

## Deal Size Matters in 2010

The factors that lead larger businesses to be more highly valued have enabled many of them to rebound more quickly

By Andrew T. Greenberg

Throughout 2009, GF Data Resources documented the “flight to quality” many deal professionals were seeing and experiencing in a troubled marketplace.

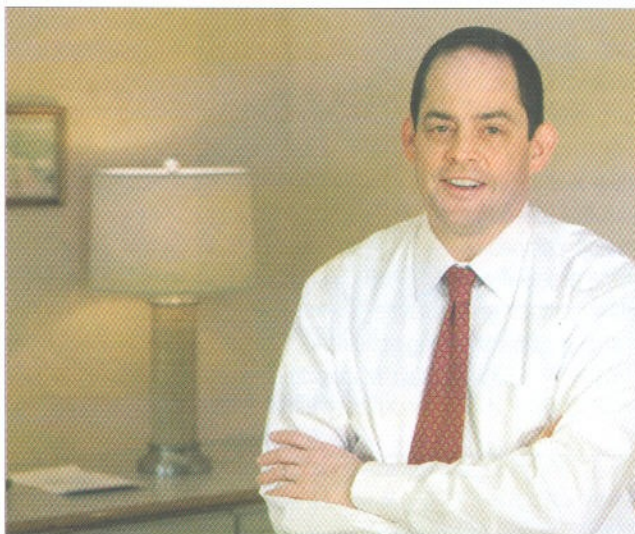
Now in mid-2010, as the M&A market appears to be stabilizing and gaining some momentum, deal quality has been joined by an equally potent determinant of value – deal size.

While it is in some ways a common sense observation to say that larger businesses will be valued more highly than smaller ones, the breakpoints within the lower middle-market became more pronounced than ever in 2009, and have been slow to narrow.

More than 150 private equity firms now report to GF Data on deals they complete in the \$10-250 million value range.

As shown in the chart to the right, in the pre-recession years of 2006 and 2007, businesses with less than \$5 million of Ebitda were actually valued at fairly modest discounts to larger businesses.

Then, as economic condi-



Andrew T. Greenberg

tions and capital availability eroded over the course of 2008 an unprecedented gap

developed. The reward for size alone soared from low- to mid-single digits to 16 percent in 2009. As deal volume has picked up in the first six months of this year, the gap has narrowed slightly to 10 percent.

The picture sharpens further when the other notable line of demarcation – deal

**“Businesses with less than \$5 million of Ebitda were actually valued at fairly modest discounts.”**

quality – is put back into the mix. Our subscribers and contributors continually heard about deal quality throughout 2009. We focused on a subset of “above-average” financial performers – businesses with trailing twelve month Ebitda margins and revenue growth rates both in excess of 10 percent.

Average valuations stayed aloft through the first half of last year because virtually the only non-distressed deals being completed involved these high-quality properties. Then, in the second half of the year, more owners of companies with good but not great financial characteristics reentered the market with a willingness to accept greater discounts in

### Buyout Transactions - TEV/EBITDA

EBITDA	2006	2007	2008	2009	2010 YTD
\$0-5 million	5.9x	5.9x	5.7x	5.1x	5.2x
> than \$5 million	6.1x	6.3x	5.9x	5.9x	5.7x
Size premium	3%	7%	4%	16%	10%

Source: GF Data Resources LLC

valuation against pre-downturn highs. The above-average group accounted for 62 percent of reported deal volume in the first half

customers, better financial information and controls, greater scale and ability to cut expenses all have tended to lead larger middle-market firms to a quicker recovery.

therefore a significant driver of divergent valuations by deal size. According to Ron Miller of the Cleary Gull investment bank in Milwaukee, "Many lenders have moved to a fairly absolute \$10 million Ebitda mark for cash flow-based lending."

There is plenty of debate over the extent to which the credit market has improved for the \$5 million to 10 million-Ebitda business, but there is no debate about the sub-\$5 million tier of the market. Cash flow-based borrowing remains hard to come by.

As long as this dynamic continues, financial acquirers will continue to gravitate to somewhat larger properties that appear able to generate better returns, even at higher valuations. "Attractive deals with more than \$5 million of Ebitda are the ones being hotly contested," says Mark Sullivan of Lineage Capital, a non-controlling equity investor in Boston. "Maybe even four."

## 2010 Buyouts Only - TEV/EBITDA

EBITDA	Good Performers	Above-Average Performers
\$0-5 million	4.3x	5.7x
> than \$5 million	5.7x	5.8x

Source: GF Data Resources LLC

of 2009 and only 31 percent in the second half. As the quality mix shifted downward, the aggregate multiple fell from 6.2x to 5.2x.

The chart below crosscuts buyouts data (e.g., excludes leveraged recaps and growth capital financings in our data base) for 2010 to date by Ebitda size and financial performance. We see that quality is still commanding a premium, and that smaller businesses with non-exceptional characteristics are continuing to face average valuations well below five times Ebitda even as the rest of the lower middle market is beginning to recover.

For a number of reasons, we believe smaller middle-market businesses will be slow to benefit from improvement in capital markets and M&A activity over the balance of this year.

### 1. Corporate performance

Few businesses were able to avoid a downturn in 2009. Intermediaries around the country report, though, that the factors that lead larger businesses to be more highly valued have enabled many of them to rebound more quickly in terms of financial performance. Less exposure to customer concentration, greater leverage with vendors and

While larger firms live in this world as well, they are often better able to anticipate or see through public policy changes. For example, a \$10 million Ebitda health care

### 2. Visibility on performance

The macroeconomic environment remains somewhat uncertain. In many industries there is an overlay of anxiety over such political matters as tax policy, health care reform, financial regulatory reform, immigration policy and environmental policy.

**"The factors that lead larger businesses to be more highly valued have enabled many of them to rebound more quickly."**

services provider subject to reimbursement from third-party insurers is more likely than the \$3 million firm to get visibility on payment changes resulting from the federal health care legislation.

Main Street Capital Corporation in Houston has continued to be an active acquirer in the sub-\$5 million Ebitda market. Vince Foster, Main Street's CEO, observes that because these businesses are tending to outperform weak comparable results for 2009, and because they have a limited window on current year results, the most relevant valuation metric is not trailing twelve months Ebitda or the 2010 estimate – its run-rate Ebitda.

### 3. Capital availability.

Availability of debt remains stratified, and

Furthermore, the unprecedented valuation gap within the middle market will make the management of seller valuation expectations at the smaller end even more challenging than usual. It is one thing to explain to a business owner that his \$3 million Ebitda firm will command a lesser multiple than a multi-billion dollar public company; increasingly it appears that intermediaries will need to explain the gap between their client's valuation and that of its \$8 million Ebitda competitor.

*Andrew T. Greenberg is CEO of GF Data Resources LLC and a managing director of Fairmount Partners, a middle-market investment bank. Both are located in West Conshohocken, PA.*