs.

Another option to expand the team's sourcing capabilities is to outsource or contract out work. Websites like Upwork allow you to outsource tasks to lower labor cost countries. It is possible to hire anyone to do data entry to higher commission freelancers that can build the valuations for the investor. It is important that outsourcing also requires time to train the freelancers, and also someone to constantly check their work. Some firms will use it as an opportunity to provide their interns leadership experience to train and manage their freelancers to do some of the more repetitive tasks and analysis. For example, the Bluegrass Equity employed freelancers to help build its internal database with information such as city, state, and industry of the target companies to help personalize the outreach.

The second strategy is increasing efficiency. This can include things as simple as learning shortcuts. Most investors have backgrounds in investment banking, consulting, or some other corporate finance role and already have a pretty strong proficiency in this area. However, they can always further improve their productivity with the augmentation of various process tools in their search. There is a large range of technology to help with this and it is nearly impossible to list them all. However, to provide a few examples, Bluegrass Equity uses:

1. An integrated customer relationship management (CRM) system that synced with its Gmail emails and streamlines the prospects pipeline.
2. An automated mail merge system that will be discussed in more detail later on.
3. Email add-ons that can track help schedule and keep track of following up on emails.
4. Programs to verify the email address. Oftentimes, databases such as Reference USA or Dun & Bradstreet can have incorrect emails because finding data on small private businesses is extremely hard. Emailing too many wrong emails can often flag an email account as spam.
5. Investing in Adobe Acrobat Pro. It has an OCR Text recognizer function that can copy text from scanned PDFs. This is important because many small businesses only have S-Corp tax returns.
6. Learning to build web scrapers to quickly process and analyze industry databases and draw information.

In summary, there are many tools available that can improve efficiency. Investors can benefit and gain an edge by staying up to date with the latest technology and successfully incorporating it into their process. Also, it is always a good idea to maintain a rough performance tracking system to review periodically. It will allow investors to see what they are spending the most time on and try and figure out a more efficient way to approach that process. Every minute that an investor saves can be spent sourcing another opportunity, working on a model, researching an industry, etc.

The final strategy is to increase the conversion rate of the cold outreaches. Ruback and Yudkoff recommend that "once you [the investor] have assembled your list of prospects, you will need to determine the right combination of personal messages and mass mailings to reach out to owners ... you might more reasonably target the more personalized messages to prospects that seem more appealing" (Ruback). Bluegrass Equity also found that personalized emails had a much higher response rate and more friendly reception than generic mass emails. They found it worthwhile to invest in freelancers to find up to five variables including city, state, industry, etc. in his mail merges to increase the personalization of the emails.

In addition, Bluegrass Equity found over time that business owners value and respect persistence. Therefore, they built into their mail merge program a series of four follow-ups that got simpler and less frequent over time. Surprisingly, many business owners will respond to the fifth email that might arrive a month or two later because they were curious about how persistent the buyer was.

There are other areas to explore that can improve response rates too. YesWare, a company that provides a variety of software solutions that track, measure, and optimize sales outreach all from your inbox, published a research report detailing the time a cold email was sent. "In an analysis of about 30 million cold emails sent by Yesware users, we found that 58% of them go unopened" (Ng). Later in the report, they also found that the people in different cities have different habits of when they are more likely to check and respond to emails too. "For example, we found that emails received by New Yorkers had the highest chance of getting a response when received at 6 pm. If you're sending that email from San Francisco, that's 3 pm for you" (Ng). In summary, there are probably thousands of ways an investor can improve their conversion rate, but it takes time to research all of these methods. It should be seen as a way to enhance their search process, not become the core focus.

It is important to keep the risks of direct sourcing in mind. The biggest risk of direct sourcing is how time-intensive the strategy is. Not only does it take time to thoughtfully design and build out some of the processes highlighted earlier, but also investors have to spend a lot of time educating the sellers too.

Oftentimes, the potential seller that investors approach has never been through an acquisition process and it is likely their first time selling a business. Therefore, the buyer has to take time to explain the valuation, process, and judge seller interest all at the same time. Bluegrass Equity found that the most efficient method is to be completely transparent with the seller (i.e. explaining that valuations in this market size are between 3 – 5x EBITDA and that the business owner can usually make that amount of money in 3 – 5 years of continuing to run the business). It helped build trust with the seller and helped Bluegrass eliminate any reluctant sellers fairly early on in the screening process.

An investor can choose to source exclusively from brokers, directly, or some combination of the two. There are tradeoffs between the strategies, but it is much more important for the investor to have a rigorous screening process. Due to the nature of the size of the business within this market, many businesses do not fall in the category of a permanent equity acquisition target for a variety of reasons such as cyclicality, owner risk, and willingness to sell. Therefore, it is imperative for the investor to create a reasonably repeatable screen process that can quickly filter for these traits. As the funnel gets narrower, the investor will have to spend more time and money on research and due diligence.

The initial screen should make sure that first the company is the correct size and is worth the time to take a second look. This can sometimes be deduced from the company website or through a quick introductory call. During this call, it is important to try and estimate the capital intensity and owner reliance while teasing out a range on their sales and EBITDA to help and determine if it is worthwhile to sign NDAs and move to the next step (Mills).

Once it is determined that a company is a prospect that warrants further diligence, the investor must then try and see if the business would be a good acquisition target for the permanent equity model. As published in *The Harvard Business Review*, "our first and most important recommendation about characteristics you want in your business is that you buy an enduringly profitable business with an established model for success – one that is profitable year after year" (Ruback). In order to screen for this, investors can look at customer retention rates, analyze the customer concentration, review both historical sales and profit, examine the strategic positioning, and avoiding cyclical industries. Permanent Equity also tries to figure out if the owner is wealthy when possible without being intrusive. For example, if the owner is able to afford second homes, boats, or even a small plane, then that business probably generates enough profit to support their strategy. In addition, it is still just as important to fully understand how dependent the business is on the original owner. A lot of owners like to think that their business is self-sustaining and they can go on a three-month vacation at a moment's notice. Unless they actually do that on a regular business, the investor needs to ask questions like what are the types of decisions only the owner can make and interview employees and business contacts like suppliers as the diligence efforts progress further.

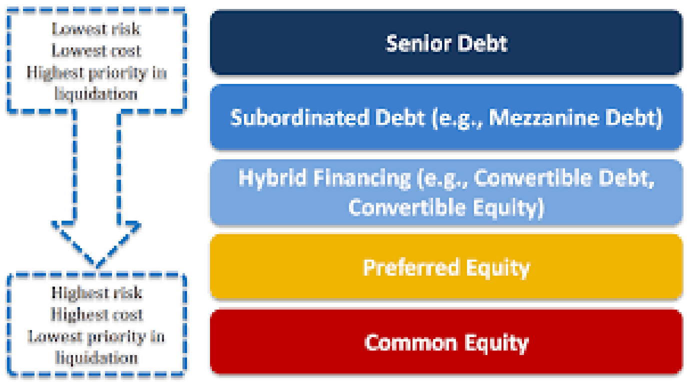
Part of the screening process often includes on-site visits. These visits can add up quickly in costs, so many investors like to wait until it is past the Indication of Interest (IOI) phase if it is an intermediated deal or after a verbal agreement on a general price range for more direct sourced deals. On-site visits provide a great opportunity to build a good rapport with the potential seller and gain a better understanding of the business and how it works. Initial on-sites might be limited to just the business owners who can be sensitive to letting their employees know that they are selling before it is set in stone. As the process moves further down the line, then introductions to the rest of the team are much more likely.

Other diligence items for investors to consider are the key business risks, any potential growth catalysts, detailed financials, sample contracts, and loan documents. In summary, the further along an acquisition process a deal moves, the investor generally wants as full of a picture as they can get before spending a lot of money on accountants and lawyers in the Letter of Intent (LOI) phase.

**Structuring**

Deal structuring is an area that can generate a lot of differentiation between funds. This section focuses on the sources of financing a permanent equity deal which includes equity from the investor, debt, and cash from existing portfolio companies as well as what percentage of the company the investor should acquire. “It influences everything from the firm’s risk profile, how easy it is to get funding, how expensive that funding is, the return its investors and lenders expect, and its degree of insulation from both microeconomic business decisions and macroeconomic downturns” (Zhu). Below in Figure 6.1 is a basic chart from Axial for how a company’s capital structure looks. Seniority is based on the riskiness and priority of being paid in the event of a default or distressed situation.

Figure 6.1




The first way to structure a deal for investors is equity. Equity investments in their simplest form are money that is invested in a company by purchasing shares of that company. In the context of permanent equity investing, equity investments would be made with any combination of the investors’ personal fortune as well as any funds raised from outside investors. While equity can be the riskiest part of the capital structure, it has a theoretically unlimited return and constitutes ownership of a business.

Permanent Equity is a fund that tries to maintain a clean (100% common shares) capital structure by only investing with equity. They often use this as a differentiator. In competitive processes, they are often able to compete against private equity funds for owners that care about more than just price. While private equity funds can often pay a higher price, the equity-only investment style often appeals to small business owners, many of whom are debt adverse and use little to no debt in their day-to-day operations. Additionally, while it doesn’t amplify returns in good case scenarios, by only using equity, Permanent

Equity does not have to worry about meeting covenants and covering interest payments. This provides them with a level of flexibility and nimbleness in downturn scenarios.

While they prefer using only equity, some deals might need some downside protection structured in. Permanent Equity is able to achieve this through negotiating seller's notes, earn outs tied to retaining customers or revenue from certain contracts. This can allow them to invest in companies with higher revenue concentration on one particular customer or tied to a few large contracts that are up for renewal.

The second way an investor could finance their acquisition is through the use of debt. The background of this thesis discussed the advantages and potential risks of applying private equity style leverage. In the small business permanent equity space, leverage can not only enhance equity returns through financial engineering but also be structured to align interest with the current owner and have potentially lower interest rates.

The primary way of financing is an SBA loan. The Small Business Administration (SBA) works with lenders to provide loans to small businesses. According to their website, the "agency doesn't lend money directly to small business owners. Instead, it sets guidelines for loans made by its partnering lenders, community development organizations, and micro-lending institutions. The SBA reduces risk for lenders and makes it easier for them to access capital. That makes it easier for small businesses to get loans." The two SBA options are an SBA 7(a) or an SBA 504. The 504 is generally larger than the 7(a) and primarily for small business to fund real estate or equipment capital expenditures. Therefore, most business acquisitions will be with the SBA 7(a).

The difference between using leverage in permanent equity with leveraged buyout private equity strategies is that permanent equity does not need to have as much, if any, job cuts. The idea behind that is that the employees are what made the acquired business successful in the past. Therefore, investors will need all of them to continue running the business smoothly and make sure it performed as it used to. The debt, in this case, is for taking advantage of the tailwinds of a successful business and enhancing the investor's return reasonably. The investor should determine if the business can reasonably withstand a debt load during their diligence process. If they are trying to own the business for an indefinite period of time, burdening the business with an unreasonable debt load would be counterintuitive. To determine what is a reasonable debt load for a business, an investor might get multiple debt reads from banks.

Both SBA loans will be the most senior form of debt in the capital structure. However, the capital structure can vary based on how large the loan is. For example, a 7(a)'s a sample capital structure could be 90% debt from an SBA loan with a 10% equity commitment from the investor. On larger 504 loans, the SBA loan can often be 50% bank debt, 40% business development corporation (BDC), and 10% equity commitment from the investor. In this structure, the bank is the most senior followed by the BDC. In addition, the lenders could ask the investor to secure the loan through a down payment or collateral upfront. The collateral could include real estate, equipment, vehicles, accounts receivable, or other business or personal assets. It is important to keep depreciation of some of these collateral items in mind because the lenders might discount the value of the collateral. The terms an investor negotiates can vary depending on the type of business, size of the loan, and how many lenders they approach (the more lenders an investor approaches, the more time will be spent in negotiations).

Moving down the capital structure, an investor might also include some owner / seller debt when structuring the offer. Owner debt effectively defers the payment of a portion of the business and offers an interest rate between 6 – 10% to compensate the seller for the time they have to wait for the rest of the payout. The sellers' note can offer the owner a higher selling price than an all-cash deal and is often a feature of a deal that contains challenging characteristics such as small size, customer concentration, growth capital needs, high capital expenditures, cyclicality, or seasonal revenues. In addition, the seller's note helps align interest during the ownership transition period. When the seller still has a percentage of the company of the selling price tied to the success of the company after the sale, they are more likely to work to ensure a smooth ownership transition. As a result, other debt financers such as banks or SBA lenders tend to prefer to see sellers' notes included in the capital structure.

It is important to keep in mind that a seller's note is generally unsecured and is usually subordinate to the bank or SBA loan in the capital structure. With the higher risk, seller's notes are generally compensated with higher interest rates which typically range from 6 – 10%. The structure of these notes can vary depending on the negations between the buyer and seller. According to the *Exit Promise,* this can sometimes appear as "initial deferred or interest-only payments followed by a balloon payment to reduce the cash flow pressure on the buyer during the transfer of ownership" (Magister). In addition, the seller can include protective covenants in the note receivable such as:

- Retention of the deed or title to the property in an Escrow account held by a third party until the note is paid in full
- Interest rate escalation rights if the buyer defaults on the payment terms
- Financial reporting rights to allow the seller to keep tabs on the business' ability to make future payments
- Debt Service Coverage Ratios requirements, similar to those a traditional bank lender may impose on a borrower

The final form of debt financing available is mezzanine debt. Mezzanine debt is typically found in-between the senior debt and equity in the capital structure. Most mezzanine debt funds in the small business space are structured as a Small Business Investment Company (SBIC). SBA.gov defines an SBIC as "a privately owned and managed investment fund that's licensed and regulated by the SBA. An SBIC uses its own capital, plus funds borrowed with an SBA guarantee, to make equity and debt investments in qualifying small businesses" (SBA). Mezzanine lenders are not to be confused with SBA lenders because they are willing to lend to riskier companies or industries that banks don't traditionally lend to such as small SAAS businesses in exchange for higher yields. In addition, mezzanine lenders such as Route 2 Capital target companies between $2 – 15 million of EBITDA and are flexible enough to participate in both the debt and equity stacks of a company's capital structure. They often participate in lower tranches of the capital structure alongside SBAs and banks and compete more with other SBICs, BDCs, and PEGs.

Mezzanine lenders typically will lend directly to the companies, Private Equity Groups (PEGs), or independent and fund-less sponsors. Their underwriting criteria have many similarities with permanent equity such as avoiding cyclical industries, real estate dominant deals, customer and supplier concentration, or uncertain cash flows. The only exception is mezzanine lenders also like to underwrite technology companies which many permanent equity funds would avoid.

There are a few advantages of using mezzanine debt. Firstly, mezzanine debt is an additional source of funding in an underserved part of the business market. Secondly, it can allow for more flexible financial engineering solutions such as recapitalizations and refinancing. Thirdly, because many of their deals include an equity portion, these managers can often lend industry and operating expertise to the companies and investors that they underwrite. Finally, SBIC fund managers have access to low-cost SBA capital which gives them more "pricing flexibility across cycles, while the 10-year term on SBA debentures avoids the problems of duration mismatch" (SBIC). A typical deal might look like a 30% bank term loan with a line of credit at the senior level, 30% mezzanine debt, and 40% equity. If there is a seller's note, it would typically be subordinate to all of the other debt. In addition, preferred equity could sometime be included in some more complex deals (Weston).

Mezzanine debt is intrinsically also riskier because of its place in the capital structure. Mezzanine lenders will underwrite a 2.0x MOIC (multiple of invested capital) and a mid-teens IRR. In order to achieve this target, they have a variety of levers they can utilize. They typically include a higher interest rate of around 11 – 13% with a 2% fee in their underwriting. In the lower middle market level, the majority of mezzanine debt includes covenants such as fixed charge, leverage ratios, CAPEX, minimum EBITDA, among others. This means that unlike the larger end of the market where cov-lite loans (covenant light or loans without covenants) are the majority of the market, these lower middle-market mezzanine loans can have these covenants that protect the lender but also increase the risk of default for the company / investor. In addition, many mezzanine lenders like Route 2 are active investors and will participate in the equity portion of the deals and request board seats in their negotiations. This will dilute an investor's control of a company which is why mezzanine funds will occasionally compete on deals against PEGs that demand 100% control.

The final way to fund a deal is through the cash flow of the existing portfolio companies. As the investor's portfolio of companies grows, they can reinvest the excess cashflow in acquiring new companies. They can apply the cash as part of the equity in the deal structure or used to back leverage.

Another important consideration for the investor is if the seller should rollover any equity ownership. Like the sellers note, allowing the current owner to maintain an equity stake increases how much "skin in the game" they have. Because the equity has an unlimited upside compared to the debt-like features of sellers notes, the owner can be more motivated to help with the transition for longer and provide more insights into running the business. This can also be a useful tool for sellers who want a little bit of liquidity, but are not old enough to retire from the business entirely and would still like to manage the day-to-day operations. Therefore, some investment groups will not do a 100% buyout deals and might require the current management to retain 10 – 30% of the equity. However, how much equity to provide the seller is a point of differentiation for the investor. Some investors prefer complete control of the equity and will buy 100% of the equity because they can experience a larger upside, while others might be more inclined to negotiate for the owners to retain a portion of the equity.

**Negotiations**

Negotiations are another area for potential differentiation or alpha generation. An investor's ability to negotiate can help them lower the initial purchase price, build in downside protection into deals, and be used as a tool for sourcing more deals.

On the smaller end of deals, negotiations often comprise of just the owner and the investor and an intermediary such as a business broker, if there is an intermediary. In these deals, most sellers understand that deals are done on a cash-free, debt-free (all current outstanding debt is paid off by prior owner) basis, but sometimes can get caught up on negotiating a reasonable working capital allowance. A typical method to account for this is applying a 6-month average. Additionally, owners might not only be worried about price and may want to negotiate guarantees for their employees. In slightly more complex deals, earnout structures can be created to account for customer concentration risk or be dependent on the renewal of an important contract.

The owner's note is another tool to help align the interest of the owner during the transition period and for the future. In a lot of cases, these owners have been working in their industry for decades and the buyer might want to bring them in occasionally on an ad hoc consultancy basis. The most important thing about the owner's notes is that the owners need to be compensated fairly for the deferral of a portion of the total purchase price and the buyer needs to keep that in mind.

As the business sizes get larger, more sophisticated investors could potentially become a permanent equity investor's competitor. These can include PEGs, mezzanine lenders like Route 2 Capital, large strategic buyers, and esoteric strategies like Raven Capital. Increasingly, all of these buyers target the same general companies (i.e. stable cash flows, steady growth, low capital intensity, low operating leverage, etc.). In these situations, it is imperative to understand what differentiates permanent equity from all of the other strategies and the value proposition of the other buyers. The way that permanent equity is designed, investors will not be nearly as competitive on price as other investors. In general, strategic buyers can offer the highest prices because of various synergies. Strategic buyers will also pitch that they can provide the acquiree's employees a job, however, it can be significantly different working for a large corporation in contrast to a small business. Additionally, acquiring companies are much more likely to find cost synergies and fire the acquiree's employees rather than its own employees. Finally, there can be a culture clash as even companies within the same industry can operate differently. Then PEGs can offer the second-highest because of their use of financial engineering. Esoteric funds can provide financing through asset-based lending like receivables, PIK, and IP with convertible debt-like structures that could allow them to participate in the equity.

Instead, permanent equity capital's pitch usually is to appeal to the business owner's risk tolerance and care for the employees. Unlike private equity, permanent equity does not seek an exit within 3 – 7 years and provides the employees of the company with a little bit more security and certainty. In addition, permanent equity funds are less likely to fire employees because of any cost synergies that a strategic might be able to find. The basic thesis for permanent equity is that the employees are what has helped make the business profitable historically. Unless their performance changes after the change of ownership, there should be no reason for layoffs.

Different permanent equity funds can have different unique value propositions that they use in negotiations. Bluegrass Equity often had many owners respond to the cold responses because of curiosity. While there is a class at Harvard Business School taught by Ruback and Yudkoff on entrepreneurship through acquisition, there are not nearly enough practitioners in such a large total addressable market for it to be widely known. The idea that the investor would take on the role of CEO and move out to the city of the potential acquisition target helped convey the seriousness of the buyer. Permanent Equity will pitch the simplicity of the deal structure. They typically structure their deals as all common equity which reduces the potential investment risk. Additionally, they will often avoid creating a formal board structure at the companies they acquire unlike many of the private equity firms they compete on deals with. They found that this can often be prohibitive or just the operators of their portfolio company merely checking off a box every few weeks.

**Differentiation**

The final area for alpha generation covered in the scope of this paper is broadly labeled as differentiation of a permanent equity fund. More specifically, it examines the various incentives of fund structure, the different value propositions of some funds, and how portfolio construction provides diversification or improved integration.

First, the fund structure can heavily influence the incentives and actions of the investor. One of the first choices that an investor is faced with is if they want to take outside money. They can decide to accept money from friends, family, institutional investors, search fund investors, or industry insiders. It is important to understand that any additional investment brought in results in equity dilution for the original investor. Additionally, each of these sources has its own set of benefits and risks.

Money from family and friends usually has less stipulations with it. However, they must understand that any investment can come with a certain risk. As a Forbes article warns, “if not handled professionally and sensitively, it can be your worst nightmare. These situations can bring new meaning to the old adage about the first tier of investors as friends, family, and fools” (Zwilling). The second type of potential outside investors is institutional investors such as family offices. These investors are often a little more sophisticated than most retail investors. On the positive side, they can serve as a good resource to evaluate investment theses and help obtain access to private market databases. On the other hand, institutional investors can also mean spending time regularly reporting to them and negotiating terms. Additionally, permanent equity funds need to be able to convince institutional investors why investing in a theoretically unlimited period fund has a positive opportunity cost compared to other types of investments. It is typically much more feasible to engage an institutional investor after a few companies have already been acquired and a larger team has been built out.

The search can be an expensive process for the investor when also accounting for foregone wages and operations costs. Some searchers will raise money from professional search fund investors that are willing to pay the searchers a salary with benefits throughout the process. The terms of these deals can vary and must be negotiated thoroughly. Some search fund investors will ask for “a first look at investing in the target company as it is being acquired and a cut of the profits once the acquisition is complete”

(Ruback). How much of the share they get and how much control are all points of negotiation between the searcher and the search fund investor.

The final type of outside investor group that could be tapped is industry insiders. These are often CEOs of larger businesses, competitors in different regions, or consultants. In some cases, the permanent equity investor might have a strong finance or accounting background but lacks the operational experience and expertise. Therefore, they might intentionally approach these industry insiders to join their board in exchange for a small equity stake. It is still important to make sure their skills are complementary to the permanent equity investors and try and devise an incentive structure that will avoid conflicts of interest, especially with competitors or larger strategics.

Despite how much an investor might try to educate their backers on the virtues of permanent equity, there is always the possibility that an investor may want an early redemption because of the long time commitment. Permanent equity is too early in its inception to have encountered this situation very many times. As a result, there are not that many anecdotal examples of other funds handling investor redemptions. Therefore, larger permanent equity can potentially learn from private equity secondaries. Secondaries allow pre-exising investors to have some liquidity in an otherwise illiquid investment in private market strategies. Since its inception 1980s, the private equity secondaries market has grown significantly to accommodate almost any customized situation and the complexities of pricing a fund. Today, the generally accepted pricing model is the reported valuation of the fund times the average percentage of high bids / NAV (Mende). Given the complexity of selling a secondary stake, the general partner (GP) will likely have to engage an investment bank to facilitate the sale to new limited partners (LP). Therefore, they should first consider buying the stake themselves or offering it to their other exisiting investors first before going to the open market. This will help lower the transaction costs and speed up the process. Smaller permanent equity funds who have raised smaller equity investments from friends and family will probably have to buy out their LPs on their own and do their own negotiating.

The second area for differentiation between permanent equity strategies is the value proposition. A few firms like Chenmark Capital and Bluegrass Equity operate more along with the entrepreneurship through acquisition strategy. For example, Chenmark is run by three siblings with backgrounds ranging from asset management to sales and trading to strategy and operations. Their team provides them the flexibility to both run the acquired companies personally while still searching for their next acquisition target. They also have some more bandwidth to invest time in publishing weekly newsletters and even podcast interviews with owners of small businesses which helps build their name recognition and brand. In contrast, Robbie at Bluegrass Equity decided to self-fund and search on his own. When he pitched to potential targets, he brought an impressive resume of experience as an investment banking analyst at Barclays and some investing and operating experience at Citadel Securities with semiconductor companies. When he acquired business, it would have his full attention to run and insure a successful transition between management teams. Then he would evaluate if anyone employees from with could be promoted to manage as CEO of his operating company or if he should bring in outside applicants.

In contrast, Permanent Equity's value proposition differs slightly because of its size and investing preferences. They generally support existing management teams and provide liquidity options through mostly pure equity investments. By investing with equity, it provides them much more flexibility and risk in environments like the COVID-19 global pandemic because they do not have any interest payment obligations or covenants to worry about. Additionally, they have a larger pool of committed capital which provides them the flexibility to inject more capital into existing companies or invest in expansion projects.

The final area of differentiation to be covered in this paper is portfolio construction. After the first acquisition, the investor has the choice to grow their existing business by integrating vertically or horizontally or by diversifying away some of their idiosyncratic risks.

After owning a business for a while, the investor can begin to explore options to grow their business organically through investments based on their investment criteria (high ROC, ROIC, ROA, ROE, etc.). This can mean upgrading equipment, building new facilities, or acquiring competitors that are also looking to exit. The acquisition of other competitors could put the permanent equity investor in a unique place as also a strategic buyer. Strategics will acquire competitors for a variety of reasons including:

- Access to customer lists or territory access
- Rights to technologies or other intellectual property
- Talent acquisition of human capital (salesmen, engineers, etc.)
- Eliminate a competitor which can provide more pricing power
- Recognize cost synergies such as gaining economies of scale when negotiating with suppliers
- Access to cheaper sources of capital (banks lend at lower rates to larger, more established businesses)

The investor could also decide to integrate vertically by buying a supplier or customer if they are operating a B2B business. This will allow them to ensure more reliable delivery, cut costs, and pricing.

The other option is for the investor to diversify their portfolio and identify new acquisition targets that have different underlying business drivers than their current business portfolio. While the permanent equity investor is trying to screen for "enduringly profitable" businesses, or businesses that can generate a consistent profit no matter what period in a business cycle it is, there is always some inherent idiosyncratic risk. Idiosyncratic risk is defined by Investopedia as "a type of investment risk, uncertainties and potential problems that are endemic to an individual asset (like a particular company's stock), or group of assets (like a particular sector's stocks), or in some cases, a very specific asset class (like collateralized mortgage obligations). It is also referred to as a specific risk or unsystematic risk." Therefore, permanent equity investors can choose to reduce this risk by buying companies in different industries, geographies, or asset classes (i.e. structure some deals with only equity and others with senior debt investments). Diversification can help reduce the impact if a particular sector is not doing well because of some extraneous shock to its underlying drivers like a drop in oil prices.

# Summary and Conclusions

This thesis aimed to cover the emerging asset class of permanent equity and examine some alpha-generating opportunities that investors should consider in their decision-making process and the potential trade-offs associated with it. Permanent equity is structured so that investors can truly focus on long-term value creation for not just shareholders, but all stakeholders. Because permanent equity tends to target lower growth businesses that can perform well throughout various market cycles, investors are provided a lot more flexibility to help provide exiting owner liquidity, ensure current employees are treated fairly and well, and grow the business with reinvested capital.

Permanent equity at its simplest form is equity investing with an unlimited investment horizon. Once mature enough, the investor can use either more equity, cashflow from existing portfolio companies, or some combination of the two to purchase more businesses. With current investment trends, it is becoming harder and harder to generate market-beating performances, or alpha. Therefore, an investor can apply permanent equity to private, small businesses where there are still a lot of opportunities and cheaper valuations. When searching for acquisition targets, they can learn from the positive traits of private equity, venture capital, and factor investing to complement their performance as long as they are aware of the risks.

This thesis examined four specific areas for investor differentiation that has each has its own set of risk and reward tradeoffs. The first section dives into the sourcing and investment process. Investors must decide how much time they want to divide between sourcing deals through intermediaries or through direct outreach to business owners. Throughout this process, they need to develop a process that can systematically and quickly weed out bad fits or poor acquisition targets for their strategy and preferences. The second area is how an investor decides to structure their investment. In general, they usually have three potential sources of capital: equity from their own pockets or investors, various forms of debt instruments, and the cash flow from their existing portfolio companies. The third area is the negotiation. While negotiation skills can improve with time and experience, it is important to understand how size affects the list of potential buyers and their different motivations, core competencies, and value propositions. Then it imperative that the investor is able to identify the strengths and weaknesses of their own strategy. Understanding this is crucial for them to stand out and have a competitive advantage. The final section covered is titled generally as differentiation. Digging a little deeper, it examines the different pros and cons of fund structure, value propositions, and portfolio construction.

This thesis is far from exhaustive in coverage of potential areas for differentiation for permanent equity investors. It is a very young asset class that has a lot of room for more development and innovation. However, for the foreseeable future, the underlying principles and strategy still present a great opportunity to find excess alpha.

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