MERCER CAPITAL

2023 Benchmarking Guide for Family Business Directors

Family Business Advisory Service Group

MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES
WWW.MERCERCAPITAL.COM

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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 over 40 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.

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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

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

		Revenue $Millions
1st Quintile	Median	$17,484
	Largest	572,754
	Smallest	3,976
2nd Quintile	Median	$4,344
	Largest	20,688
	Smallest	1,278
3rd Quintile	Median	$2,134
	Largest	6,532
	Smallest	459
4th Quintile	Median	$1,047
	Largest	2,413
	Smallest	154
5th Quintile	Median	$317
	Largest	1,148
	Smallest	10

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

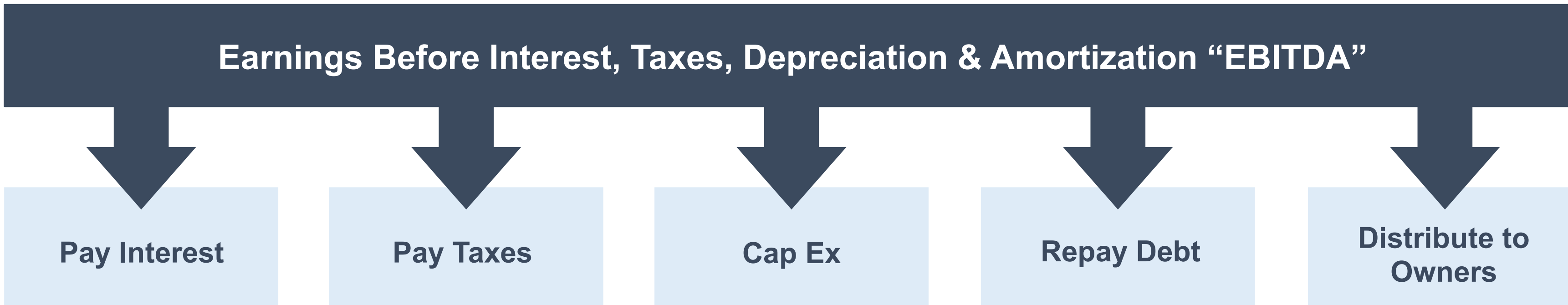
We have also excluded companies with revenue less than $10 million in 2022.

How Much Money Do Companies Like Ours Make?

Section 1

What is EBITDA?

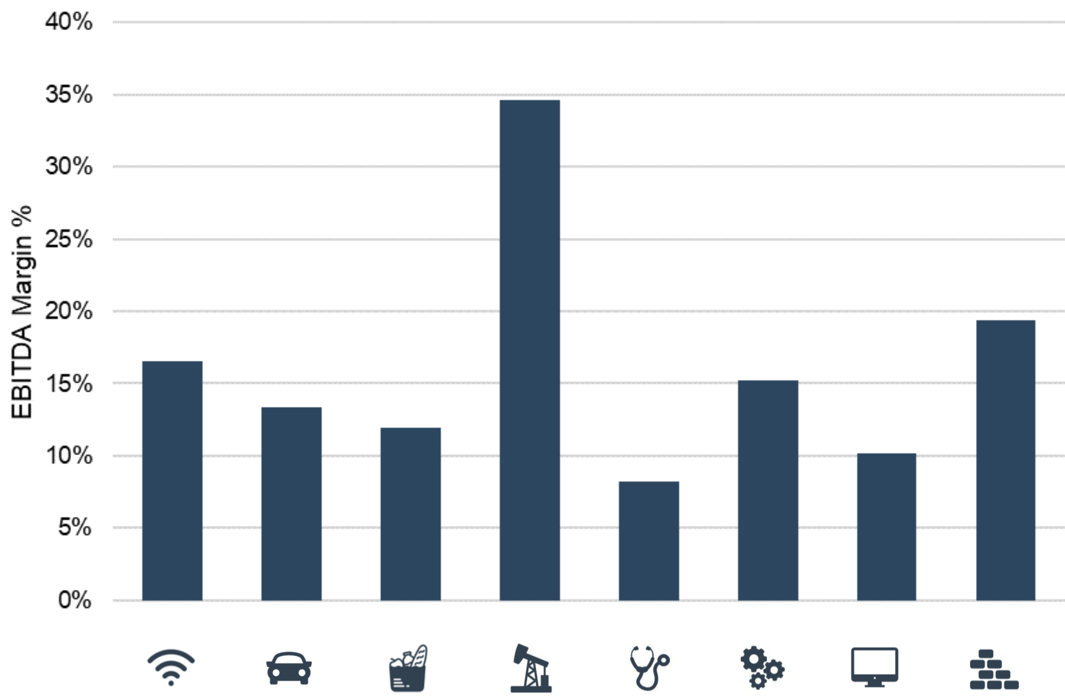
Defining Profitability



EBITDA, or Earnings Before Interest, Taxes, Depreciation & Amortization, is the most cited measure of earnings for operating 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 CY22 EBITDA Margin



The overall average EBITDA margin for the group was 14.4%. However, there is significant variation among the analyzed industry sectors. Generally, 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

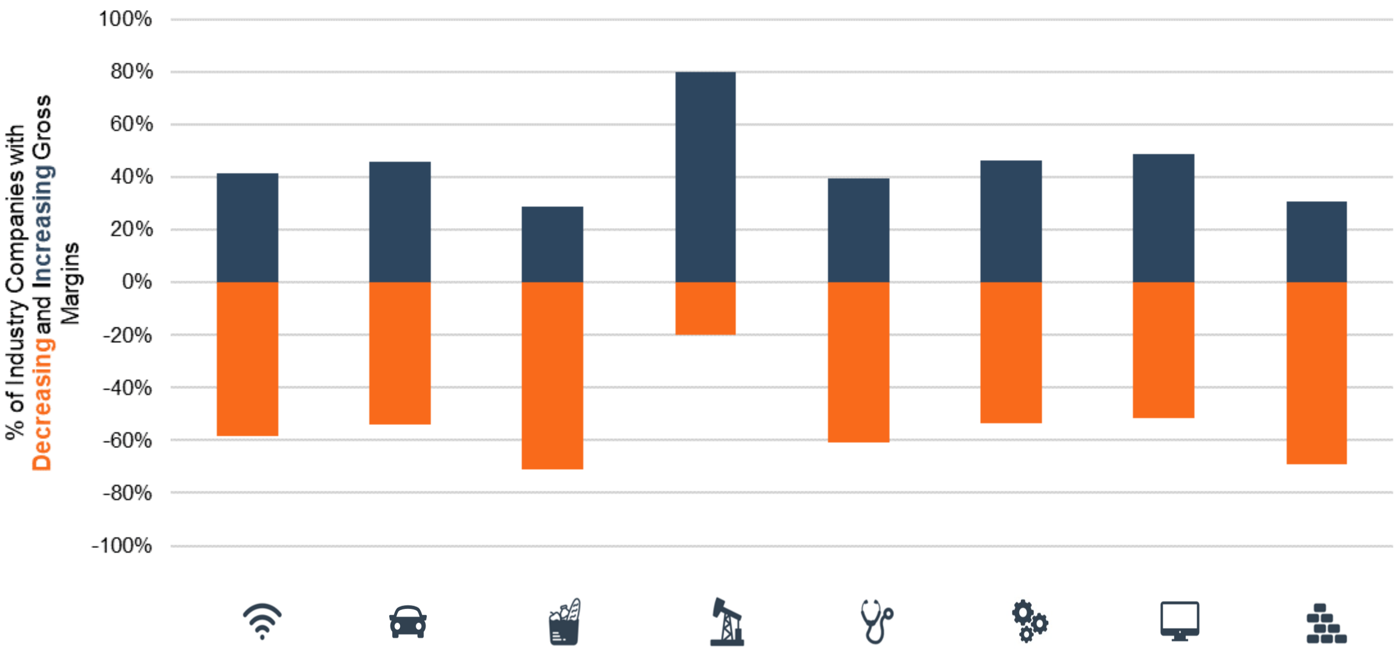
Data Suggests that Economies of Scale More Important in Some Industries Than Others

	All Companies	Size Quintile (1 = largest)				
		1	2	3	4	5
Communication Services	**16.6%**	23.8%	23.7%	13.4%	20.3%	1.8%
Consumer Discretionary	**13.3%**	12.7%	16.1%	13.3%	16.6%	7.8%
Consumer Staples	**11.9%**	11.4%	17.7%	12.8%	11.6%	5.3%
Energy	**34.6%**	25.3%	39.3%	43.2%	31.3%	33.2%
Health Care	**8.2%**	24.0%	16.6%	7.2%	-7.4%	-18.2%
Industrials	**15.2%**	15.8%	16.5%	16.1%	14.8%	12.6%
Information Technology	**10.2%**	24.4%	15.8%	8.2%	6.9%	-5.0%
Materials	**19.4%**	20.1%	20.5%	16.0%	16.4%	24.3%
All Companies	**14.4%**	**19.2%**	**18.7%**	**14.3%**	**11.7%**	**7.1%**

Comparing average EBITDA margins across size quintiles confirms that economies of scale matter. Larger companies tend to earn higher margins than smaller companies, albeit not universally across sectors.

Gross Margin Year-over-Year

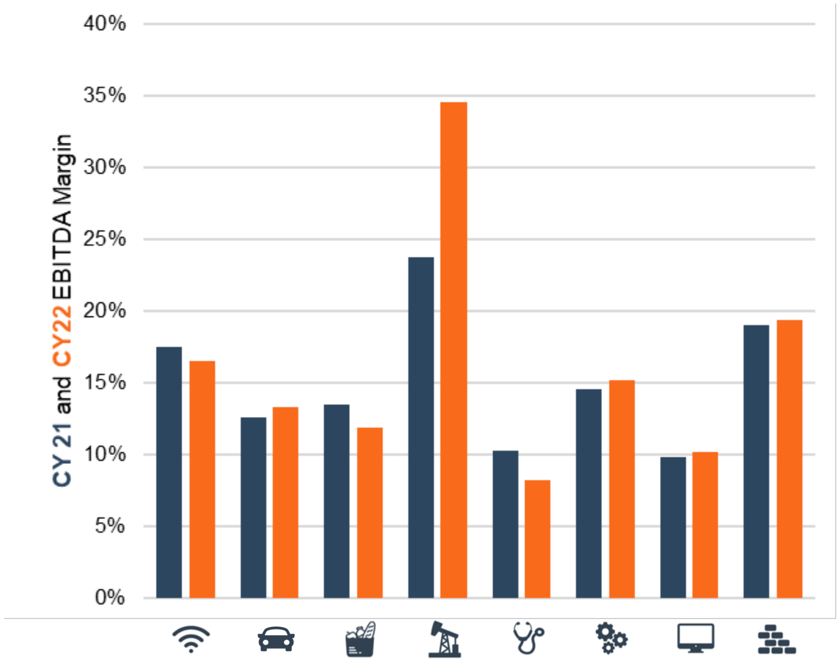
Majority of Companies Saw Gross Margin Compression

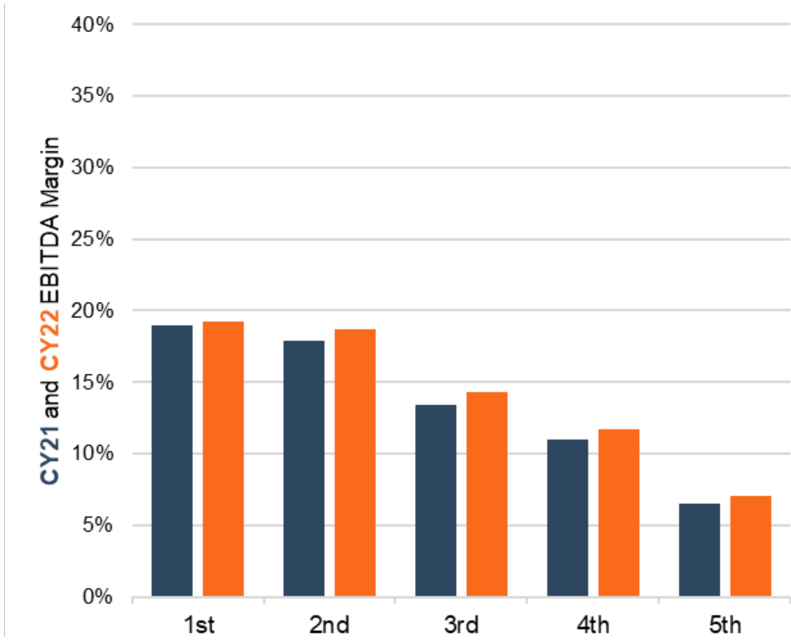


Strong results in the energy sector masked gross margin challenges across other industries as companies struggled to adapt to an inflationary environment not seen since the early 1980s. The majority of energy companies saw gross margin expansion, while the majority of companies in all other industry sectors saw gross margins decline. Companies in the consumer staples, materials, and healthcare saw the largest declines in gross margin.

EBITDA Margin Year-over-Year

Industry Performance Mixed, Overall Margins Up Despite Pricing Pressure

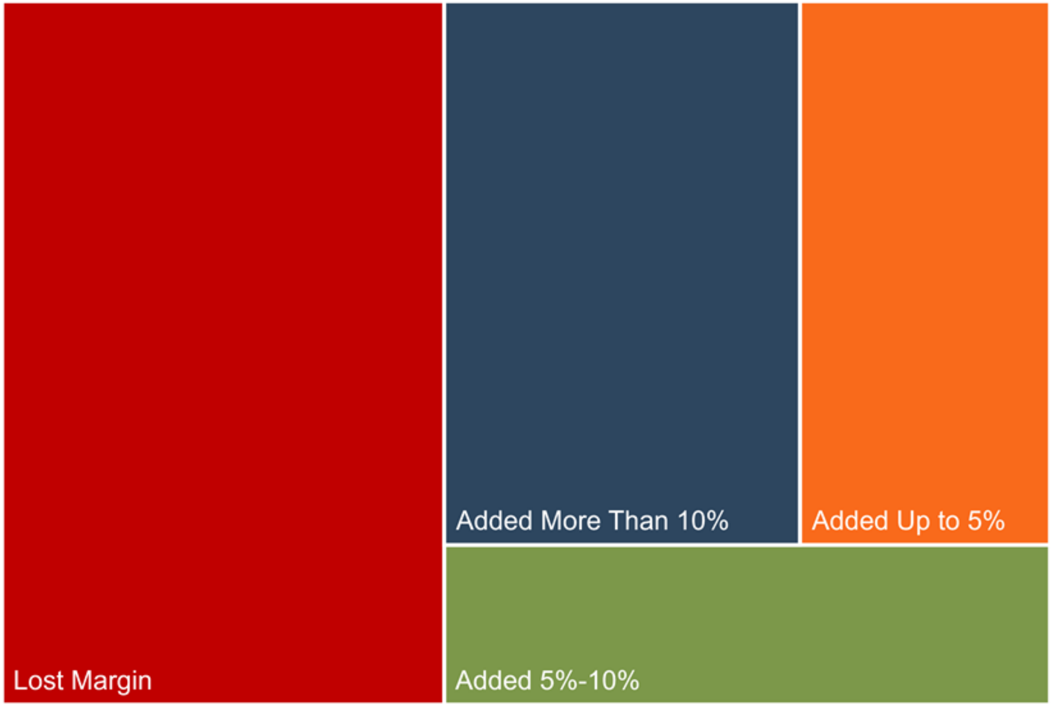




Following gross margins, EBITDA margins compressed in certain industries as pricing pressure affected industries less able to pass along price increases or reduce operating expenses. Communication services, consumer staples, and healthcare all saw year-over-year EBITDA margin declines. The energy sector saw the largest change in margin, with steady commodity prices serving as a tailwind to the sector. Margins across the entire sample increased slightly, implying some amount of pricing power among the sample.

EBITDA Margin and Growth

Change in EBITDA Margin for Companies that have Successfully Scaled



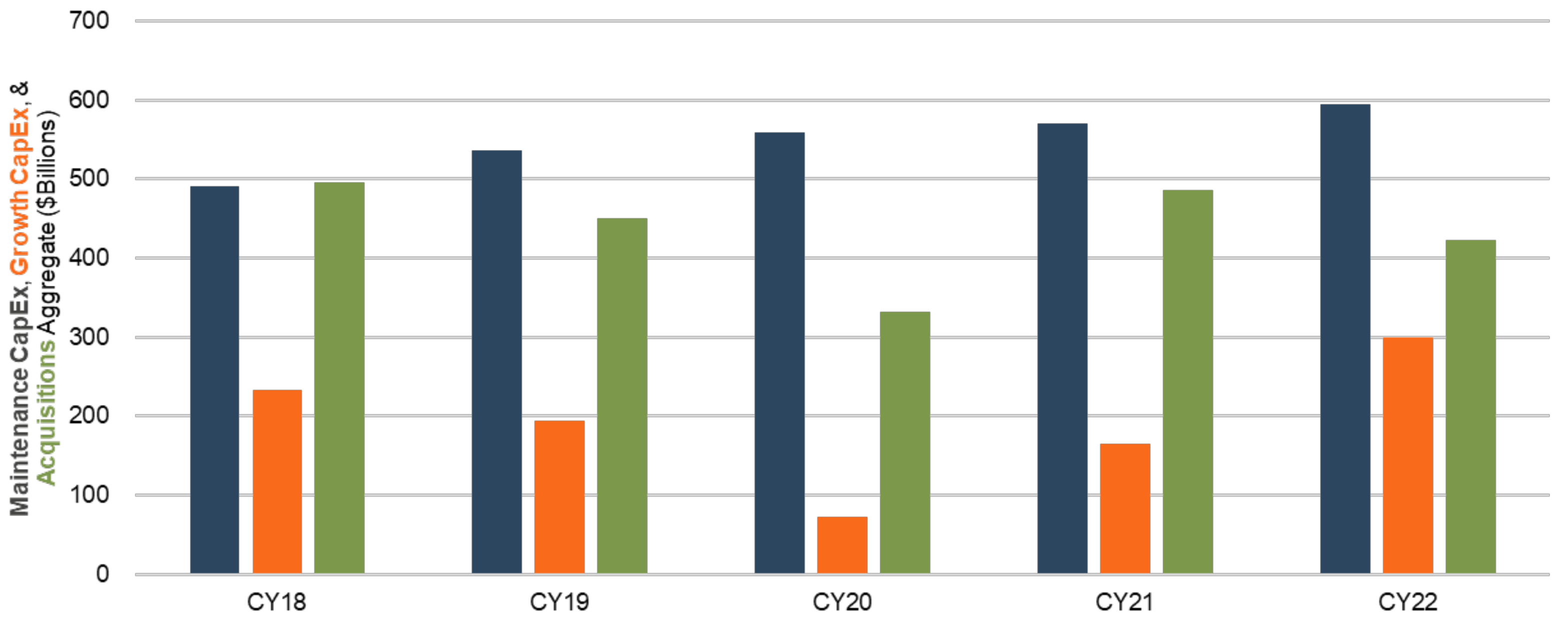
Of the companies in our sample, 358 at least doubled revenue from CY18 to CY22. For this subset of companies that have successfully scaled, nearly 60% experienced margin expansion, with about 27% increasing EBITDA margin by more than 10% over the period.

How Much 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 analyzed period. Spending on acquisitions exceeded growth capital expenditures by 58%, highlighting a "buy" vs. "build" mentality to a degree among the sample. 2022 did see a shift in this relationship relative to 2021, with an increase in spending on growth capital amid less acquisition spending. Maintenance capital expenditure was still the largest single investment category.

Investment Benchmarks

Three Ways to Measure Relative Investment

Revenue	EBITDA	Invested Capital
$\frac{Gross\ Investment}{Revenue}$	$\frac{Gross\ Investment}{EBITDA}$	$\frac{Net\ Investment}{Beg\ Investment\ Capital}$
5.0%	**30%**	**2.0%**

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

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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	7.9%	40.8%	2.0%	$103,519	$67,079	$24,967	52.9%	34.3%	12.8%
Consumer Discretionary	3.7%	22.9%	1.2%	$107,310	$54,440	$46,770	51.5%	26.1%	22.4%
Consumer Staples	3.5%	28.2%	2.0%	$47,605	$14,978	$36,012	48.3%	15.2%	36.5%
Energy	14.1%	38.8%	3.8%	$105,799	$23,280	$19,685	71.1%	15.6%	13.2%
Health Care	5.9%	28.8%	1.6%	$40,316	$23,618	$108,571	23.4%	13.7%	62.9%
Industrials	4.9%	31.4%	3.0%	$72,666	$58,404	$67,841	36.5%	29.4%	34.1%
Information Technology	4.7%	27.8%	1.7%	$79,463	$42,749	$94,242	36.7%	19.7%	43.5%
Materials	5.8%	37.3%	2.4%	$38,413	$15,701	$24,415	48.9%	20.0%	31.1%
All Companies	**5.0%**	**29.8%**	**2.0%**	**$595,092**	**$300,250**	**$422,502**	**45.2%**	**22.8%**	**32.1%**

The level of investment when measured relative to EBITDA ranged from 23% to 41%. Maintenance capital expenditures are most prominent for communications services, consumer discretionary, and energy firms. Consumer discretionary firms allocated more net investment dollars to capex, while acquisitions were the primary avenue of growth for health care and information technology companies.

Investment and Company Size

Limited 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	4.6%	27.1%	2.6%	$469,946	$237,854	$291,710	47.0%	23.8%	29.2%
2nd Quintile	4.8%	30.3%	2.1%	$71,659	$25,916	$76,632	41.1%	14.9%	44.0%
3rd Quintile	5.0%	31.4%	2.5%	$29,693	$23,806	$31,512	34.9%	28.0%	37.1%
4th Quintile	4.9%	30.8%	1.6%	$17,366	$6,530	$17,813	41.6%	15.7%	42.7%
5th Quintile	5.8%	33.4%	1.1%	$6,428	$6,145	$4,836	36.9%	35.3%	27.8%
All Companies	**5.0%**	**29.8%**	**2.0%**	**$595,092**	**$300,250**	**$422,502**	**45.2%**	**22.8%**	**32.1%**

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 (27.1%) than for the smallest companies (33.4%). The smallest companies tend to be somewhat less acquisitive than their larger counterparts.

How Much Money Do Companies Like Ours Distribute?

Section 3

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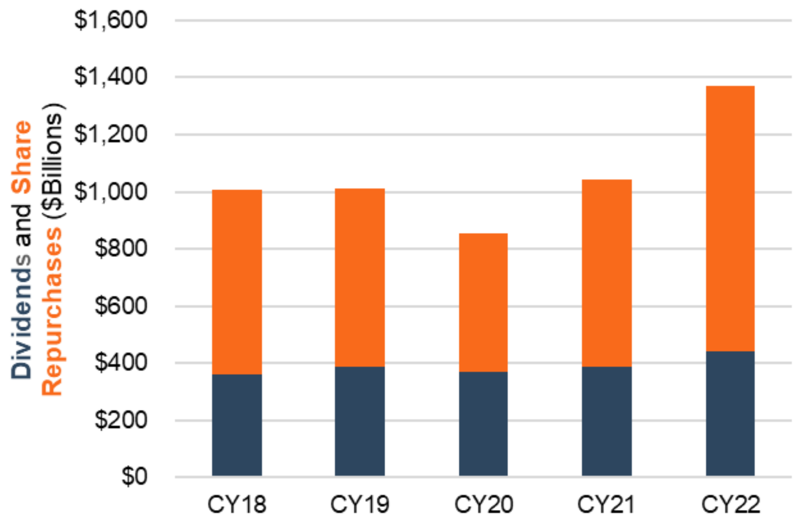
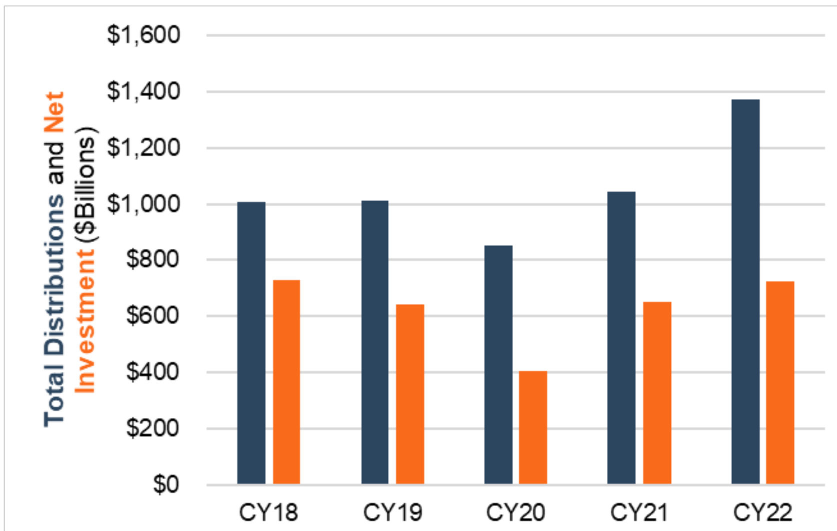
Aggregate Distribution Trends

Companies Weigh Distributions Against Available Investment Opportunities





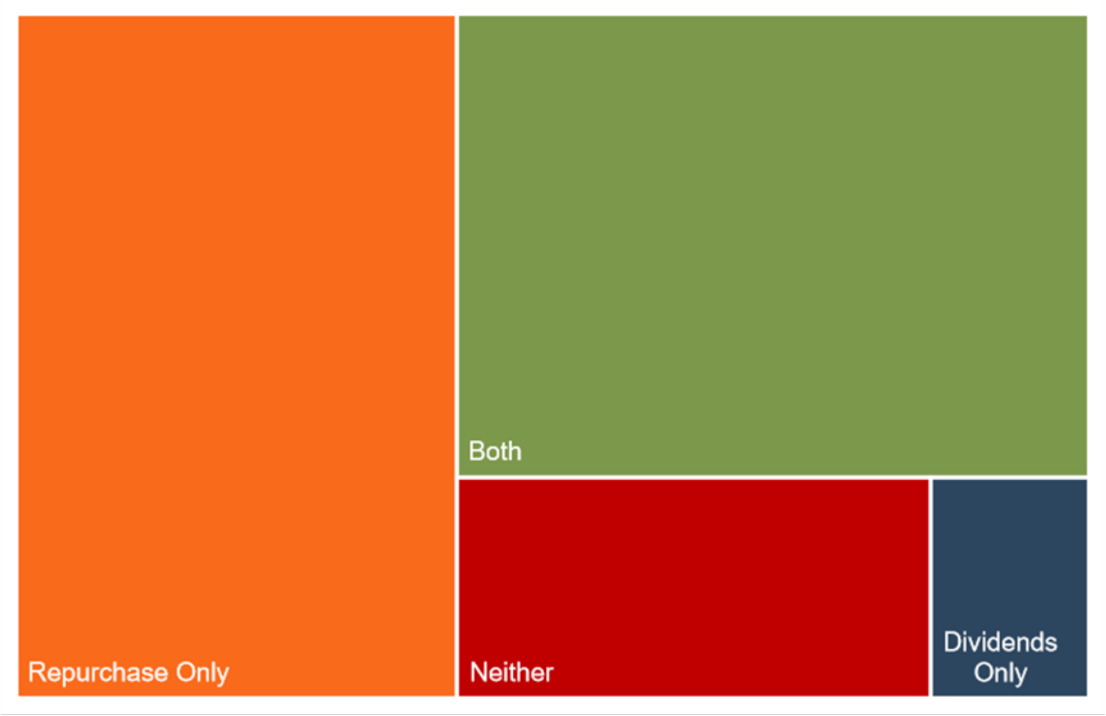
Public companies generally prefer a sustainable level of dividends that can withstand temporary downturns in performance. As a result, aggregate share purchases have exceeded dividends paid in each of the preceding five years.

Across the sample, dividends paid increased 13% while share repurchases rose 43% in aggregate. Energy and consumer discretionary companies saw the largest dividend and share repurchase growth. Communication services was the only industry segment to see total distributions (dividends + share repurchases) decline year-over-year.

For the universe of companies we analyzed, total distributions exceeded net investment by nearly 90% for the period.

Prevalence of Distributions

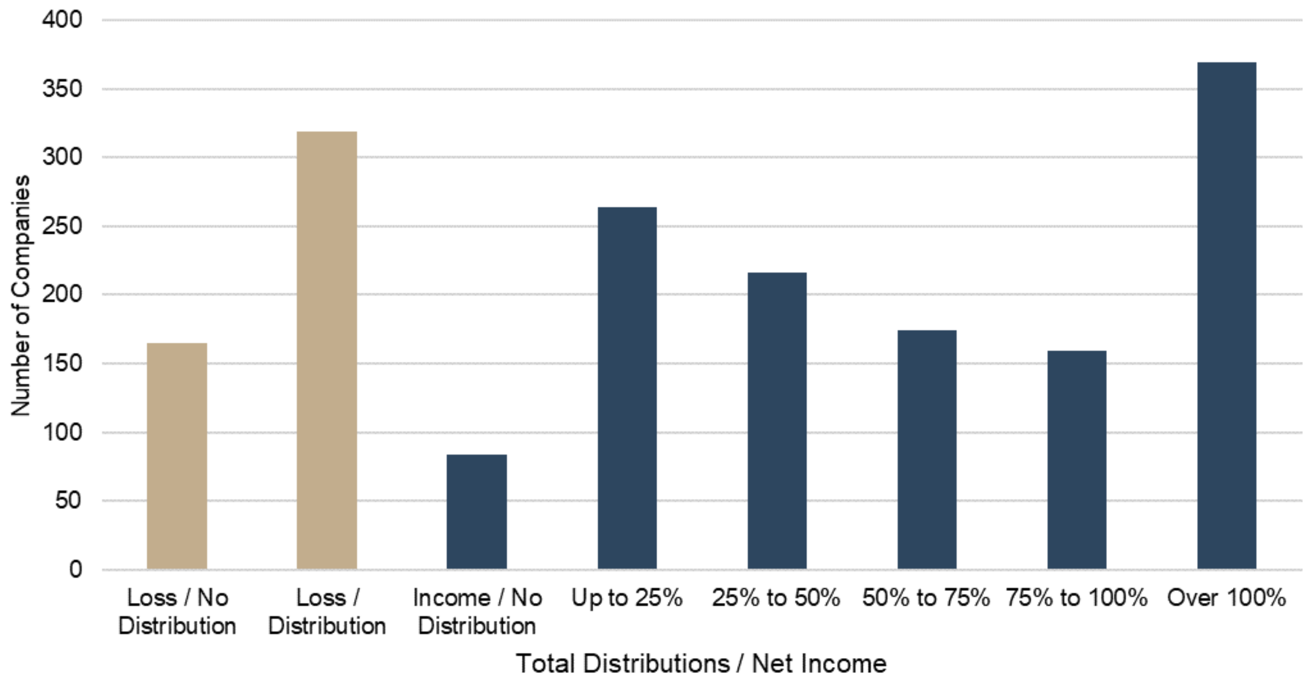
Companies Select Form of Shareholder Distributions



14% of the companies in our sample neither paid dividends nor repurchased shares during CY22. Only 5% of companies paid dividends only, while 81% of companies either repurchased shares alone or did both. 45% of companies in the sample paid dividends but did not repurchase shares.

Magnitude of Distributions

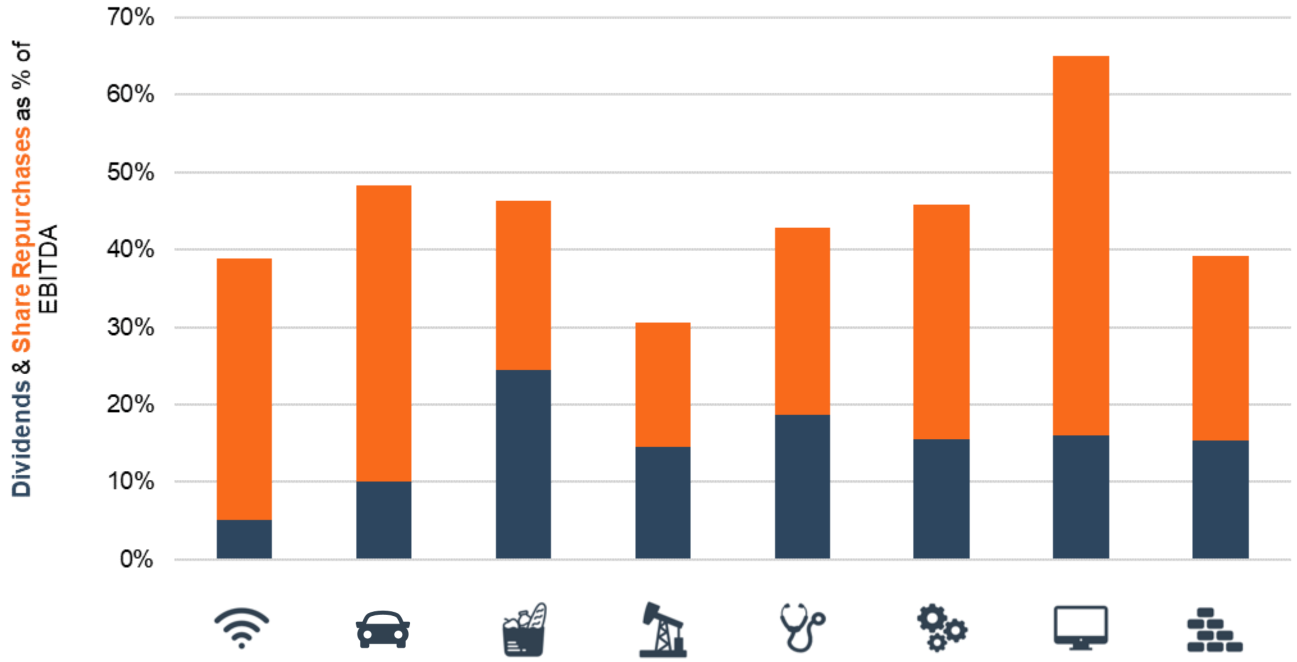
Distributions as a Percentage of Net Income



Approximately 28% of the companies in our sample reported a net loss during CY22. Of these companies, nearly 66% still made a distribution (dividend, share repurchase, or both) to shareholders. Of the profitable companies in our sample, approximately 30% made total distributions in excess of net income during CY22.

Distributions by Industry

Aggregate Distribution Data Reveals Differences Among Industries



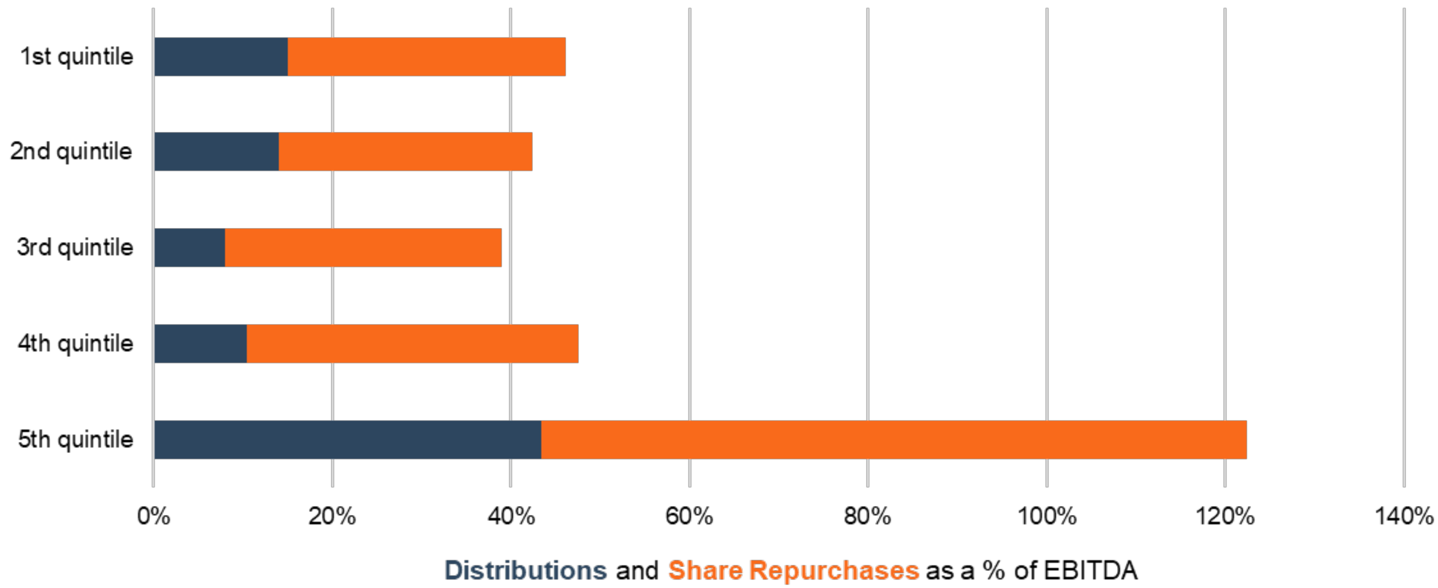
Capital intensive industries such as communication services devote a smaller portion of cash flow to shareholder distributions.

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



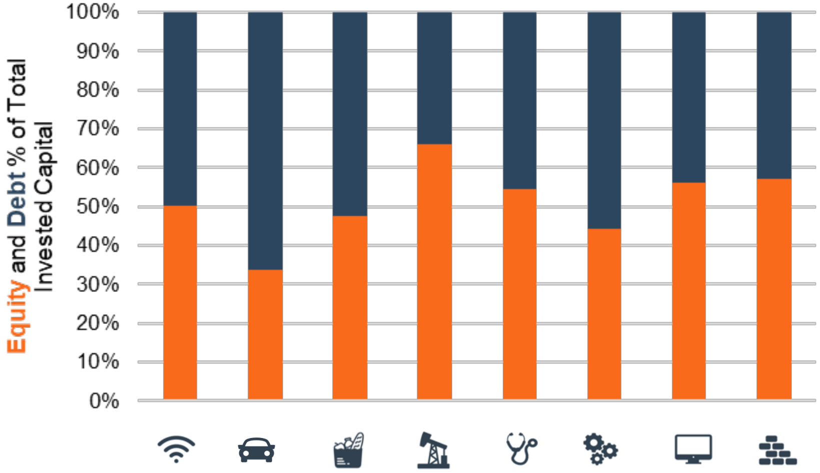
The smallest companies distribute the greatest proportion of operating cash flow (as proxied by EBITDA) to shareholders. This can be attributed to generally weaker EBITDA margins for such companies creating a "denominator" effect in the data. The largest (and generally most mature) firms distribute a larger proportion of EBITDA relative to companies in the middle of the bell curve (third quintile companies).

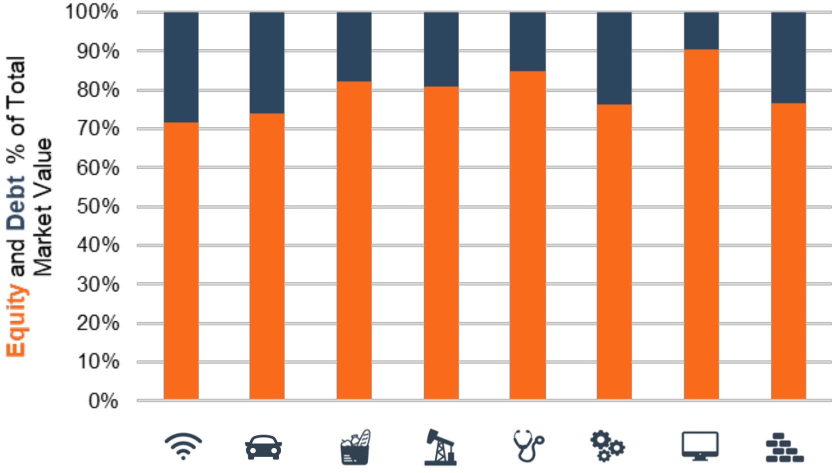
How Much Money Do Companies Like Ours Borrow?

Section 4

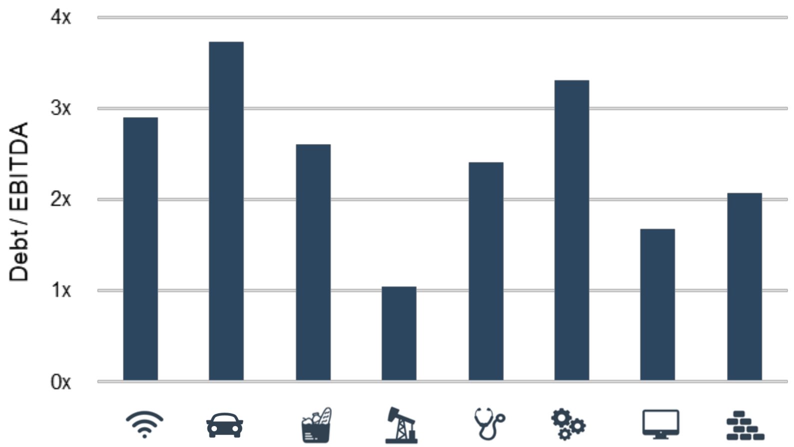
Financial Leverage by Industry

Borrowing Capacity Influenced by Assets and Cash Flow



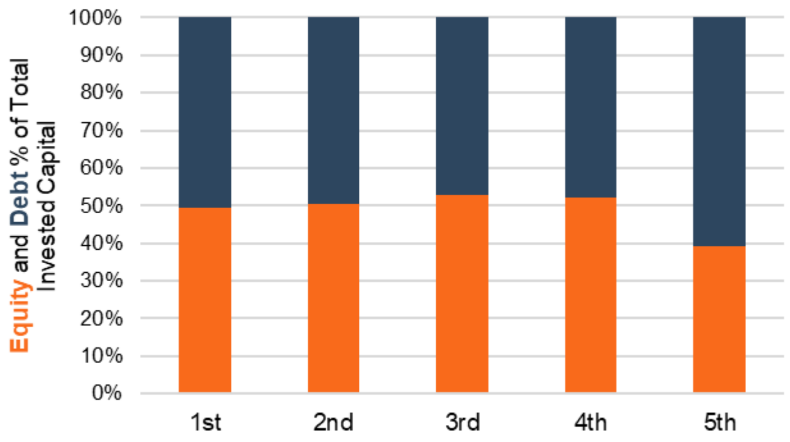


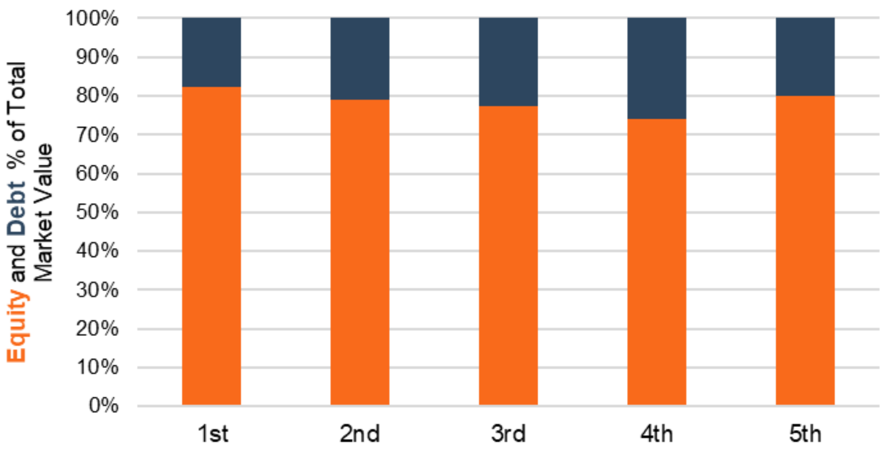
Financial leverage can be measured by comparing total debt to invested capital (book values of debt and equity), market values, or relative to cash flow. On a market value basis, leverage at the end of 2022 ranged from 10% (IT) to 28% (Communication).



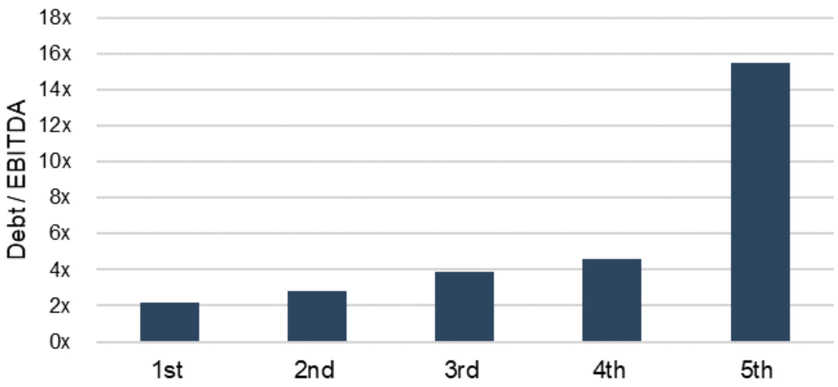
Financial Leverage by Company Size

Smallest Firms Have Less EBITDA to Cover Debt Obligations



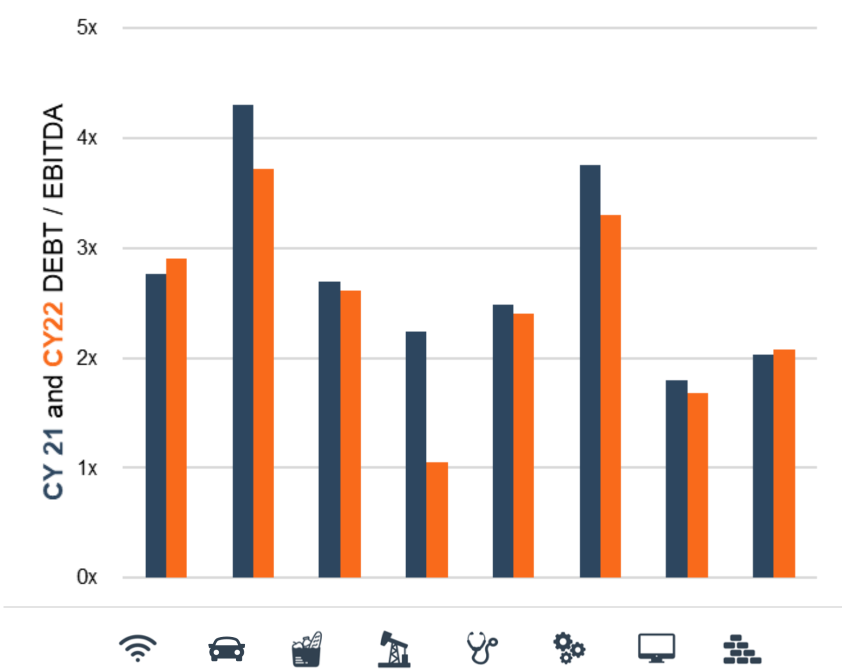


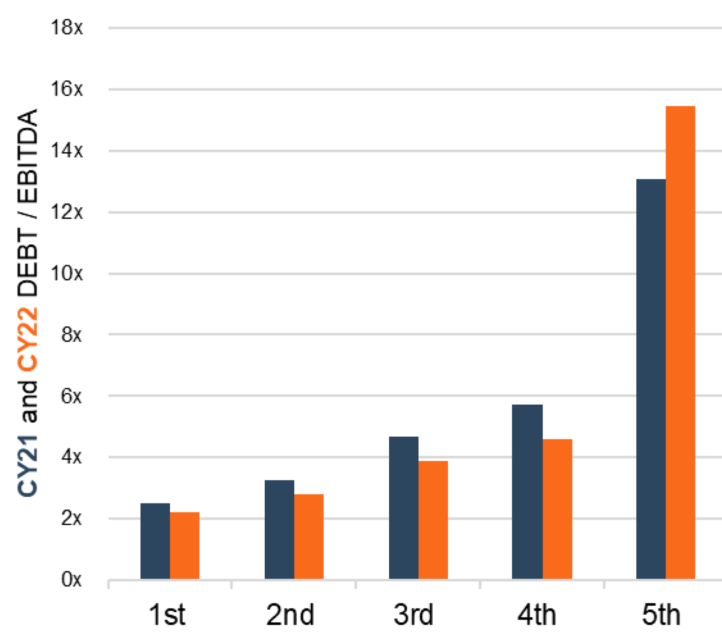
There is little discernable size effect with respect to book or market values. However, lower EBITDA margins on the part of the smaller firms increase the aggregate ratio of debt to EBITDA for such firms.



Financial Leverage Year-over-Year

Industry Change Mixed, Smaller Firms see Leverage Rise





Rising interest rates from 2021 to 2022 impacted leverage ratios and Company's borrowing capacity and appetite. Most industries, outside communications and materials, saw their Debt-to-EBITDA ratios decline as companies grew wary of taking on additional debt amidst higher borrowing costs. In aggregate, EBITDA grew 16% from 2021 to 2022, while debt balances only rose 2.1%. From a size perspective, the smallest companies saw both EBITDA declines year-over-year and debt balances rise, with leverage ratios increasing over 2.0x from 2021 to 2022.

Use of Debt by Industry

Debt Reliance Measured Relative to Total Invested Capital

	All Companies								
No Debt	4	0	1	0	0	1	2	0	0
0% to 20%	360	20	34	16	27	104	56	90	13
20% to 40%	448	14	53	27	45	72	113	83	41
40% to 60%	452	31	85	36	25	64	130	45	36
60% to 80%	258	18	71	17	19	26	53	30	24
Over 80%	228	18	74	15	8	33	26	47	7
Total	1,750	101	318	111	124	300	380	295	121

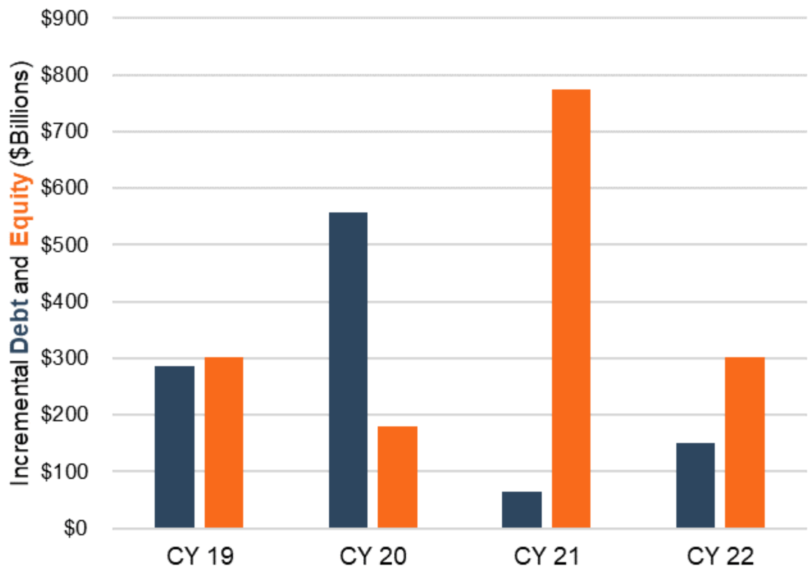
No Debt	0.2%	0.0%	0.3%	0.0%	0.0%	0.3%	0.5%	0.0%	0.0%
0% to 20%	20.6%	19.8%	10.7%	14.4%	21.8%	34.7%	14.7%	30.5%	10.7%
20% to 40%	25.6%	13.9%	16.7%	24.3%	36.3%	24.0%	29.7%	28.1%	33.9%
40% to 60%	25.8%	30.7%	26.7%	32.4%	20.2%	21.3%	34.2%	15.3%	29.8%
60% to 80%	14.7%	17.8%	22.3%	15.3%	15.3%	8.7%	13.9%	10.2%	19.8%
Over 80%	13.0%	17.8%	23.3%	13.5%	6.5%	11.0%	6.8%	15.9%	5.8%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

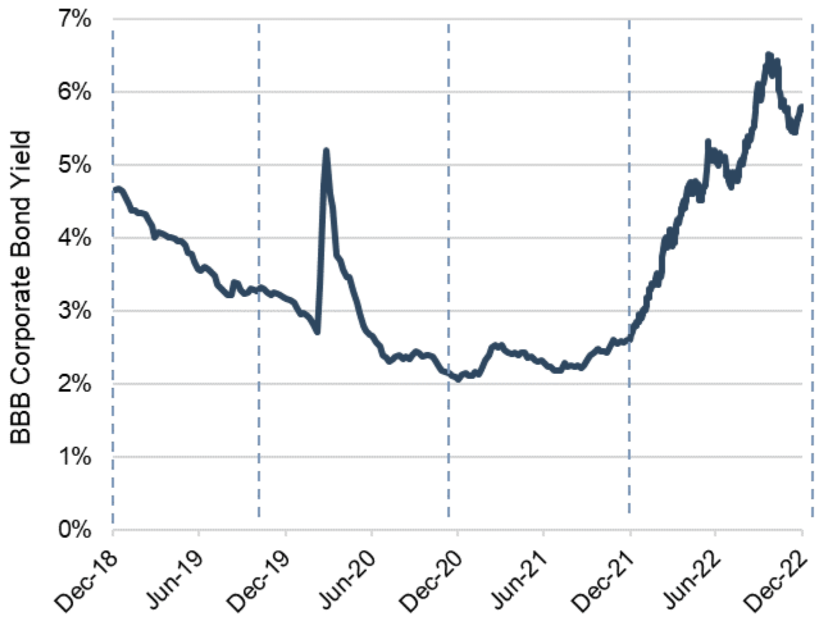
With respect to the companies in our sample, the use of debt is evenly distributed, with approximately 21% of companies having less than 20% debt in their capital structure, 51% between 20% and 60%, and 28% above 60%.

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 in 2019, with historically low interest rates, and in 2020, in the face of the economic slowdown resulting from COVID-19. Companies relied on incremental equity financing in both 2021 and 2022 in light of rising interest rates.

What is The Hurdle Rate for Companies Like Ours?

Section 5

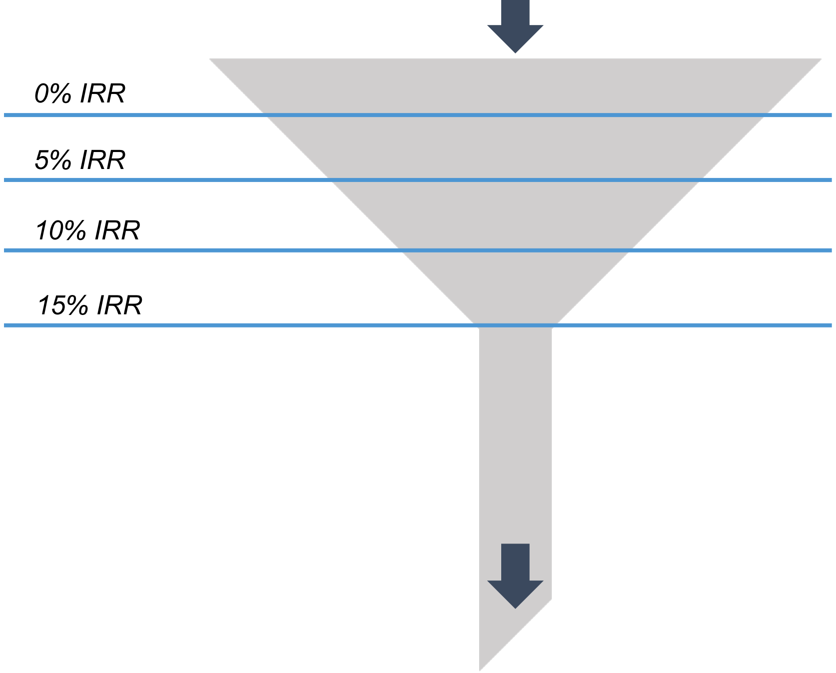
What is a Hurdle Rate?

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 <u>could</u> invest in than they <u>should</u> 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.

Available projects the family business <u>could</u> invest in



Available projects the family business <u>should</u> invest in

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 Quintile (1 = largest)				
		1	2	3	4	5
Communication Services	1.08	1.12	0.91	1.21	1.05	1.10
Consumer Discretionary	1.45	1.48	1.51	1.44	1.46	1.33
Consumer Staples	0.75	0.78	0.59	0.72	0.76	0.88
Energy	1.68	1.60	1.94	2.03	1.53	1.32
Health Care	0.99	0.88	0.98	0.95	1.01	1.14
Industrials	1.21	1.19	1.26	1.24	1.28	1.07
Information Technology	1.18	1.26	1.22	1.24	1.12	1.07
Materials	1.27	1.29	1.18	1.20	1.42	1.27

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.

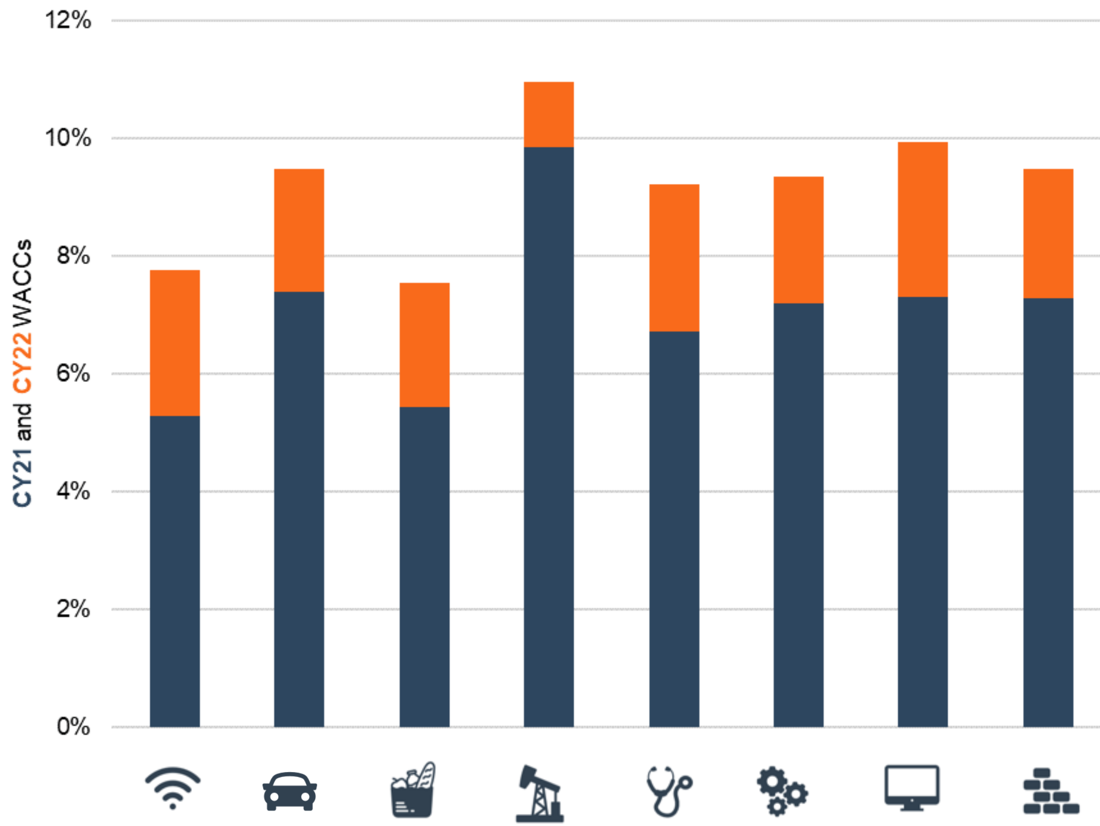
	All Companies	Size Quintile (1 = largest)				
		1	2	3	4	5
Communication Services	8.2%	7.8%	6.5%	8.6%	8.4%	9.9%
Consumer Discretionary	9.7%	9.0%	9.5%	9.7%	9.8%	10.7%
Consumer Staples	7.7%	7.1%	6.8%	7.3%	8.2%	9.3%
Energy	11.4%	10.8%	12.6%	12.3%	10.8%	10.3%
Health Care	9.4%	7.7%	8.9%	8.9%	10.0%	11.3%
Industrials	9.6%	9.1%	9.7%	9.3%	9.9%	9.8%
Information Technology	10.2%	9.8%	9.9%	10.6%	10.1%	10.5%
Materials	9.6%	9.6%	8.7%	9.1%	9.9%	10.7%

Weighted Average Cost of Capital

Fed Policy and Interest Rates Contributed to Higher Cost of Capital Across Industries

Calculated WACCs in 2022 were over 2.0% higher than in 2021 on average.

Increase in interest rates, with 20-Year Treasury rising from 1.94% to 4.14% from CY21 to CY22 main driver. Borrowing costs (as reflected in BBB Corporate Bond Yields) were also up.

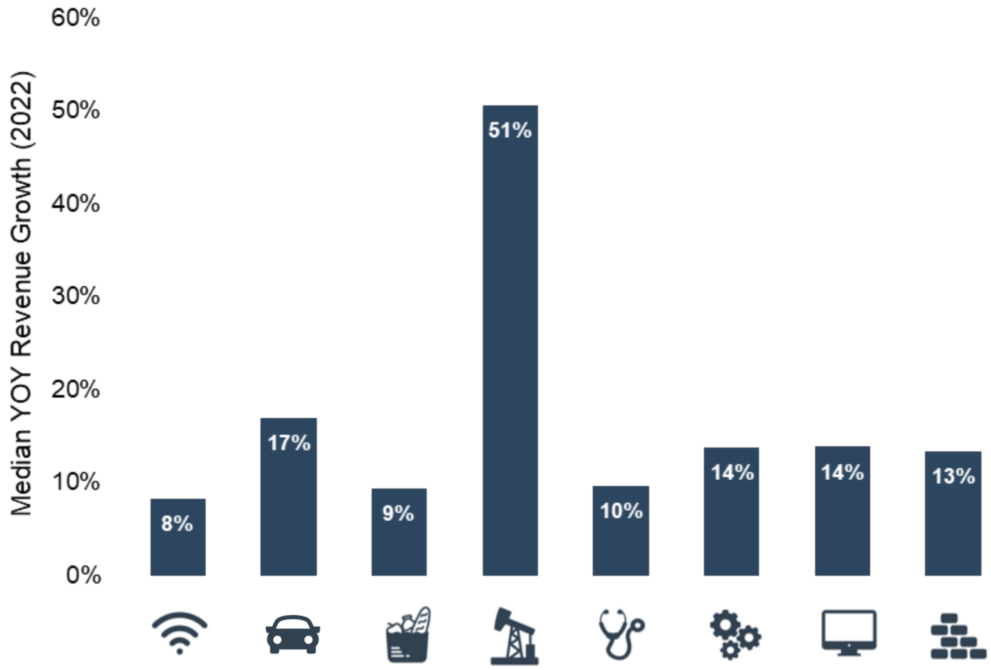


How Fast Do Companies Like Ours Grow?

Section 6

Revenue Growth by Industry

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



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

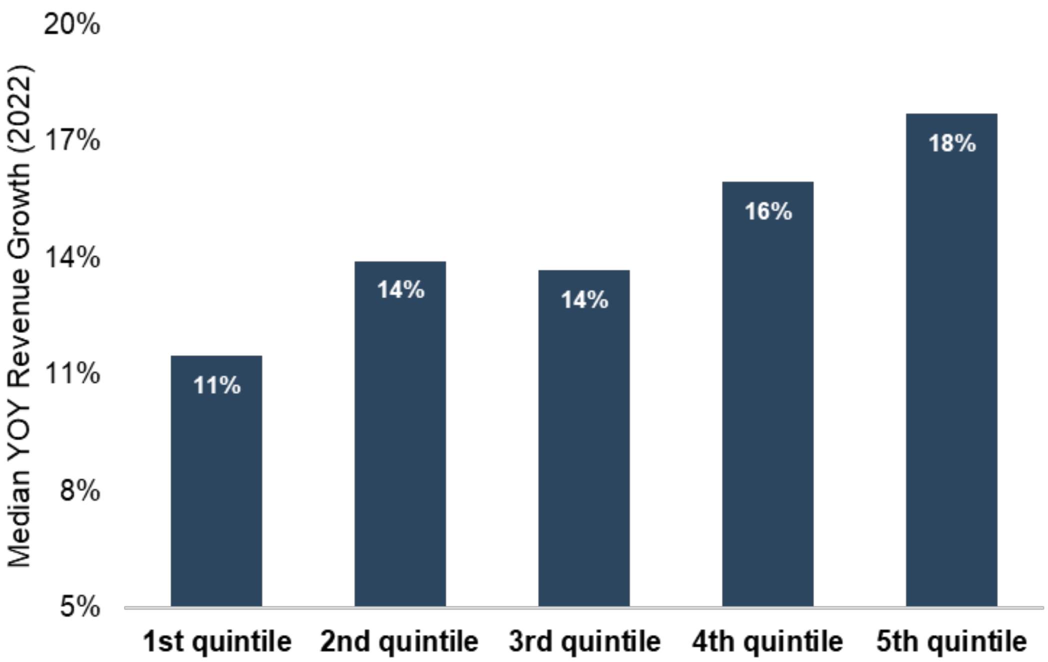
For other sectors, revenue growth reflects both broader economic growth, industry demand, and investment activity.

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

Revenue Growth by Size

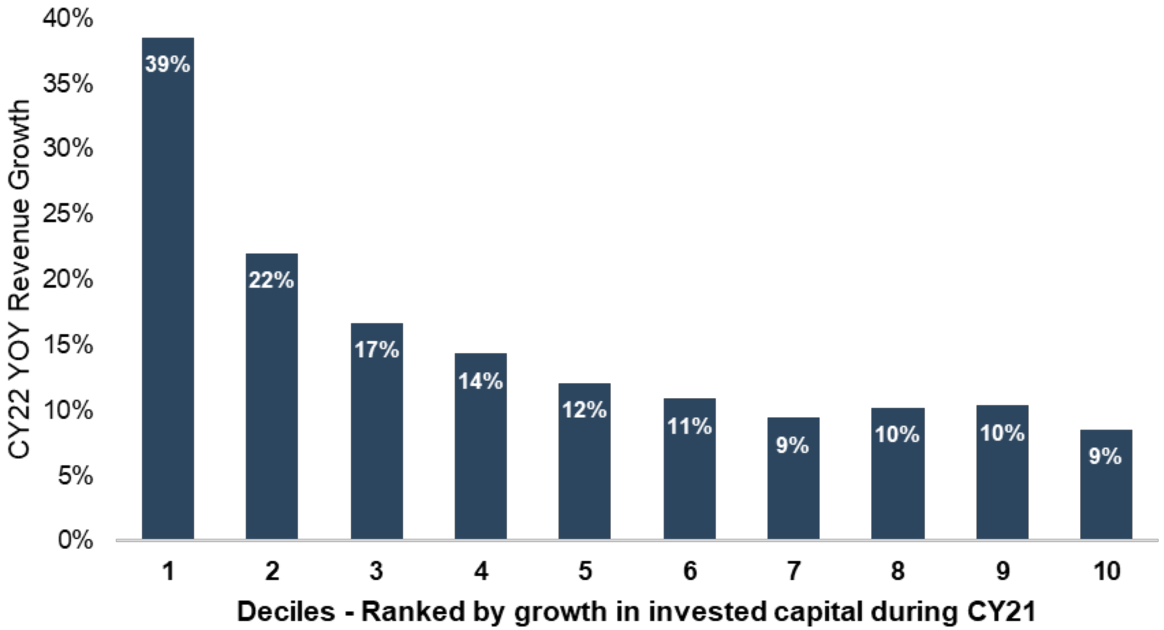
Revenue Growth a Function of Industry Factors, Organic Growth, and Investment

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.



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 CY21 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 CY22 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

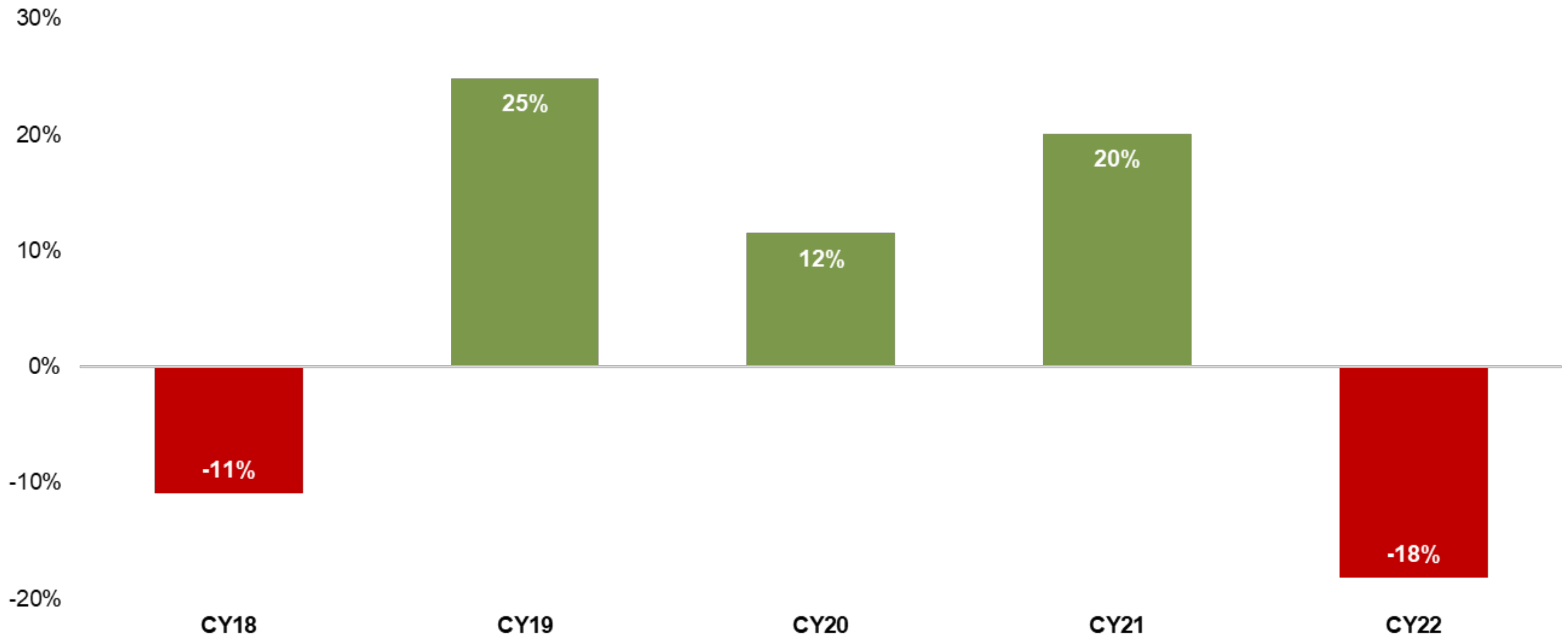
$$\frac{Change\ in\ value\ during\ the\ year}{Value\ at\ the\ beginning\ of\ the\ year}$$

Total Return

$$Dividend\ Yield + Capital\ Appreciation$$

Annual Return Trends

Annual Returns for Public Companies have been Volatile



Annualized Returns

Average Total Shareholder Returns (CY18 through CY22)

	All Companies	Size Quintile (1 = largest)				
		1	2	3	4	5
Communication Services	-1.9%	-2.5%	-2.5%	-4.2%	1.4%	-2.2%
Consumer Discretionary	2.8%	4.5%	4.6%	1.3%	-0.9%	4.1%
Consumer Staples	5.2%	6.2%	4.6%	4.3%	2.1%	9.0%
Energy	5.1%	5.5%	4.7%	3.6%	3.4%	7.8%
Health Care	5.8%	10.5%	10.4%	6.6%	3.3%	-3.7%
Industrials	5.0%	6.7%	7.5%	3.0%	4.6%	3.1%
Information Technology	10.1%	12.1%	11.6%	7.1%	10.8%	7.5%
Materials	3.0%	6.4%	7.4%	2.3%	-2.8%	2.5%
All Companies	**5.1%**	**7.2%**	**7.3%**	**3.6%**	**3.3%**	**3.1%**

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

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

ADDITIONAL RESOURCES AVAILABLE

RESOURCE CENTER

Family Business Director ON DEMAND

The one-stop shop for families and their advisors who have questions about the financial challenges common to family businesses.

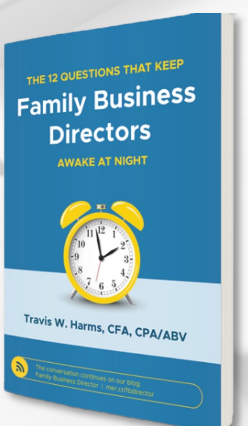
www.familybusinessondemand.com

BLOG

Family Business Director Blog

Corporate Finance & Planning Insights for Multi-Generational Family Businesses.

www.mercercapital.com/family-business-director/



BOOK

12 Questions That Keep Family Business Directors Awake at Night

Based on our years of experience working with family businesses, we've identified 12 important questions and suggest possible next steps.

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