

Porter, White & Company

What's it Worth?

Valuation Review, Winter 2015, Number 1

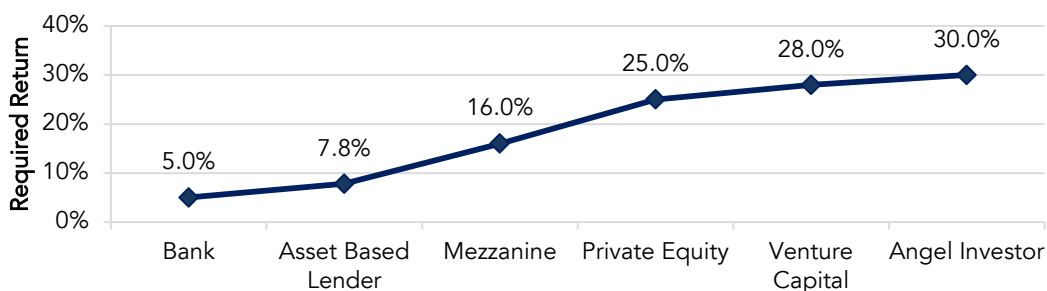
This report initiates Porter, White & Company's Quarterly Valuation Review, directed to small and middle market business owners and the professionals and financial institutions that serve them. The Review is designed to provide realistic guidance on the question "What's it Worth?," keeping in mind that proper preparation for real world transactions requires analysis of specific situations based on up to date data.

I. Overview

The law of supply and demand helped business sellers in 2014. An apparent lack of quality companies interested in selling and an abundance of liquidity in private equity funds pushed up deal multiples. The private equity firms we've spoken with recently indicate that the demand supply imbalance persists in 2015. The middle-market deal space appears to have more demand than supply in the \$5 million to \$25 million EBITDA range. There is less competition in smaller deals. In our view, an increase in prices as reflected in deal multiples does not imply that the underlying value of companies have improved, only that market forces have pushed up transaction prices.

The chart below shows estimates of required rates of return for different market participants: banks/senior lenders (\$5M loan size), asset based lenders (\$5M loan size), mezzanine lenders (\$5M loan size), private equity groups (\$5M EBITDA), venture capital firms (early stage investments), and angel investors (seed investments). Returns shown are based on survey data and not actual transactions and should be considered indicative only. Additional detail is provided later in the document.

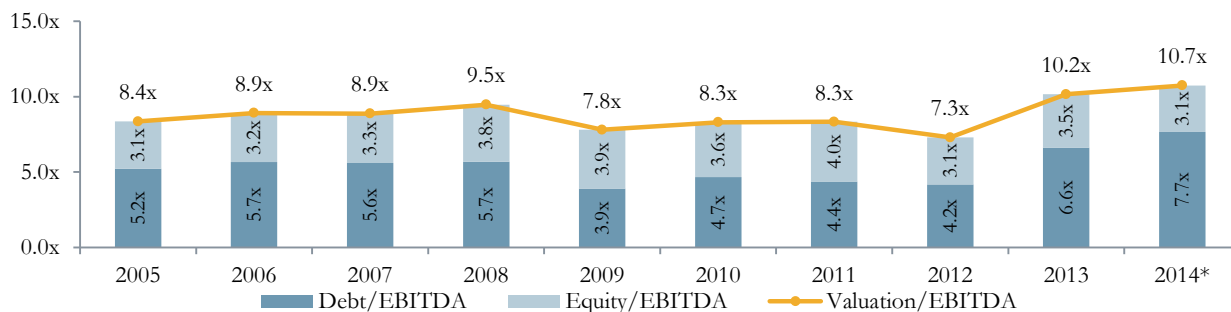
Figure A: Private Capital Markets Required Rates of Return¹



II. Valuation Multiples in M&A Deals

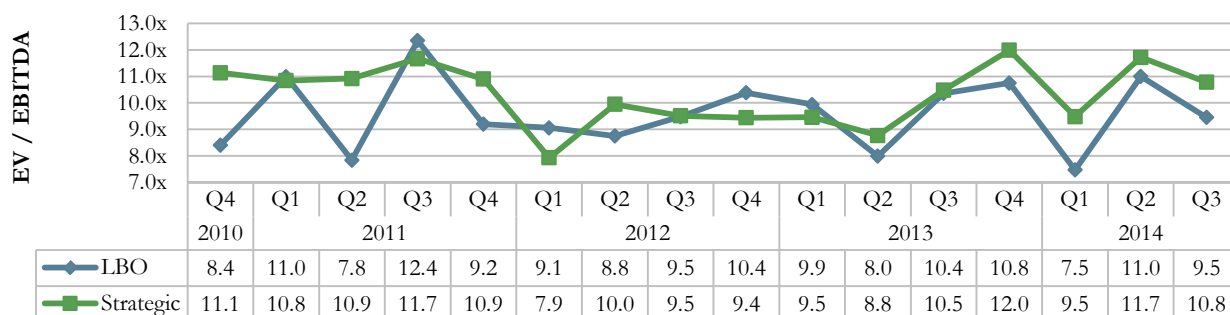
Multiples of middle-market companies (defined here as companies with transaction values between \$25M and \$1B) trended upwards in 2014, as shown in Figure A below. This is consistent with what we are hearing from private equity professionals around the country.

Figure B: Valuation Multiples in Middle-Market M&A Deals²



As is almost always true, strategic acquirers continue to pay more than financial buyers. Valuation multiples for strategic acquirers in North America have averaged 10.3X EBITDA since Q4 2010, while financial buyers have paid 9.6X EBITDA on average. Strategic buyers typically pay more than financial buyers because they are often able to extract additional value (synergy) from the post-acquisition combined company. Financial buyers aim to improve operational performance, restructure the capital structure, and cut costs to generate a required return.

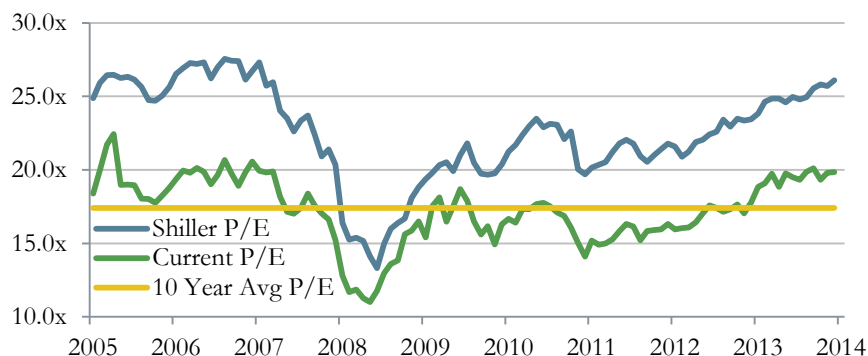
Figure C: Deal Multiples – Strategic Buyer vs. Financial Buyer (LBO)³



III. Publicly Traded Valuation Multiples

Private transaction multiples are the most direct evidence of valuations in the private markets. However, public markets also provide an important view of valuation metrics and show how sophisticated investors currently view and quantify risk in a given company, industry, or geography. The current P/E ratio (current price divided by latest 12 month earnings) of the S&P 500 index increased to 19.9 at the end of September 2014, up from 17.8 one year prior. The Shiller P/E ratio (current price divided by average earnings over 10 years) also increased to 26.1 from 23.4 over the same time period.

Figure D: Publicly Traded Valuation Multiples Over Last 10 Years⁴



	13-Sep	14-Sep
Current P/E	17.8	19.9
Shiller P/E	23.4	26.1
10 Yr Avg P/E		17.4

The following table provided by Aswath Damadoran shows the current market EBITDA multiples by industry at the beginning of 2015. It is important to know what the industry looks like when valuing a business, and industry multiples provide a current market view of growth and risk. The table is color coded to reflect the relative valuation metrics. Green rows indicate the highest multiples, yellow rows indicate mid-range multiples, and red rows indicate the lowest EBITDA multiples.

Table 1: Publicly Traded EBITDA Multiples⁵

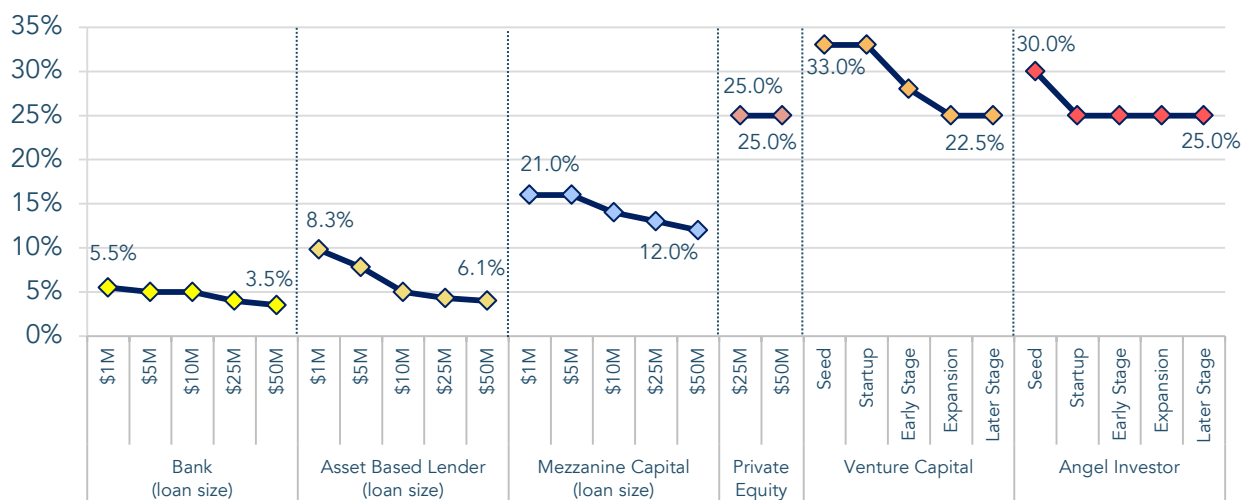
Industry	#	EV / EBITDA	Industry	#	EV / EBITDA	Industry	#	EV / EBITDA
Advertising	52	9.8	Entertainment	84	11.7	Power	82	9.9
Aerospace/Defense	93	10.3	Environmental & Waste Services	103	10.0	Precious Metals	147	6.1
Air Transport	22	8.1	Farming/Agriculture	37	9.6	Publishing & Newspapers	43	9.6
Apparel	64	12.4	Food Processing	96	11.9	R.E.I.T.	213	22.7
Auto & Truck	22	14.5	Food Wholesalers	14	11.2	Real Estate	81	16.8
Auto Parts	75	8.2	Furn/Home Furnishings	27	10.4	Recreation	68	10.4
Beverage	68	15.3	Green & Renewable Energy	26	14.3	Reinsurance	4	6.7
Broadcasting	28	10.7	Healthcare Products	261	14.5	Restaurant/Dining	79	11.9
Building Materials	39	11.8	Healthcare Support Services	138	10.5	Retail	343	12.5
Business & Consumer Services	177	10.2	Healthcare IT	127	17.6	Rubber& Tires	4	5.3
Cable TV	18	9.2	Homebuilding	35	14.4	Semiconductor	100	10.3
Chemical	159	10.1	Hospitals/Healthcare Facilities	56	12.2	Semiconductor Equip	47	12.2
Coal & Related Energy	42	8.9	Hotel/Gaming	80	13.0	Shipbuilding & Marine	14	9.4
Computer Services	119	8.4	Household Products	135	12.8	Shoe	13	15.2
Computers/Peripherals	64	10.0	Information Services	67	14.1	Software	606	17.9
Construction Supplies	55	10.3	Insurance	101	8.8	Steel	40	8.6
Diversified	23	14.0	Investments & Asset Management	148	20.8	Telecom	224	9.6
Drugs (Biotechnology)	400	19.1	Machinery	137	10.5	Tobacco	20	11.5
Drugs (Pharmaceutical)	151	13.6	Metals & Mining	124	6.5	Transportation	31	10.6
Education	42	7.6	Office Equipment & Services	25	8.9	Trucking	30	10.0
Electrical Equipment	126	10.1	Oil/Gas	646	7.0	Utility (General)	21	10.6
Electronics	217	12.1	Packaging & Container	26	9.1	Utility (Water)	19	11.4
Engineering/Construction	56	7.6	Paper/Forest Products	22	9.1	Total Market		14.7

IV. Private Capital Markets Required Rates of Return

The annual Pepperdine Private Capital Markets Project provides an interesting look at how capital market participants price risk. Within each category reported by Pepperdine, the cost of capital is identified based on specific risk metrics (size of loan, size of company, or stage of compa-

ny). As shown below, banks require the smallest return in exchange for the most security (first lien on assets). On the other hand, equity investors are willing to take substantially more risk if there is significant up-side potential. Notwithstanding the Pepperdine numbers, in our experience venture capital firms, private equity groups, and angel investors are often not enticed to invest in start-up companies with expected returns of only 20-30 percent; rather, they invest in multiple start-ups with far higher return potential in anticipation that most start-ups will fail and a few will be highly successful.

Figure E: Private Capital Markets Cost of Capital by Size and Stage⁶



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For related commentary, see [Great Time to be a Seller – Takeaways from ACG Conference](#).

¹Figure A. Source: Derived from the Pepperdine Private Capital Markets Project | Capital Markets Report – 2015

²Figure B. Source: PitchBook, 2H 2014 U.S. PE Middle Market Report, accessed November 17, 2014; * data through Q3 2014 was used in the analysis.

³Figure C. Source: S&P Capital IQ, Market Observations October 2014, accessed November 17, 2014.

⁴Figure D. Sources: Multpl.com, accessed November 24, 2014. Dimensional Fund Advisors, received December 3, 2014.

⁵Table 2. Source: Damadoran, Aswath. <http://www.damodaran.com>, accessed January 20, 2015.

⁶Figure F. Source: Derived from the Pepperdine Private Capital Markets Project | Capital Markets Report – 2015