Porter, White & Company

What's It Worth

Valuation Review, Spring 2019

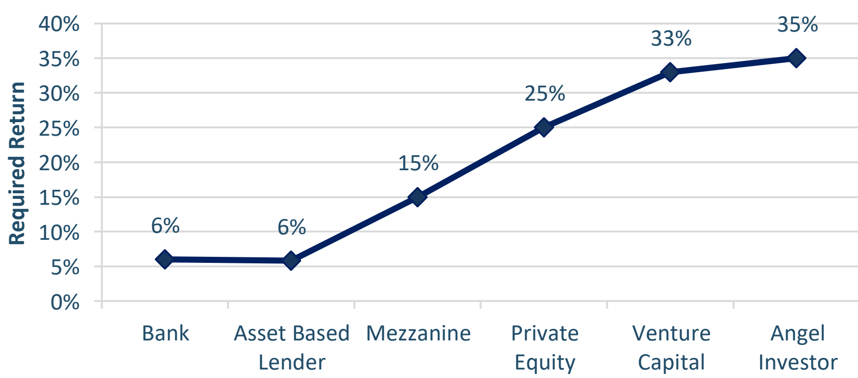
Our valuation review explores recent valuation trends in the public and private markets, directed to small and middle market business owners and the professionals and financial institutions that serve them. The review is designed to provide realistic guidance on the question "What's it Worth?," keeping in mind that proper preparation for real world transactions requires analysis of specific situations based on up-to-date data.

I. Executive Summary

U.S. private equity deal activity dipped slightly in Q1 2019 along with total transaction value as PE firms closed on smaller deals, but prices on completed deals remain elevated. Continued record-breaking fundraising efforts and private equity dry powder (funds raised but not yet invested) will continue to drive competition and push deal prices upwards. Private equity firms continue to search aggressively for smaller deals in the lower middle market, which is often less competitive and lacks the strategic acquirer interest.

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 ($10M EBITDA), venture capital firms (startup investments), and angel investors (startup 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 1: Private Capital Markets Required Rates of Return[1]

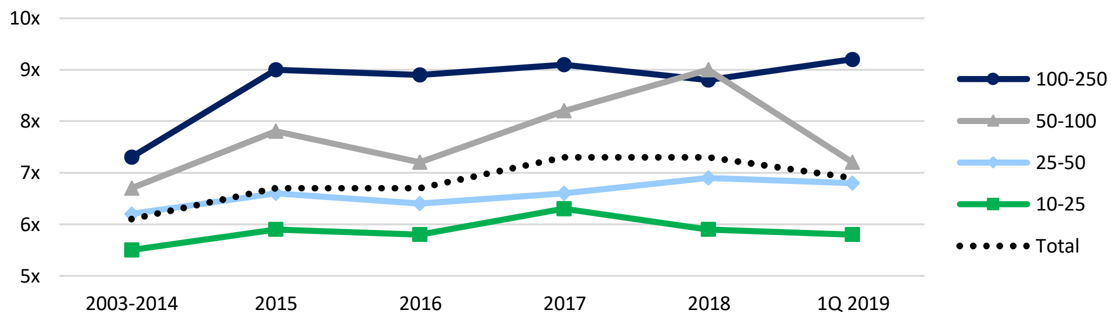


II. Valuation Multiples in M&A Deals

Multiples of middle-market companies (defined here as companies with transaction values between $10M and $250M) continued to remain strong in 2018 and Q1 2019; however, multiples in both the largest and smallest size categories dipped in 2018, as shown in Figure 2 below. As shown in the figure below, middle-market companies sold to financial buyers for an average of

6.9x trailing 12-month EBITDA during 2019, down from 2018 levels; however, a similar dip occurred during Q1 2018 and multiples recovered and strengthened throughout the year.

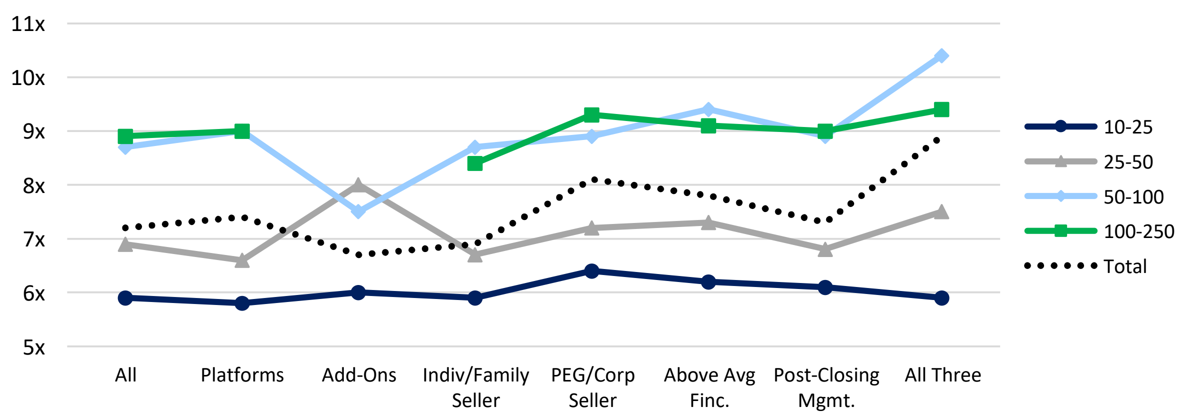
Figure 2: Valuation Multiples in Middle-Market M&A Deals by Size[2]



Source: GF Data®; Size is based on enterprise value of the target (in millions).

As shown in Figure 3 below, value is driven by a variety of factors, including existing ownership (individual/family or institutional), transaction purpose (platform or add-on), financial characteristics, and continuation of management post-closing. In almost all of these categories, private equity buyers have paid a "size premium" for larger businesses over comparable smaller ones. At the lower end of the middle market with enterprise value less than $25 million, sellers don't appear to be getting a premium for all three relative value factors compared to larger deals.

Figure 3: Valuation Drilldown: Private Equity Buyout Multiples in 2018 and Q1 2019[3]

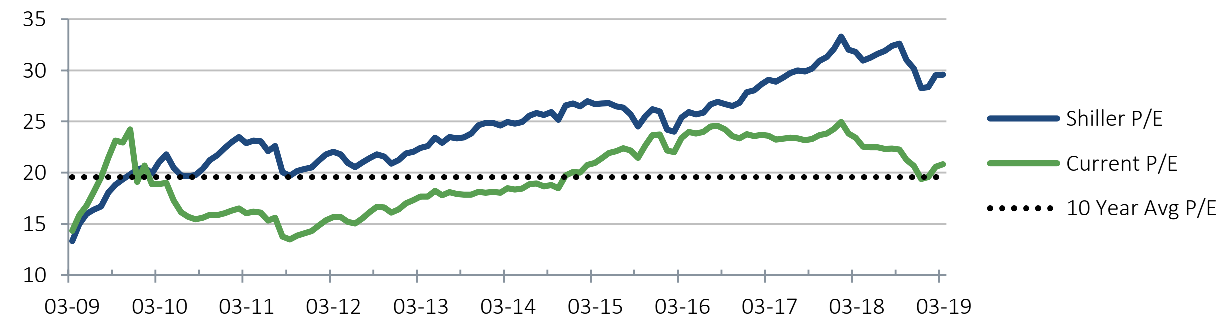


Source: GF Data®; Note: 'All Three' denotes buyouts featuring above-average financial characteristics, a post-closing management solution and private equity/corporate seller. "Add-Ons" buyout multiple for companies with an enterprise value between $100 million and $250 million is not available.

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 has decreased to 21.6 from 22.5 during the last twelve months and the Shiller P/E ratio (current price divided by average earnings over 10 years) decreased to 30.1 from 31.0 over the same time period.

Figure 4: Publicly Traded Valuation Multiples Over Last 10 Years[4]



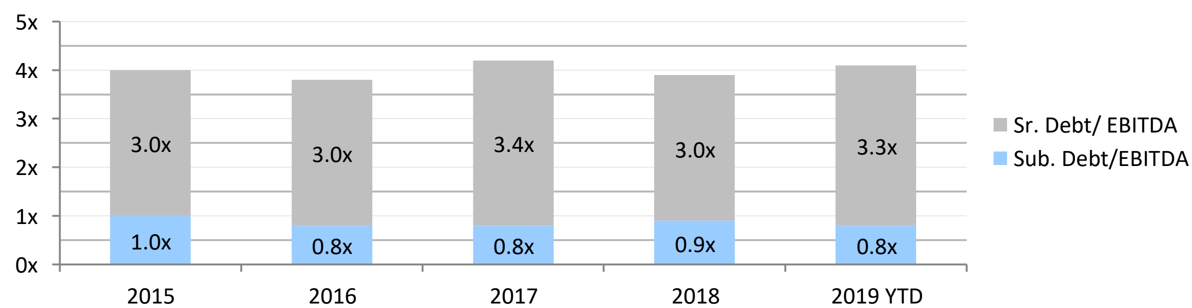
Note: The average P/E over the last 10 years was 19.3 as of March 31, 2019.

IV. Debt Markets

Debt utilization remained elevated in 2019, helping private equity firms fund expensive transactions at current deal prices. Total leverage for add-on transactions averaged 5.1x EBITDA (compared to 3.5x EBITDA for platform acquisitions), as acquirers used their existing company's financials to obtain increased levels of debt. Senior debt pricing averaged 6.3% (3.7% spread over 90-day LIBOR) in Q1 2019, an increase from 2018 levels, and subordinated debt interest rates averaged 11.5% (13.9% all-in, including PIK and warrants) in Q1 2019. [5]

The figure below summarizes the change in leverage ratios over the past five years.

Figure 5: Debt Multiples[6]

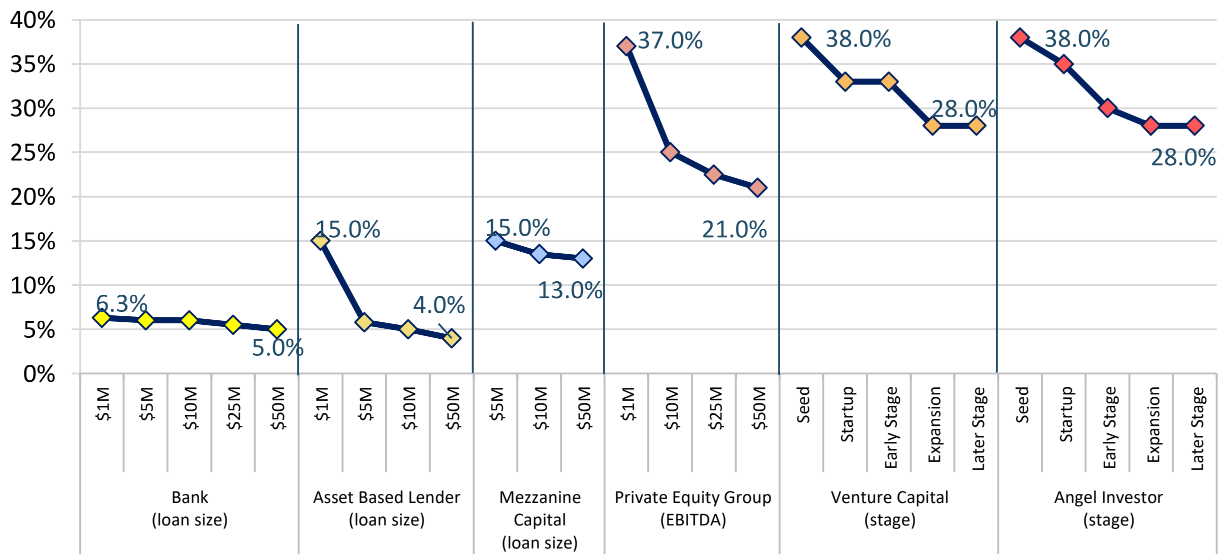


Source: GF Data®; Notes: Total debt multiples are additive. For example: a company with $10M in EBITDA in 2019 could borrow $33M from a senior lender and $8M from a subordinate loan ($41M debt total).

V. 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 company). 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 6: Private Capital Markets Cost of Capital by Size and Stage[7]



VI. Conclusion

Business owners often have a significant amount of their net worth tied to their own businesses. When evaluating business options (expansion opportunity, company sale, ESOP feasibility, succession plan, etc.) a business valuation is often a good place to start. At PW&Co, our expertise in valuation allows us to advise clients on valuation issues in connection with the sale of companies and informs our advice on the process by which they are sold. When selling an entire company, we advise clients to look for synergistic and industry buyers who can realize the greatest benefits from the acquisition, and thus pay the highest price for the company. Regardless of market conditions, successful liquidity events take preparation and time. We encourage our clients who are considering the sale of their business, raising debt or equity capital for growth, evaluating succession plan options, or contemplating how to put their capital to work most effectively to contact us to discuss how to prepare in advance to achieve the best possible outcome.

Michael C. Stone, CFA, AM

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[1] Derived from the Pepperdine Private Capital Markets Project | Capital Markets Report – 2019.
[2] GF Data®, M&A Report, May 2019.
[3] GF Data®, M&A Report, May 2019.
[4] Bloomberg, accessed 6/7/19.
[5] GF Data®, Leverage Report, May 2019.
[6] GF Data®, Leverage Report, May 2019.
[7] Derived from the Pepperdine Private Capital Markets Project | Capital Markets Report – 2019.