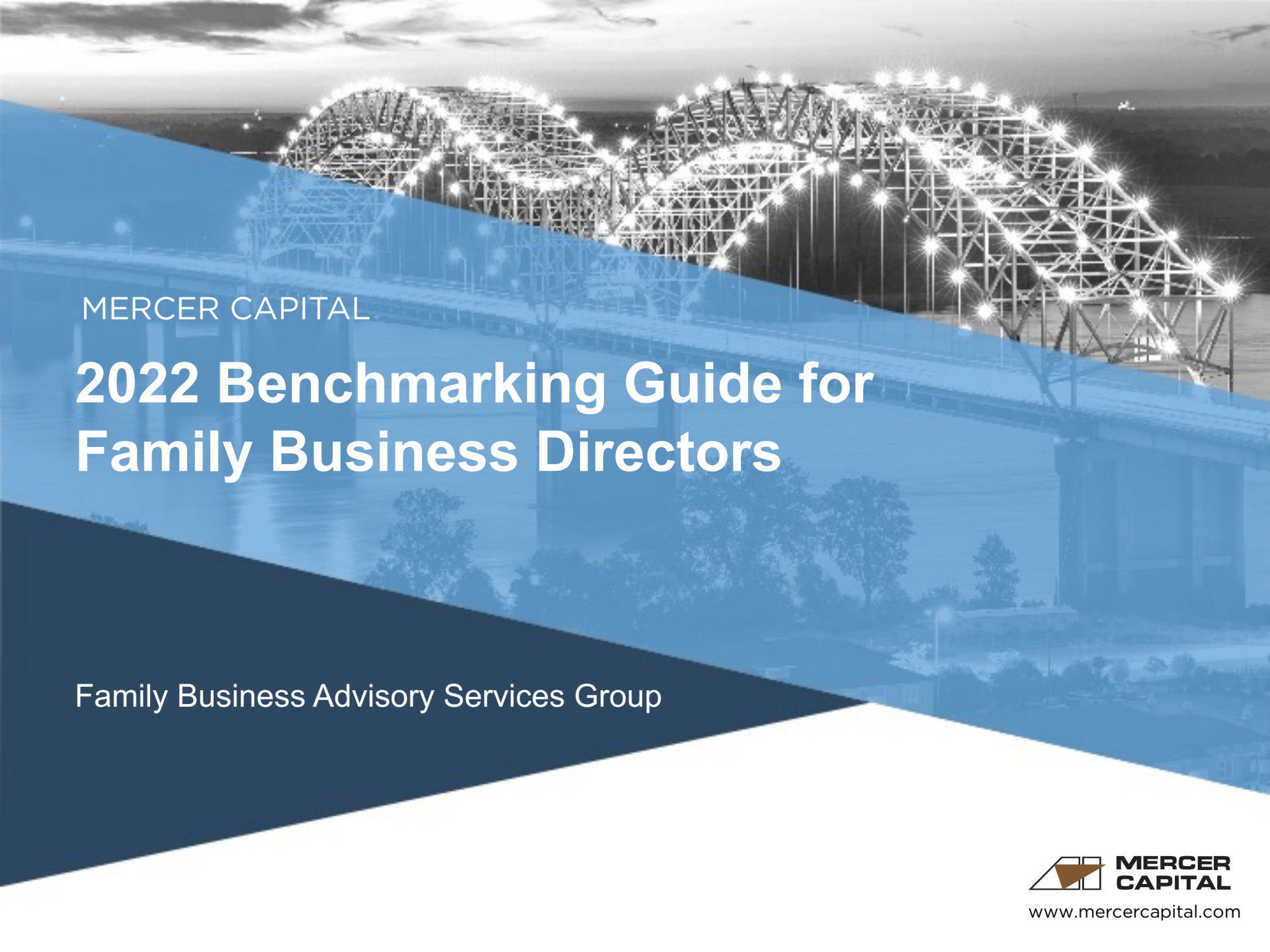


MERCER CAPITAL

2022 Benchmarking Guide for Family Business Directors

Family Business Advisory Services Group

MERCER CAPITAL

www.mercercapital.com

About Mercer Capital

Mercer Capital provides valuation, financial education, and other strategic financial consulting services to family businesses.

We help family ownership groups, directors, and management teams align their perspectives on the financial realities, needs, and opportunities of the business.

We have had the privilege of working with successful family and closely held businesses for the past 35 years. Given our experience, we are convinced that an effective board of directors and an engaged shareholder base are essential for the long-term health and success of a family business. Yet, equipping family business directors and cultivating an engaged shareholder base are often difficult. We can help.

Services Provided

- Customized Board Advisory Services
- Confidential Shareholder Surveys
- Management Consulting
- Benchmarking / Business Intelligence
- Independent Valuation Opinions
- Shareholder Engagement
- Transaction Advisory Services
- Shareholder Communication Support

The group also publishes weekly content about corporate finance & planning insights for multi-generational family businesses in the blog,

Family Business Director.

Family Business Advisory Services Team

Travis W. Harms, CFA, CPA/ABV
harmst@mercercapital.com
901.322.9760

Bryce Erickson, ASA, MRICS
ericksonb@mercercapital.com
214.468.8411

Timothy R. Lee, ASA
leet@mercercapital.com
901.322.9740

Nicholas J. Heinz, ASA
heinzn@mercercapital.com
901.322.9788

Brooks K. Hamner, CFA, ASA
hamnerb@mercercapital.com
901.322.9714

Scott A. Womack, ASA, MAFF
womacks@mercercapital.com
615.345.0234

Atticus L. Frank, CFA, ABV
franka@mercercapital.com
941.244.1020

John T. (Tripp) Crews, III
crewst@mercercapital.com
901.322.9735

Table of Contents

Why Benchmarking?

Helping You Become a More Informed Director

Family business directors need the best information available when making strategic financial decisions that will help set the course of their business for years to come.

Benchmarking helps provide valuable context to directors when making the most critical decisions.

- **What should our dividend policy be?**
- **What investments should we be making to ensure a sustainable future for our family business?**
- **How should we finance our family business?**

Questions Addressed

7 Questions Benchmarking Data Can Answer

1. How much money do companies like ours make?
2. How much money do companies like ours invest?
3. How much money do companies like ours distribute?
4. How much money do companies like ours borrow?
5. What is the hurdle rate for companies like ours?
6. How fast do companies like ours grow?
7. What kinds of returns do companies like ours generate for shareholders?

Data Set

Universe of Benchmarking Companies :: Russell 3000 Index Companies

- **Communication Services**
- **Consumer Discretionary**
- **Consumer Staples**
- **Energy**
- **Health Care**
- **Industrials**
- **Information Technology**
- **Materials**

		Revenue $millions
1st Quintile	Median	$16,532
	Largest	572,754
	Smallest	4,139
2nd Quintile	Median	$3,912
	Largest	19,440
	Smallest	1,120
3rd Quintile	Median	$1,837
	Largest	6,412
	Smallest	331
4th Quintile	Median	$894
	Largest	3,019
	Smallest	129
5th Quintile	Median	$286
	Largest	1,068
	Smallest	10

Note: Our data set excludes the following industry sectors: Financials, Real Estate, and Utilities.

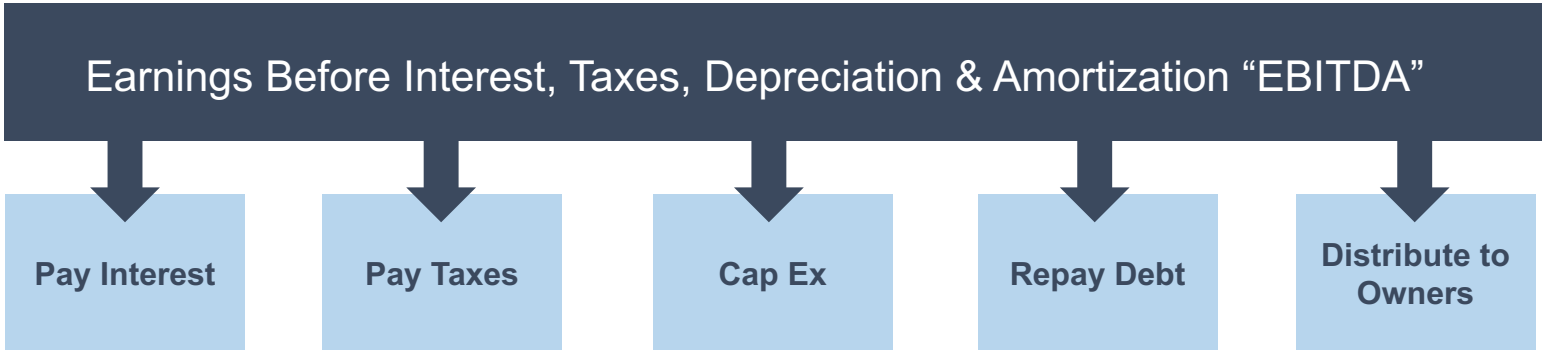
We have also excluded companies with revenue of less than $10 million in 2021

How Much Money Do Companies Like Ours Make?

Section 1

What is EBITDA?

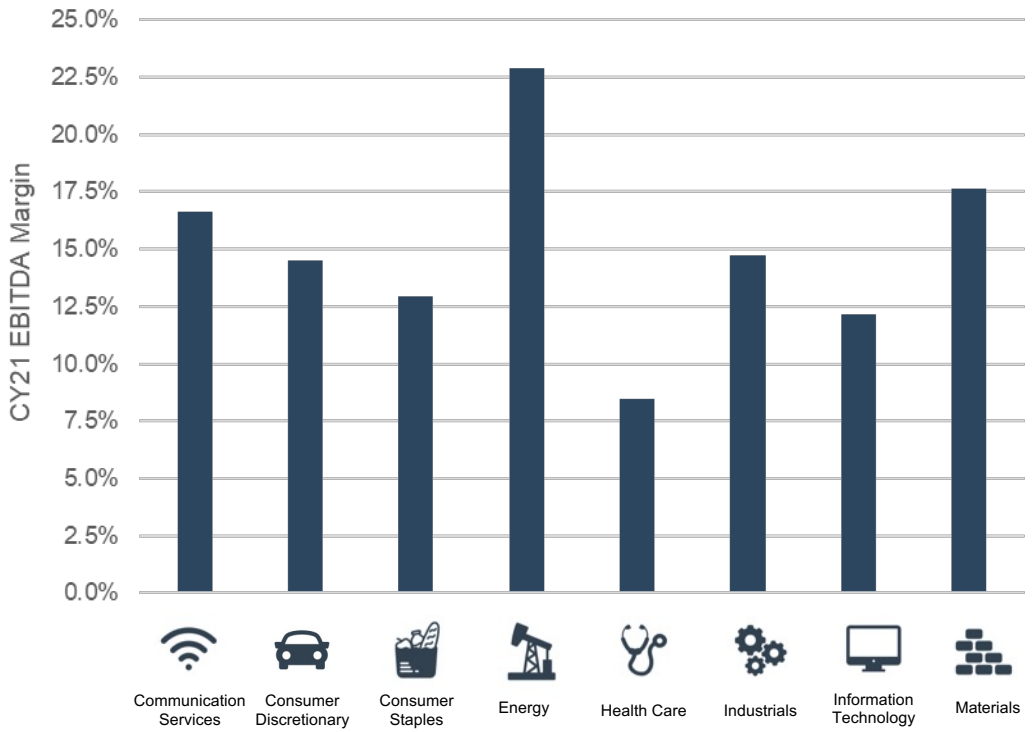
Defining Profitability



EBITDA, or Earnings Before Interest, Taxes, Depreciation & Amortization, is the most cited measure of earnings for private companies. EBITDA is a proxy for discretionary cash flow available to service debt, pay taxes, fund reinvestment, and provide for shareholder distributions. EBITDA promotes comparability among firms with differing capital structures, tax attributes, and fixed asset intensity.

EBITDA Margin by Industry

Industry Influence on EBITDA Margin



The overall average EBITDA margin for the group was 14.3%. However, as depicted in the chart to the left, there is significant variation among the different industry sectors analyzed. In short, asset-intensive industries tend to earn higher EBITDA margins, which is necessary to fund ongoing capital expenditures and other investments.

EBITDA Margin by Company Size

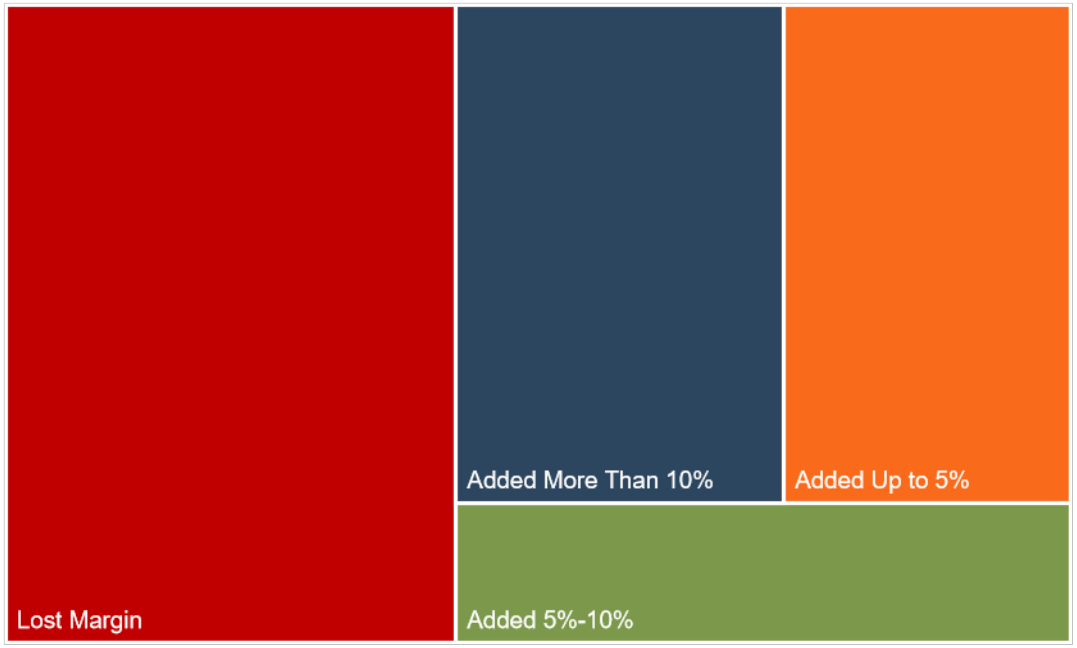
Data Suggests That Economies of Scale are Less Important in Some Industries

Comparing average EBITDA margins across size quintiles confirms that economies of scale matter. Larger companies tend to earn higher margins than smaller companies. However, the data reveals that economies of scale tend to be less important for companies in the consumer discretionary, energy, and industrial sectors.

	Size Quintile (1 = largest)				
	1	2	3	4	5
Communication Services	28.0%	21.2%	18.8%	15.2%	0.0%
Consumer Discretionary	13.7%	17.1%	15.4%	16.4%	10.0%
Consumer Staples	13.4%	16.1%	14.9%	11.6%	8.4%
Energy	22.4%	26.0%	26.7%	21.3%	18.4%
Health Care	25.2%	18.4%	8.6%	-0.5%	-9.4%
Industrials	14.6%	15.8%	16.4%	13.5%	13.4%
Information Technology	25.8%	17.1%	11.0%	7.0%	-0.2%
Materials	23.0%	20.1%	17.8%	15.1%	12.1%
All Companies	**20.1%**	**17.9%**	**14.5%**	**10.9%**	**5.3%**

EBITDA Margin by Company Size

Change in Margin for Companies That Have Successfully Scaled



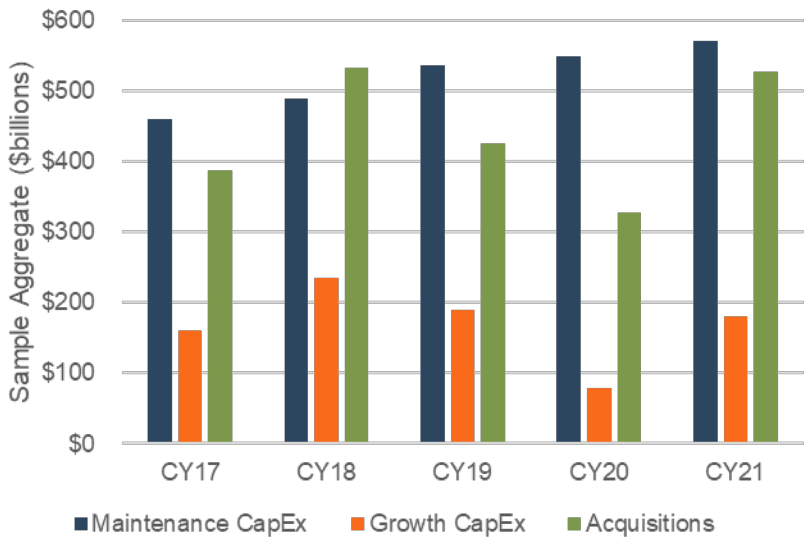
Of the companies in our sample, 308 at least doubled revenue from CY17 to CY21. For this subset of companies that have successfully scaled, nearly 60% experienced margin expansion, with about 25% of the companies increasing EBITDA margin by more than 10% over the period.

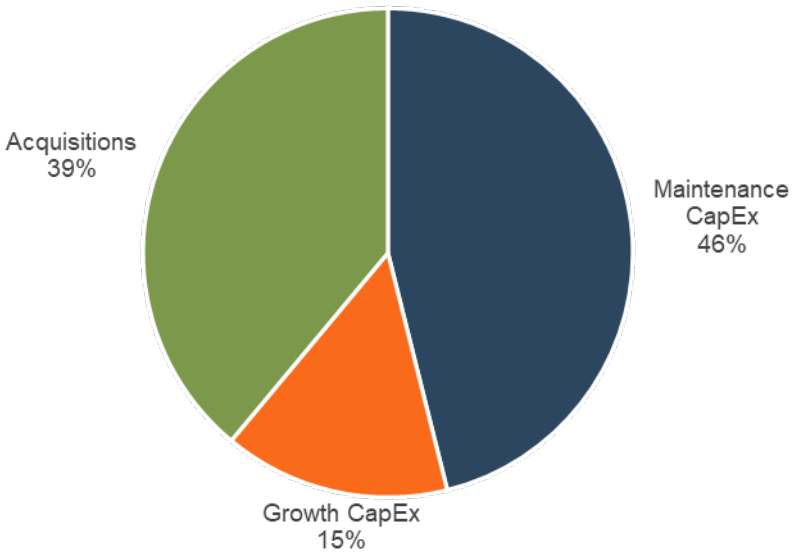
How Much Money Do Companies Like Ours Invest?

Section 2

Aggregate Investment Trends

Companies Invest to Maintain Productive Capacity and Grow





Aggregate annual investment for the companies in our sample fluctuated between $1.0T and $1.3T over the period analyzed. Excluding maintenance capital expenditures, spending on acquisitions exceeded growth capital expenditures by 160%.

Investment Benchmarks

Three Ways to Measure Relative Investment

Revenue	EBITDA	Invested Capital
$\frac{Gross\ Investment}{Revenue}$	$\frac{Gross\ Investment}{EBITDA}$	$\frac{Net\ Investment}{Beg\ Invested\ Capital}$
5.5%	**37%**	**2.3%**

To make meaningful comparisons of investment activity across industries and companies, we must scale investment activity to another measure of size. Using EBITDA as a proxy for cash flow, reveals how discretionary cash flow is allocated to different uses. Treating revenue as the denominator removes the effect of profitability on investment decisions. Finally, assessing investment relative to invested capital removes the impact of differing turnover attributes.

Percentages are overall median observations from the sample universe

Investment by Industry

Both Magnitude and Composition of Investment Vary by Industry

	Median Observations			Industry Aggregates ($millions)			% of Total		
	Gross / Revenue	Gross / EBITDA	Net / Invested Capital	Maintenance CapEx	Growth CapEx	Acquisitions	Maintenance CapEx	Growth CapEx	Acquisitions
Communication Services	7.2%	42.9%	1.5%	$98,946	$32,640	$61,682	51.2%	16.9%	31.9%
Consumer Discretionary	3.8%	27.7%	1.5%	$101,938	$55,696	$51,566	48.7%	26.6%	24.6%
Consumer Staples	3.6%	38.2%	2.4%	$43,666	$10,037	$29,089	52.7%	12.1%	35.1%
Energy	11.5%	56.9%	-0.5%	$104,174	($17,509)	$14,764	102.7%	-17.3%	14.6%
Health Care	6.2%	36.4%	2.1%	$37,434	$22,571	$132,841	19.4%	11.7%	68.9%
Industrials	5.9%	41.9%	3.8%	$69,966	$34,143	$88,758	36.3%	17.7%	46.0%
Information Technology	6.7%	36.9%	2.7%	$79,978	$33,349	$117,528	34.6%	14.4%	50.9%
Materials	6.9%	35.9%	2.4%	$33,774	$9,695	$30,555	45.6%	13.1%	41.3%
All Companies	**5.5%**	**36.7%**	**2.3%**	**$569,876**	**$180,621**	**$526,783**	**44.6%**	**14.1%**	**41.2%**

Excluding the energy sector, the median level of investment when measured relative to EBITDA ranged from 28% to 43%. Maintenance capital expenditures are most prominent for communication services, consumer staples, and energy firms. Consumer discretionary firms allocated more net investment dollars to growth capex, while acquisitions were the primary avenue of growth for health care, information technology, industrials companies.

Investment and Company Size

No Pronounced Size Effect Discernable From the Data

	Median Observations			Industry Aggregates ($millions)			% of Total		
	Gross / Revenue	Gross / EBITDA	Net / Invested Capital	Maintenance CapEx	Growth CapEx	Acquisitions	Maintenance CapEx	Growth CapEx	Acquisitions
1st Quintile	5.0%	31.4%	2.7%	$444,697	$141,280	$329,276	48.6%	15.4%	36.0%
2nd Quintile	5.9%	37.8%	3.0%	$68,219	$15,174	$103,296	36.5%	8.1%	55.3%
3rd Quintile	5.5%	41.7%	2.1%	$31,618	$10,075	$54,947	32.7%	10.4%	56.9%
4th Quintile	5.7%	41.7%	1.8%	$17,398	$11,512	$27,886	30.6%	20.3%	49.1%
5th Quintile	5.6%	39.9%	1.7%	$7,945	$2,579	$11,378	36.3%	11.8%	51.9%
All Companies	**5.5%**	**36.7%**	**2.3%**	**$569,876**	**$180,621**	**$526,783**	**44.6%**	**14.1%**	**41.2%**

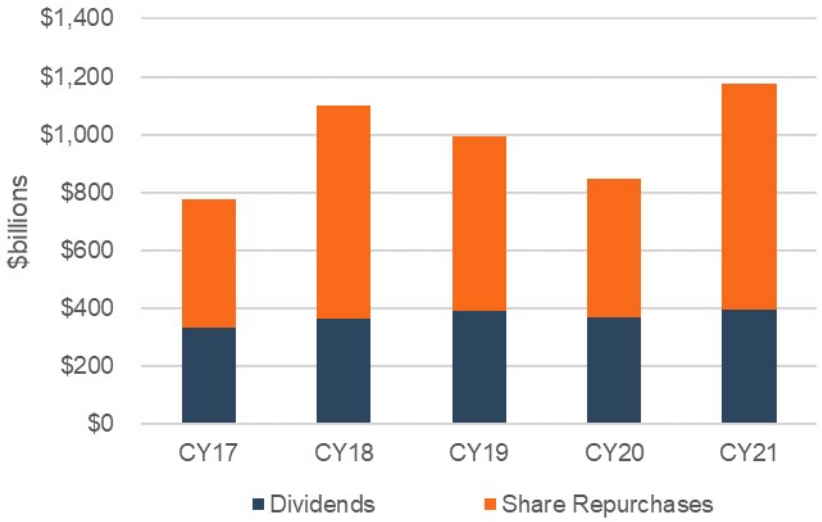
Larger companies tend to be more profitable and deploy capital more efficiently (i.e., generate more revenue per dollar of invested capital). As a result, investment represents a lower portion of available cash flow for the largest companies (31.4%) than for the smallest companies (39.9%). The smallest companies tend to be somewhat less acquisitive than their larger counterparts.

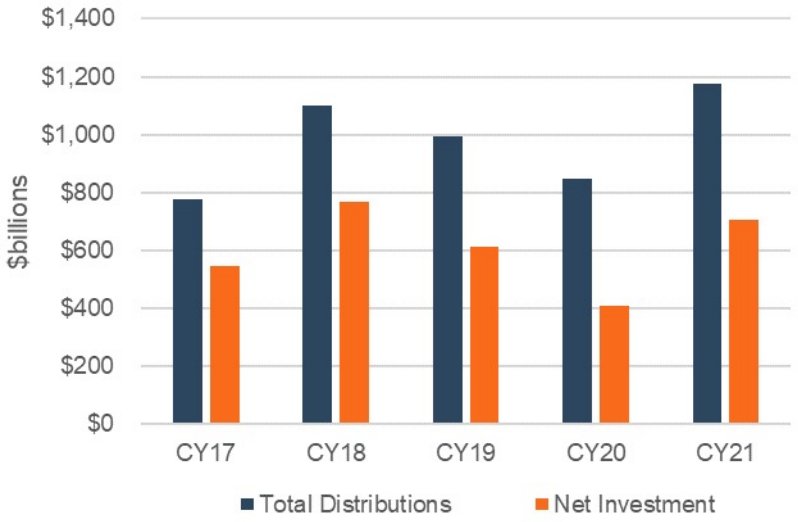
How Much Money Do Companies Like Ours Distribute?

Section 3

Aggregate Distribution Trends

Companies Weigh Distributions Against Available Investment Opportunities

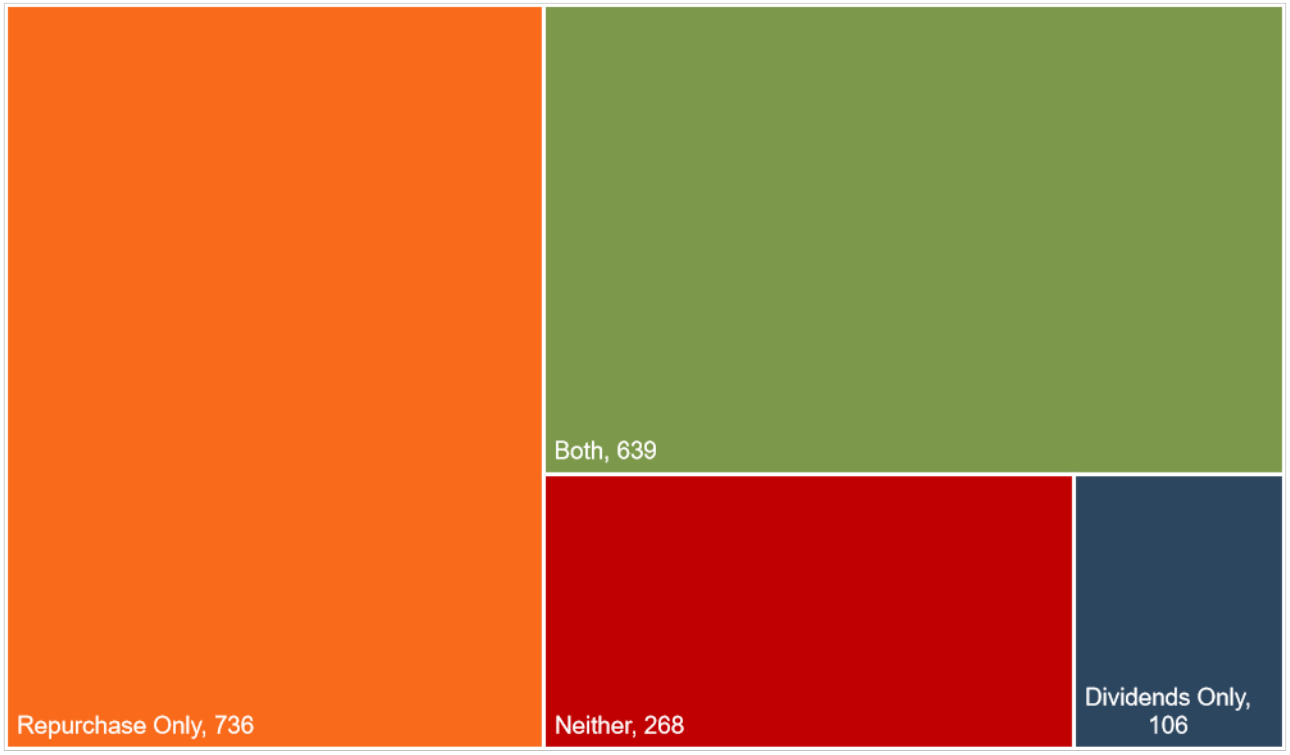




Public companies generally prefer a sustainable level of dividends that can withstand temporary downturns in performance. As a result, aggregate share purchases have exceeded dividends paid during each of the preceding five years. For the universe of companies we analyzed, total distributions (dividends + share repurchases) exceeded net investment by over 60% for the period.

Prevalence of Distributions

Companies Select Form of Shareholder Distributions



15% of the companies in our sample neither paid dividends nor repurchased shares during CY21.

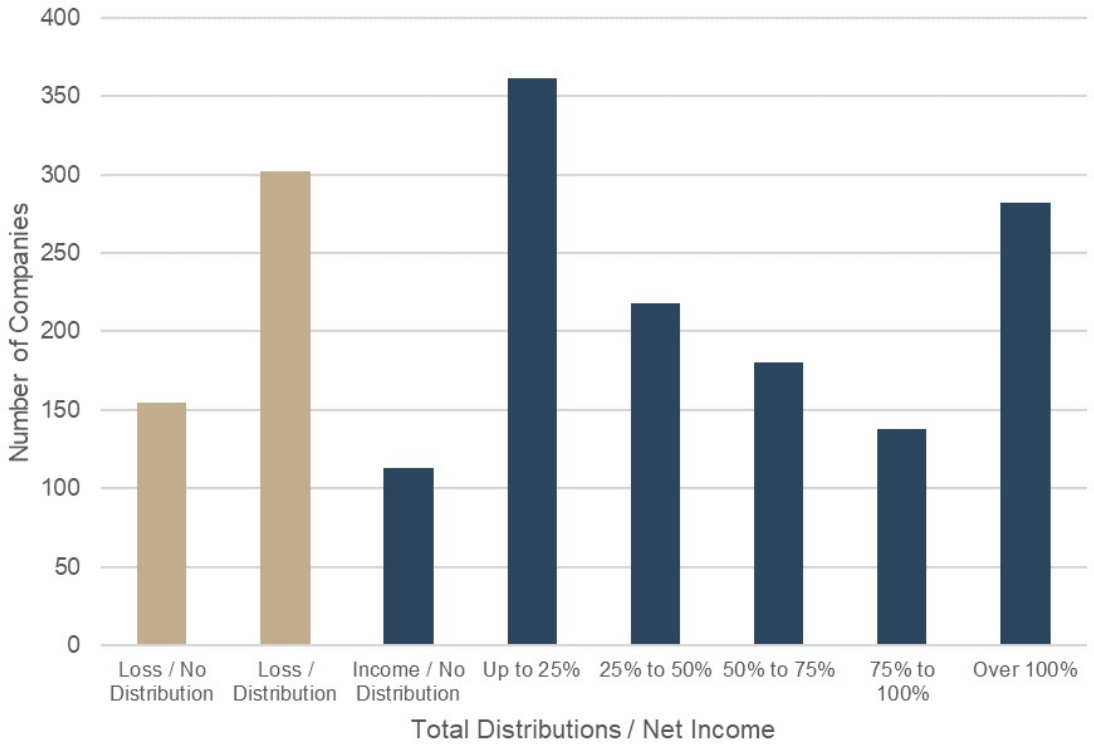
Only 6% of companies only paid dividends, while 79% of companies either repurchased shares alone or did both.

Magnitude of Distributions

Distributions as a Percentage of Net Income

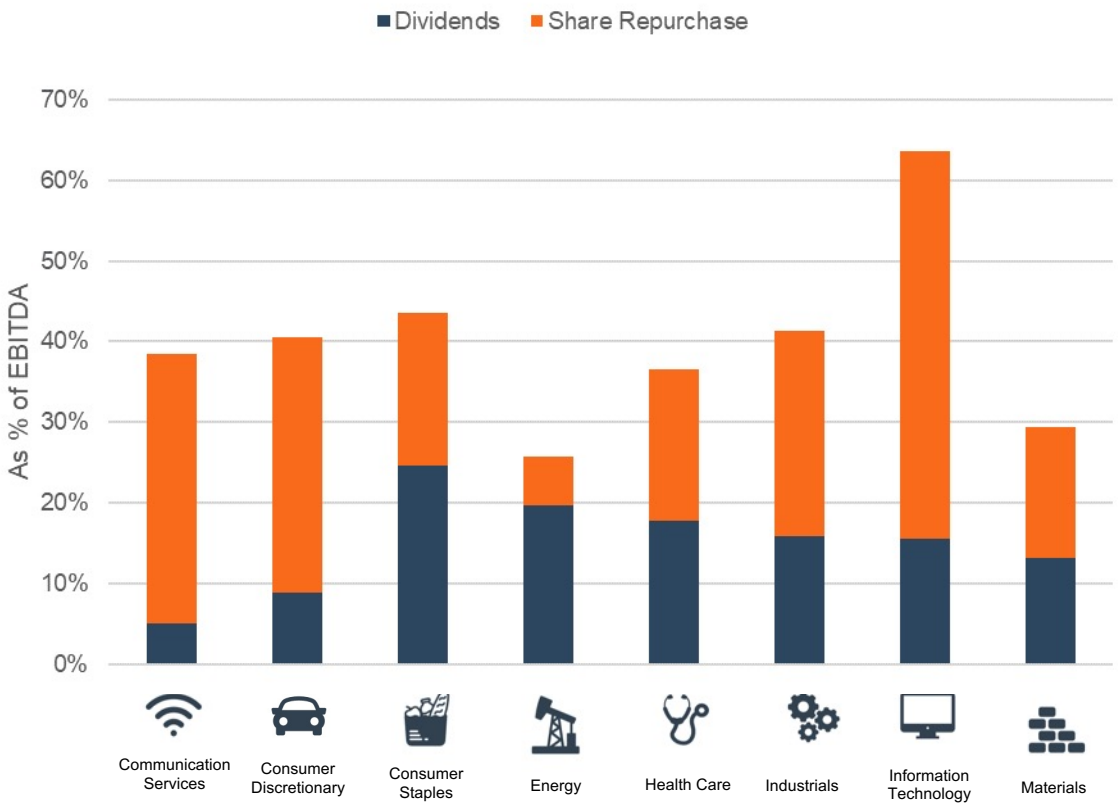
Approximately one-fourth of the companies in our sample reported a net loss during CY21. Of these companies, over 66% still made a distribution (dividend, share repurchase, or both) to shareholders.

Of the profitable companies in our sample, approximately 16% made total distributions in excess of net income during CY21.



Distributions by Industry

Aggregate Distribution Data Reveals Differences Among Industries



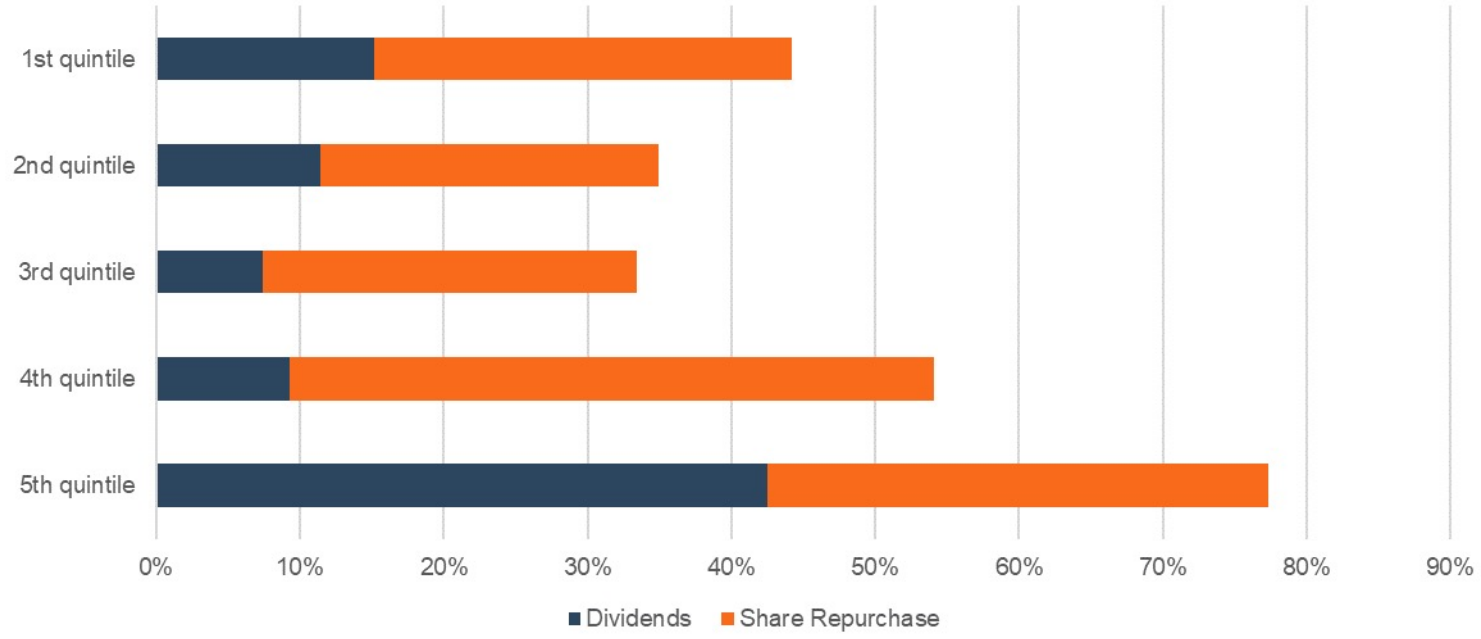
Capital intensive industries such as communication services devote a smaller portion of cash flow to shareholder distributions.

Relative to consumer staples companies, consumer discretionary companies hedge their higher volatility by relying more on share repurchases than dividends.

Information technology companies were the most aggressive share repurchasers.

Distributions and Company Size

Smallest Firms Make Larger Shareholder Distributions



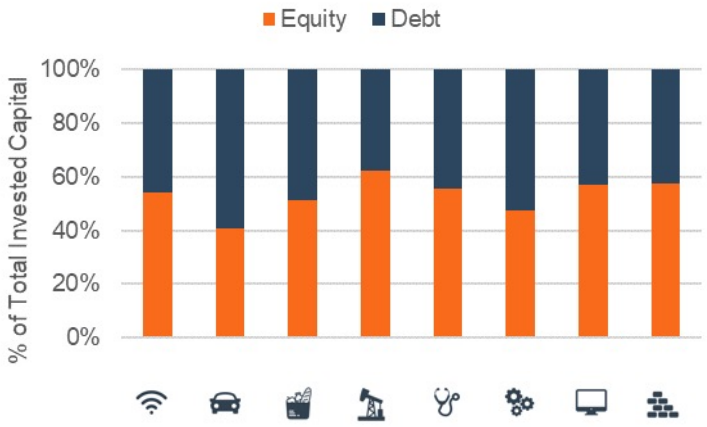
The smallest companies distribute the greatest proportion of operating cash flow (as proxied by EBITDA) to shareholders. The largest firms also make a significant portion of distributions relative to companies in the middle of the bell curve (second and third quintile companies)

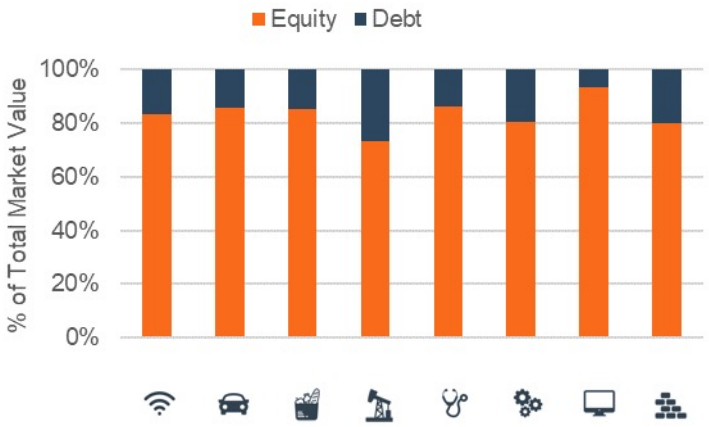
How Much Money Do Companies Like Ours Borrow?

Section 4

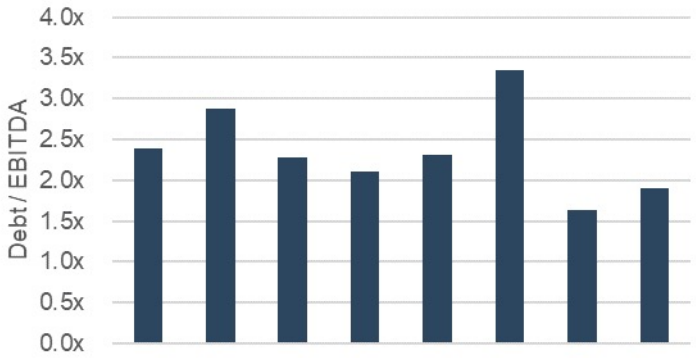
Financial Leverage by Industry

Borrowing Capacity Influenced by Assets and Cash Flow



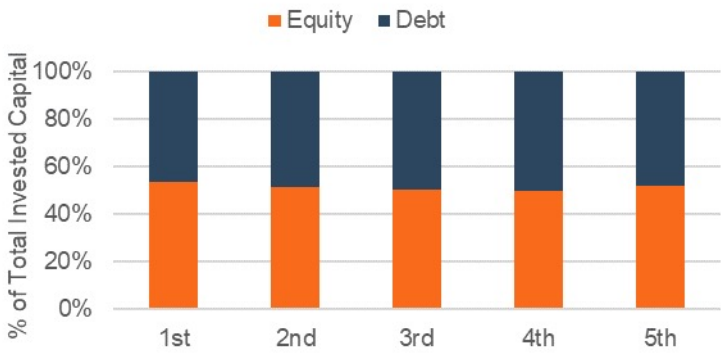


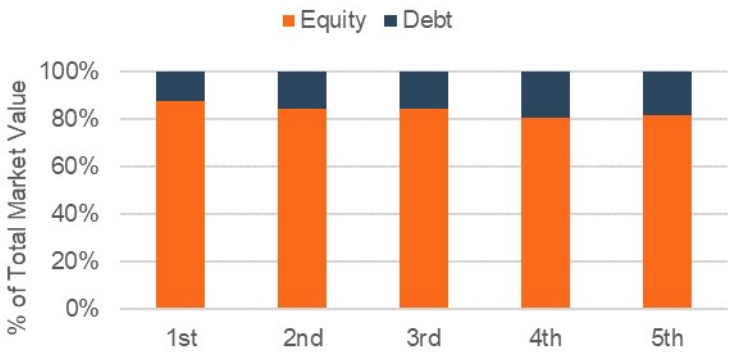
Financial leverage can be measured by comparing total debt to invested capital (book values of debt and equity), market values, or relative to cash flow. On a market value basis, leverage at the end of 2021 ranged from 6% (IT) to 27% (energy).



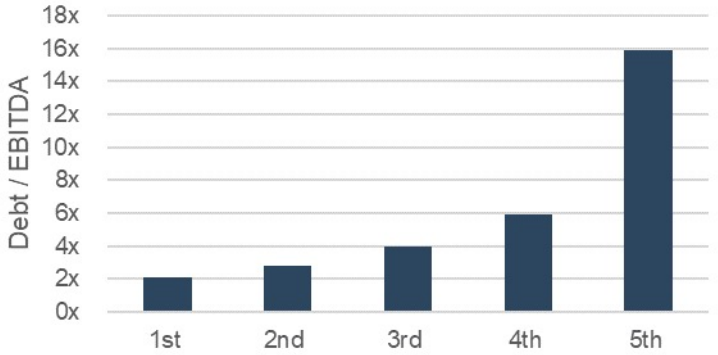
Financial Leverage by Size

Impact of Size Most Evident in Cash Flow Leverage Multiples





There is little discernable size effect with respect to book or market values. However, lower EBITDA margins on the part of the smaller firms increase the aggregate ratio of debt to EBITDA for such firms.



Use of Debt by Industry

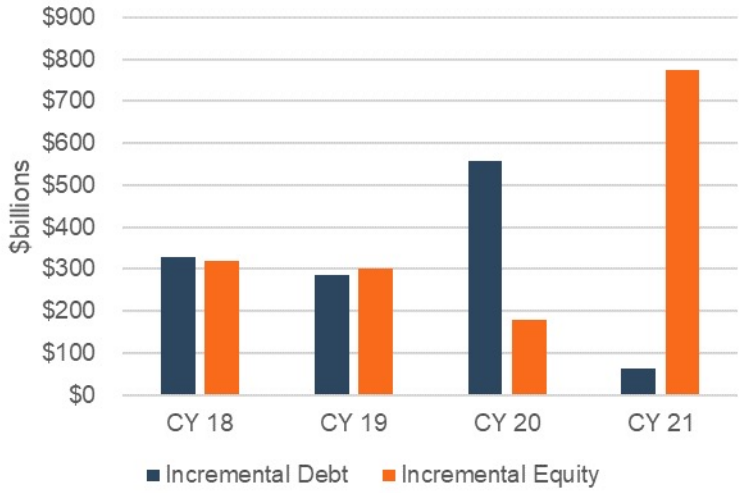
Debt Reliance Measured Relative to Total Invested Capital

	All Companies	Communication Services	Consumer Discretionary	Consumer Staples	Energy	Health Care	Industrials	Information Technology	Materials
No Debt	199	12	37	6	4	52	30	55	3
0% to 20%	301	12	41	20	19	75	55	68	11
20% to 40%	429	14	69	22	31	75	98	85	35
40% to 60%	380	22	57	30	19	52	107	56	37
60% to 80%	238	17	54	14	21	26	47	39	20
Over 80%	202	17	62	11	10	27	32	33	10
Total	1,749	94	320	103	104	307	369	336	116
No Debt	11.4%	12.8%	11.6%	5.8%	3.8%	16.9%	8.1%	16.4%	2.6%
0% to 20%	17.2%	12.8%	12.8%	19.4%	18.3%	24.4%	14.9%	20.2%	9.5%
20% to 40%	24.5%	14.9%	21.6%	21.4%	29.8%	24.4%	26.6%	25.3%	30.2%
40% to 60%	21.7%	23.4%	17.8%	29.1%	18.3%	16.9%	29.0%	16.7%	31.9%
60% to 80%	13.6%	18.1%	16.9%	13.6%	20.2%	8.5%	12.7%	11.6%	17.2%
Over 80%	11.5%	18.1%	19.4%	10.7%	9.6%	8.8%	8.7%	9.8%	8.6%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

With respect to the companies in our sample, the use of debt is evenly distributed, with approximately 28% of companies having less than 20% debt in their capital structure, 46% between 20% and 60%, and 25% above 60%. Health care and IT firms are most likely to avoid debt, while companies in the communication services, energy, and consumer discretionary sectors are more likely to fund capital needs with larger amounts of debt.

Marginal Funding Sources

Annual Changes in Invested Capital Balances



Assessing the annual change in debt and equity balances reveals how companies view the marginal costs of incremental financing needs. On a relative basis, the companies in our sample borrowed most aggressively during CY20 in the face of the economic slowdown resulting from the response to COVID-19. Companies relied on incremental equity financing at the margin in 2021.

What is The Hurdle Rate for Companies Like Ours?

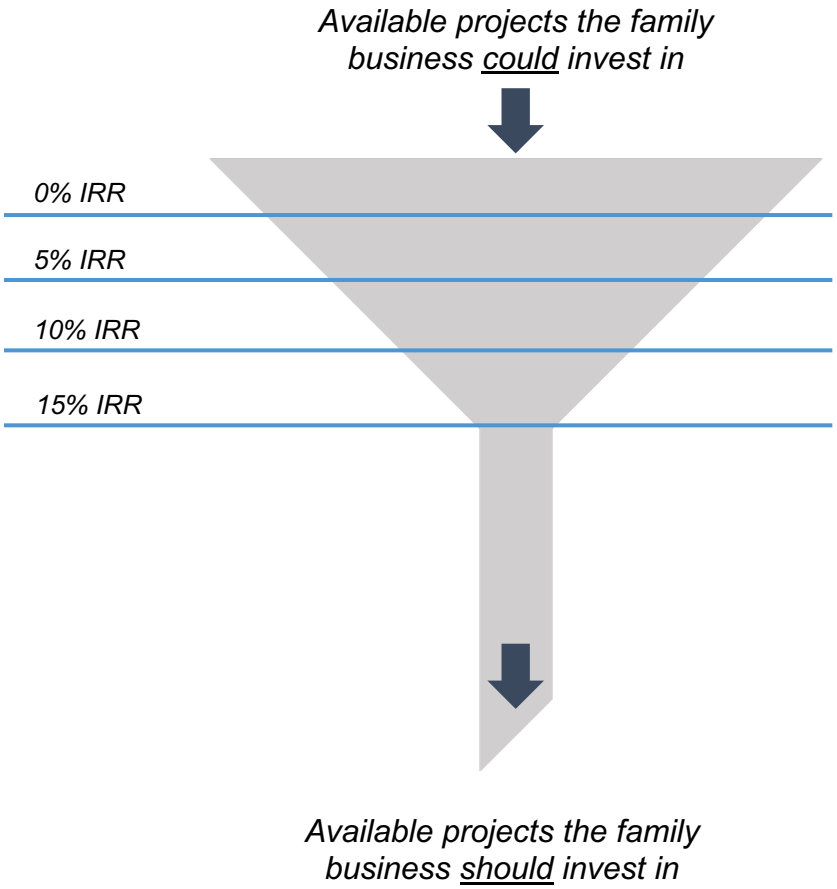
Section 5

What is a Hurdle Rate?

Evaluating Potential Investments

Companies use hurdle rates to help screen out potential investments. All family businesses face capital constraints, which means there are more investments they could invest in than they should invest in. Along with a robust strategic review, using a hurdle rate can help directors limit review of potential projects to those that are financially feasible.

Some companies use their weighed average cost of capital, or WACC, as their hurdle rate. Others prefer to add a discretionary premium to the WACC as a means of rationing scarce capital and mitigating the risk that projected cash flows are too aggressive.



What is the WACC?

The WACC is the Blended Return Expectation for Lenders and Shareholders

Market Value of Debt

Market Value of Equity

Total Capital

What would an informed lender charge our family business to borrow this money today?

- Credit metrics (leverage, cash flow multiples, collateral quality)
- Relevant market data (treasury rates and credit spreads)
- Tax benefits from deductibility of interest expense

What return would an informed shareholder expect to earn from the equity in our family business?

- Total return = Dividend Yield + Capital Appreciation
- Available return on “risk-free” assets
- Premium return expected on basket of large cap stocks
- Relative risk of family business compared to market
    - Industry characteristics
    - Financial leverage
- Size of family business – equity returns tend to be higher for smaller companies
- Unique risks of the family business
    - Key person dependencies, geographic concentrations, etc.

WACC the is blended (after-tax) expected return for both lenders and shareholders

Returns and Risks are Related

Beta Coefficient Measures Relevant Risk for Equity Investors

Return follows risk, so riskier companies should have higher hurdle rates.

According to the most prominent theoretical model, beta measures the relevant risk of an individual company.

Beta is positively related to risk, with a beta of 1.0 indicating risk equal to that of the market.

	All Companies	Size Quintiles (1 = Largest)				
		1	2	3	4	5
Communication Services	1.16	1.08	1.10	1.17	1.18	1.30
Consumer Discretionary	1.57	1.52	1.59	1.67	1.55	1.53
Consumer Staples	0.80	0.82	0.64	0.69	0.96	0.90
Energy	2.09	1.94	2.15	2.50	2.39	1.51
Health Care	1.06	0.95	0.96	1.05	1.11	1.24
Industrials	1.32	1.31	1.42	1.38	1.37	1.13
Information Technology	1.19	1.22	1.14	1.30	1.15	1.16
Materials	1.30	1.30	1.19	1.22	1.65	1.15

Weighted Average Cost of Capital

Academic Research Suggests That Smaller Companies Face Higher Capital Costs

The weighted average cost of capital is the blended return expectation of lenders and shareholders.

We calculate the cost of each source of capital and calculate the weighted average with reference to the market value of total capital.

WACCs are generally higher for smaller companies.

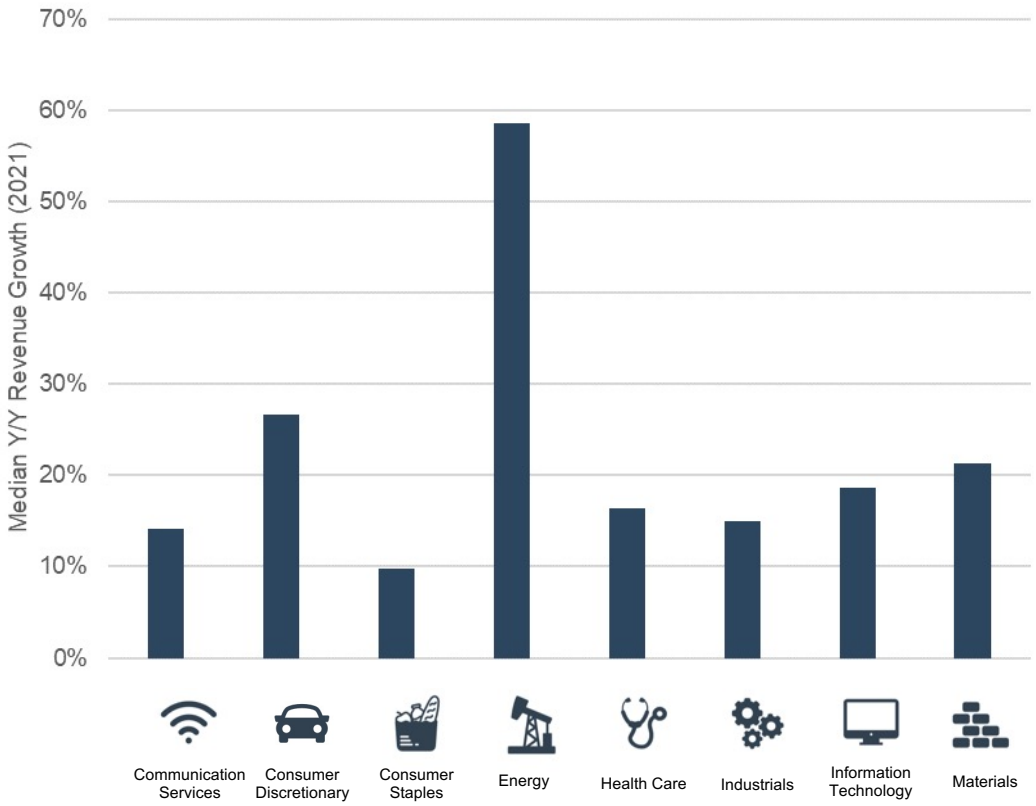
	All Companies	Size Quintiles (1 = Largest)				
		1	2	3	4	5
Communication Services	7.0%	6.2%	5.6%	6.5%	7.5%	9.2%
Consumer Discretionary	9.5%	8.4%	9.2%	9.5%	9.8%	10.5%
Consumer Staples	6.1%	5.3%	5.0%	5.6%	6.7%	7.7%
Energy	9.9%	9.4%	9.4%	9.9%	11.3%	9.7%
Health Care	8.0%	6.1%	6.7%	7.9%	8.7%	10.4%
Industrials	8.3%	7.9%	8.5%	8.3%	8.4%	8.4%
Information Technology	8.5%	7.7%	7.8%	8.8%	8.7%	9.5%
Materials	8.0%	7.8%	7.0%	7.6%	9.0%	8.8%

How Fast Do Companies Like Ours Grow?

Section 6

Revenue Growth by Industry

Revenue Growth a Function of Industry Factors, Organic Growth, and Investment



Revenue growth in 2021 was boosted by the COVID recovery from depressed 2020 levels.

Revenue growth rates for energy and materials companies are heavily influenced by commodity price trends.

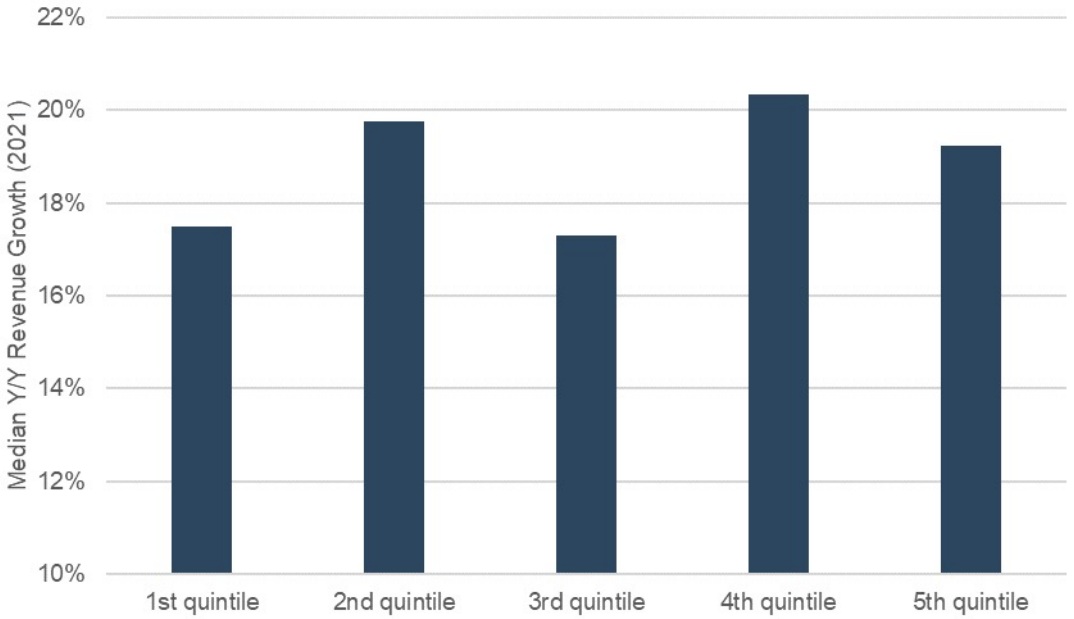
For other sectors, revenue growth reflects both broader economic growth, industry demand, and investment activity.

Unless disclosed by reporting companies, organic and acquisition-related sources of growth are not easily distinguished.

Revenue Growth by Size

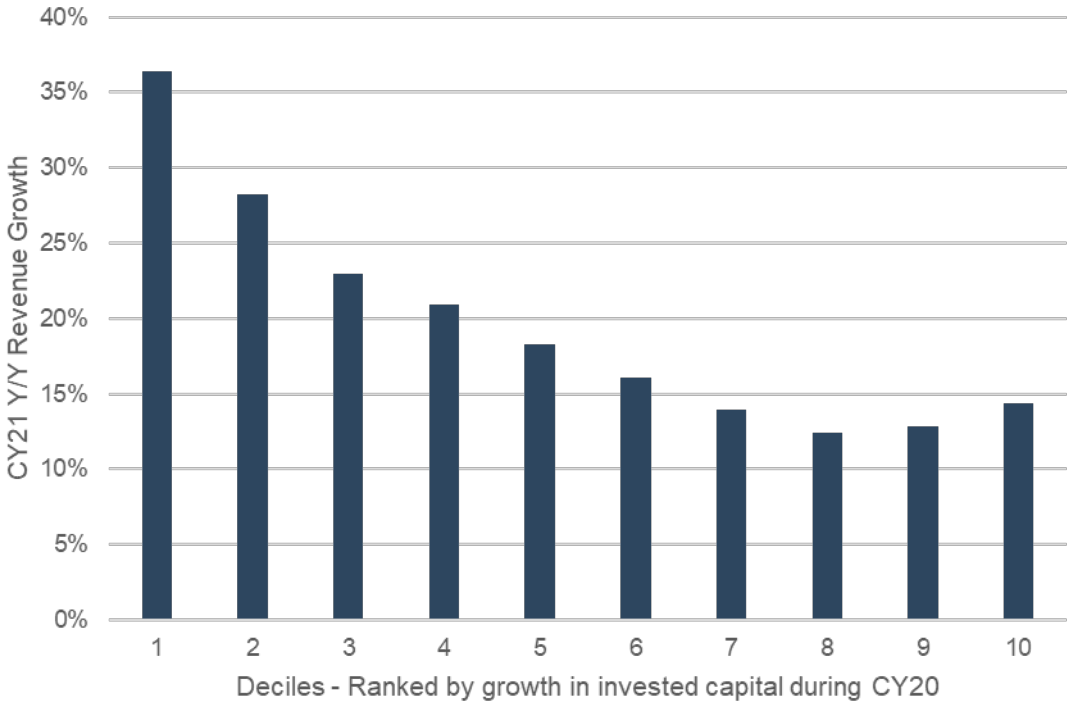
Revenue Growth a Function of Industry Factors, Organic Growth, and Investment

Smaller companies generally exhibit faster revenue growth. In general, it is easier for such firms to generate revenue growth through investment, while it is relatively harder for the largest firms to "move the needle" decisively through incremental investment. However, this observation was less pronounced in 2021 as revenue growth from the COVID recovery was the dominant factor.



Acquired vs. Organic Growth

Revenue Growth Correlated to Previous Investments



To help shed some light on the difference between organic growth and that associated with incremental investment, we first calculated the percentage increase in invested capital during CY20 for each of the companies in our sample. We then sorted the companies into 10 deciles based on that measure. The chart to the left depicts the year-over-year revenue growth during CY21 for each decile.

What Kinds of Returns Do Companies Like Ours Generate for Shareholders?

Section 7

What are Shareholder Returns?

Two Potential Sources of Shareholder Return

Dividend Yield

$$\frac{Dividends\ received\ during\ the\ year}{Value\ at\ the\ beginning\ of\ the\ year}$$

Capital Appreciation

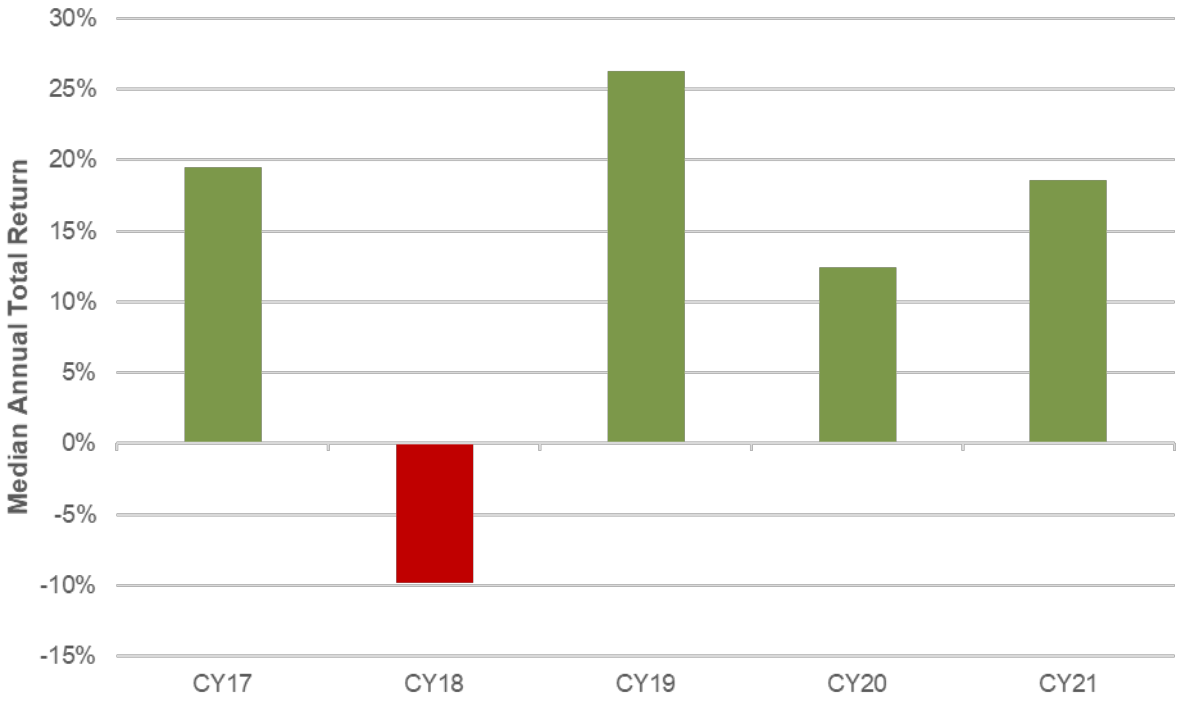
$$\frac{Change\ in\ value\ during\ the\ year}{Value\ at\ the\ beginning\ of\ the\ year}$$

Total Return

$$Dividend\ Yield + Capital\ Appreciation$$

Annual Return Trends

Annual Returns for Public Companies are Volatile



Annualized Returns

Average Total Shareholder Returns (CY17 through CY21)

	All Companies	Size Quintile (1 = largest)				
		1	2	3	4	5
Communication Services	5.1%	9.2%	6.5%	5.5%	5.2%	-2.3%
Consumer Discretionary	13.1%	15.5%	16.0%	11.8%	10.4%	10.9%
Consumer Staples	9.2%	6.0%	5.7%	10.4%	5.4%	19.3%
Energy	-3.7%	-1.9%	-3.0%	-12.6%	-15.1%	10.5%
Health Care	17.5%	17.2%	21.6%	16.0%	16.6%	15.8%
Industrials	12.1%	14.0%	13.7%	10.1%	13.8%	8.4%
Information Technology	22.4%	23.7%	19.3%	26.1%	25.0%	17.5%
Materials	8.9%	11.7%	14.2%	11.5%	2.5%	4.4%
All Companies	**13.9%**	**14.9%**	**14.9%**	**13.6%**	**12.0%**	**11.7%**

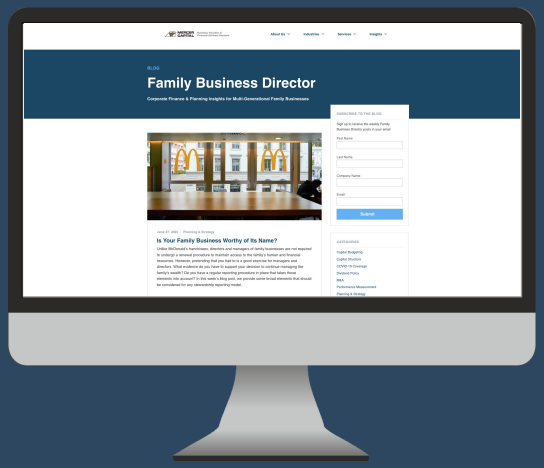
Annualized returns over the preceding five years revealed mixed performance, with information technology firms leading and the energy sector lagging.

Larger companies provided superior returns to smaller companies over the period analyzed, despite theoretical expectations that smaller companies should generate higher returns.

Subscribe to our weekly blog

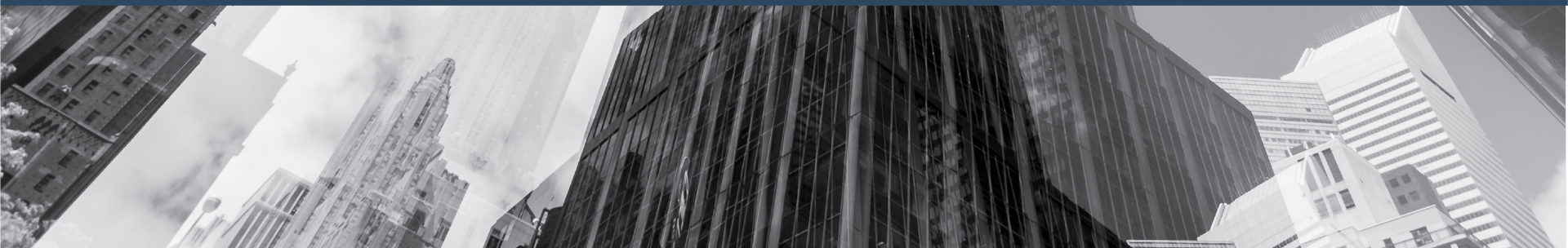
Family Business Director

Corporate Finance & Planning Insights for
Multi-Generational Family Businesses



SUBSCRIBE

Or visit https://mercercapital.com/family-business-director/



MERCER CAPITAL

www.mercercapital.com