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**Intelligent Growth Capital for the Lower Middle-Market**

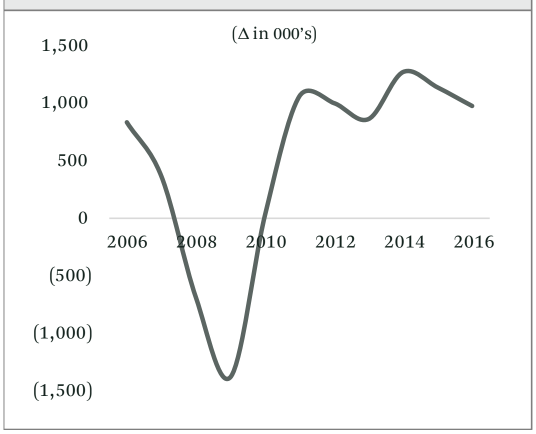
# The Current State of U.S. Small Business (Q4:2016)

**Hunting Dog Capital is a San Francisco-based investment manager that specializes in providing flexible financing, primarily in the form of senior-secured term loans, to lower middle-market U.S. companies. Investment opportunities are generated through a nationwide referral network that the Hunting Dog Capital team has developed and grown since 2004. The referral network is comprised of more than 7,200 contacts that provide investment opportunities from every state and across a wide range of industries. Although we fund only a small percentage of what we review each year, our information access provides a real-time, inside view from the perspective of owners and managers of lower middle-market companies nationwide. Our Q4:2016 white paper shares our observations on the state of growth for U.S. small businesses and the availability of growth capital. Based on our observations as well as economic data, we believe the lower middle-market will continue to generate solid growth, which will drive sustained demand for growth capital, particularly from unconventional sources.**

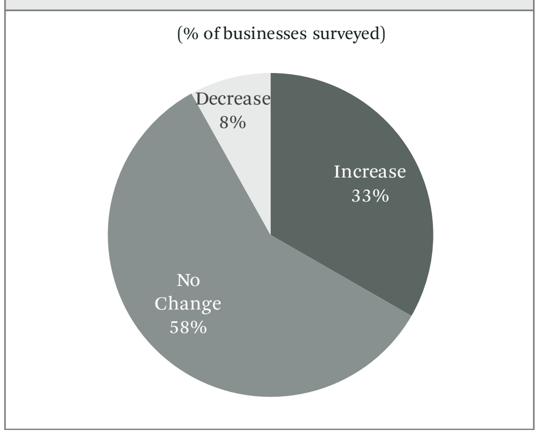
*Small Business Growth*

We begin with a brief review of select employment statistics for small businesses, focusing on historical and projected hiring trends. The chart on the left depicts the annual change in nonfarm employment for small businesses[1]. The chart on the right highlights the results of a National Small Business Association ("NSBA") survey whereby small business owners were asked whether they plan to hire in the next 12 months[2].

Nonfarm Employment[1]




Hiring Plans in Next 12 Months[2]




As evidenced above, small businesses have hired steadily since the 2008/2009 recession and plan to continue that trend. According to ADP, small business employment increased by approximately 88,000 positions per month, on average, or by approximately 1 million positions per annum, on average, from 2011 – July 2016. The strongest level of employment growth since the 2008/2009 recession occurred in 2014. Approximately 1.3 million positions were created during that year. Year-to-date, as of July 2016, employment increased by approximately 570,000 positions, or approximately 1 million on an annualized basis. At the current rate, hiring is on pace with employment growth exhibited prior to the 2008/2009 recession, although not at peak levels experienced in 2014.

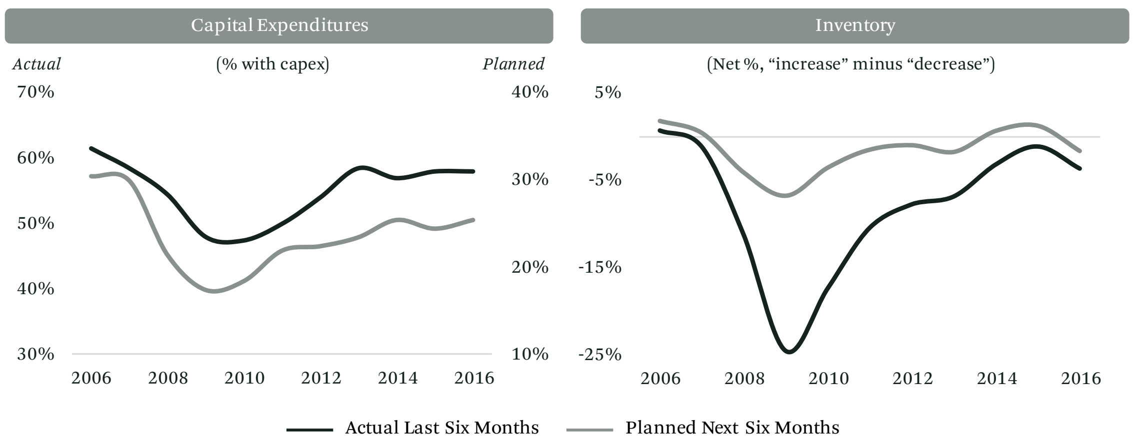
[1] Source: ADP National Employment Report, July 2016. Data represents employment change for businesses with <50 employees.
[2] Source: NSBA 2016 Mid-Year Economic Report. Businesses surveyed included those with <100 employees (96% of those surveyed).

According to the NSBA, 33% of small business owners that were surveyed in July 2016 plan to hire additional staff over the next 12 months, which is flat versus 2015. Importantly, the number of small business owners surveyed who said they plan to decrease their workforce in the next 12 months is at its lowest point in more than eight years at 8%. **Additionally, 12% of small businesses surveyed indicated they plan to increase their workforce by more than 10% – the highest this indicator has been since the question was introduced to the survey in 2008.**

While hiring remains a focus for small businesses, the most significant challenge to hiring – according to various small business surveys and feedback from our network – is the ability to find and retain qualified workers. As a result, wages may need to increase as a means to attract talent; however, the capacity for businesses to raise wages is constrained by their ability to generate profits and/or raise growth capital.

In addition to hiring trends, capital spending is another statistic we review here to assess the state of growth for small businesses. The charts below depict annual survey results conducted over the past 10 years whereby small business owners were queried on capital expenditures and inventory changes for the last six months and following six months[3].

Capital Spending[3]




The results of the surveys indicate capital expenditures and inventory levels have rebounded from the lows experienced during the 2008/2009 recession, but have not fully recovered. Economic reports cite a number of reasons why capital spending has not returned to pre-recession levels, including, among others, economic uncertainty and muted profit growth. Despite the slower growth environment as compared to pre-recession levels, small businesses continue to invest and require support from capital providers.

*Growth Capital*

As discussed in a prior white paper, commercial banks are retrenching from lower middle-market lending, which will continue to drive opportunities for alternative credit providers such as ourselves. Because of the growing investment opportunity and investor demand for yield in a yield-starved environment, dry powder for private debt funds in North America has increased markedly from approximately $53 billion in 2006 to approximately $131 billion in September 2016[4]. However, the vast majority of these funds focus on large and middle-middle market transactions (i.e., above $25 million), where capital can be more efficiently deployed at scale. As a result, there remains relatively little competition for private debt transactions within the lower middle-market, despite the seemingly large growth in dry powder.

Private and public equity are additional options available to small businesses looking to raise capital. Unlike debt capital, raising new equity capital causes meaningful ownership dilution, which may not be amenable to existing shareholders. Private equity dry powder has grown materially since 2006, albeit at a slower rate as compared to private debt. The same circumstances associated with private debt funds apply

[3] Source: NFIB Small Business Economic Trends, September 2016.

[4] Source: Preqin Quarterly Update for Private Debt, Q3:2016.

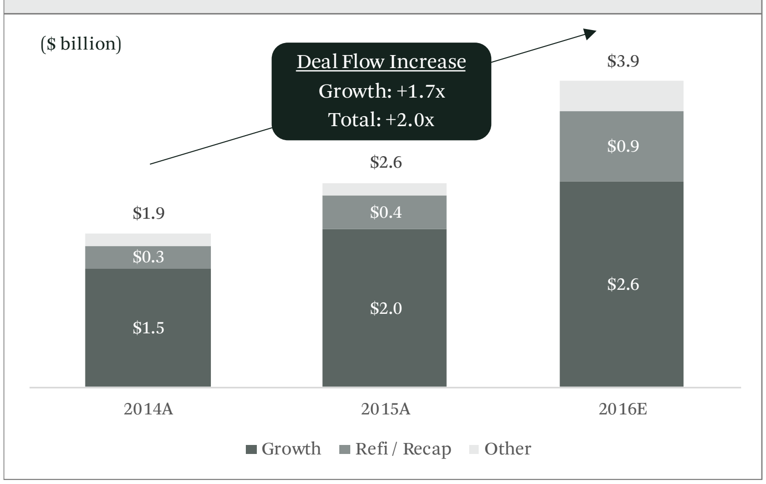
to private equity funds, where the vast majority of the capital raised is focused on large and middle-market transactions. **Public equity has become less prevalent as a means of raising capital as evidenced by the significant reduction in the number of publicly-listed companies – approximately a 50% decline from the peak in 1996**[5]. This decrease is the result of delistings and fewer new listings. Research shows that a resurgence in mergers and acquisitions account for a large portion of the delistings. Research studying the cause for a decline in new listings, which is especially prevalent for small companies, is not conclusive; however, the trends suggest companies are pursuing alternative routes to raising capital. Interestingly, despite the decline in the number of publicly-listed companies, the total market capitalization of the U.S. stock market increased from approximately $8.5 trillion in 1996 to approximately $26.5 trillion in September 2016, which supports the notion that small businesses are increasingly seeking alternative forms of capital[6]. We believe it is a reasonable assumption that the cost and complexity of going public are major factors.

*Conclusion*

Small businesses have continued to grow since the conclusion of the 2008/2009 recession, albeit at a slower rate as compared to pre-recession levels. The select statistics we review in this paper – hiring, capital expenditures and inventory trends – suggest business owners continue to invest in their businesses to maintain and oftentimes expand operations. As a result, growth capital is in strong demand, particularly in the lower middle-market where banks have retrenched and private debt / equity funds have shifted up-market. Large institutions need to be part of large funds and large funds cannot afford to make small investments. Public equity is also employed less often by small businesses as a means of raising capital.

In our experience, demand for growth capital, particularly from alternative lending sources, continues to increase. Our deal flow associated with growth (excluding refinancings and recapitalizations) has grown from approximately $1.5 billion in 2014 to approximately $2.6 billion expected by year end 2016 (see chart below)[7]. While a portion of this increase is attributable to our own efforts, we believe heightened demand among lower-middle market borrowers accounts for a significant portion as well. We find it particularly encouraging that capital demand associated with growth is a key contributor to our deal flow.

HDC Deal Flow[7]




*About Hunting Dog Capital*

Hunting Dog Capital is a San Francisco-based investment manager that specializes in providing flexible financing, primarily in the form of senior-secured term loans, to lower middle-market U.S. companies. We partner with business owners and management teams to provide capital that enables their companies to achieve growth objectives. Our dedicated team has the experience to understand unique situations and

5 Source: "The U.S. Listing Gap," published by NBER's working paper series in May 2015.

6 Source: World Federation of Exchanges. Data represents the total U.S. domestic market capitalization.

7 Deal flow for 2016E is estimated based on annualized data through October 2016.

capital raising challenges faced by lower middle-market businesses. We act quickly to provide the necessary capital when it is most essential. Transactions typically include the following:

| | |
|---|---|
| **Investment Size:** | $5mm+ |
| **Term:** | 2 – 5 years, prepay without penalty after the first year |
| **Borrower Profile:** | Meaningful tangible assets |
| **Industry:** | Agnostic |
| **Geography:** | U.S. |
| **Structure:** | Senior-secured term loans, typically non-amortizing |
| **Use of Proceeds:** | Growth, Refinancing, Acquisition, Working Capital, Buyout |
| **Ownership:** | Concentrated with at-risk equity |

We differentiate ourselves from other lower middle-market direct lenders by focusing on tangible assets instead of cash flow. If comfortable with the underlying collateral, typically a collateral coverage ratio of 1.1x or greater, we will structure non-amortizing bullets. We believe our terms are especially attractive to businesses owners with substantial at-risk equity as they enable retention of control, delay (or avoidance) of significant equity dilution and capture of equity appreciation as the business grows. We believe this type of liquidity is essential for entrepreneurs to execute their plans, and exceed objectives.

To learn more, please visit our website (www.hdcap.com) or contact us directly.