Dissecting the Data

GF Data Resource's Andrew Greenberg provides his take on the latest valuation data for the middle market.

By Andrew T. Greenberg

Three years ago, Graeme Frazier and I set out to improve on existing sources of data relating to private transactions in the middle market. Today, GF Data Resources (GFDR) collects valuation, volume, leverage and key deal term data from more than 100 private equity groups. We focus on completed transactions in the $10 million to $250 million value range. We make the information available to our data contributors and to paid subscribers, a group that now includes dozens of middle-market investment banks, valuation firms, lenders and law firms.


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Our private equity transactions data base has given us a great vantage point on the world of middle-market M&A as it tries to regain its footing in the midst of global economic upheaval unprecedented in our lifetimes.

What we've seen so far is that deal volume has dropped steadily since September. Bank liquidity remains blocked. And there is a widespread sense - justified more in some industries than others - that it's not the right time for an attractive business to commence an outright sale.

These adverse conditions have made it easy to overlook an important reality about our industry. The middle-market private equity world - the system that has expanded so greatly over the past 10 to 15 years as a vehicle for the evaluation, financing and purchase of small and mid-sized businesses — remains fundamentally intact.

Deal activity in this tier of the market has slowed but avoided much of the turmoil affecting larger transactions because middle-market buyers and lenders generally steered clear of excesses during the boom years.

Taking a closer look at the second quarter of 2007, for instance, the mortgage lending crisis first hit the public equity markets in July of that year. The market clearly began to weaken at that point.

The deals that are getting done reflect the operation of a cautious but functioning market.

As the chart to the TK demonstrates, valuations never rose as high as the deals in the larger market may have suggested. In fact, during that quarter and the several years preceding it, valuation multiples never exceeded the mid-sixes. The average multiple for our universe in the $10 million to $25 million total enterprise value (TEV) tier was 5.6x trailing twelve months (TTM) adjusted Ebitda. In the largest deal size bracket, $100 million to $250 million, it was 6.8 times.

Anecdotal shop talk in those years suggested routine valuations of eight to 10x or more. However, it seems clear this elevated "sense of the market" was based on larger transactions, selected high-value industries and imperfect information. In the lower middle market, the prices at which deals actually were closed remained fairly restrained.

The debt and equity levels shown in the 2007 example were typical in the several years heading into the market downturn. Senior debt in our universe reached highs of 2.7 to 2.8 times in 2006 and 2007, while total debt was 3.7x to 3.8 times. In this period, equity accounted for 40% to 42% of the average capital structure.

As we look at the wider private-company landscape in spring 2009, many businesses have exhausted their capital, and face restructuring or bankruptcy. It is worth noting that many of these companies exposed themselves to hazards outside of the template prevailing in lower middle-market private equity.

For instance, business owners completed acquisitions or leveraged recapitalizations without bringing in an equity sponsor. Also, buyers of somewhat larger businesses paid elevated multiples fueled by total debt of 5x to 6x or greater. Moreover, many of the lending institutions that did these deals, or that could be in a position now to provide some relief, are the ones that took the greatest risks and are now in the most dire financial condition themselves.

This is not to suggest that the market segment we cover has been unmarked by these difficult conditions. Alongside the 2007 Q2 data, are the numbers reflecting the fourth quarter of 2008.

The 114 firms in our universe as of year-end 2008 reported a continued decline in completed deals in the fourth quarter, but still showed some level of activity. This was out of sync with the impression that deal flow last fall was grinding to a near halt.

It now seems clear that there remained a certain level of momentum supplied by sale processes begun earlier in 2008. Our report for the first quarter of 2009 will be the one in which the general impression of a market slowdown is fully present in the numbers.

The deals that are getting done reflect the operation of a cautious but functioning market. Valuation multiples have contracted about half a turn on average. Our data confirms that "A" businesses under no duress to sell are in short supply. Many are trading at modest discounts to the market-high multiples of 2005 through mid-2007.

In our last report, we examined 200 deals with "above average" financial characteristics, which we defined as TTM Ebitda margins and projected year-one revenue growth both in excess of 10 percent. We concluded that businesses meeting these standards are now trading at 0.3x to 0.5x less than they were a year and a half ago.

Of course, "B" and "C" properties face a tougher valuation environment and conditions have never been more unforgiving for companies in distress.

Businesses under no duress to sell are in short supply.

While aggregate valuations have held much of their ground, there have been seismic changes in the availability of debt and in deal structure. Debt levels have fallen off the table. Senior and total debt averaged 1.9x and 2.4x in the fourth quarter of 2008. The average equity component of completed deals has soared to almost 60% - up nearly 20 percentage points in a little mo than a year - to make up the difference.

In many cases, the lenders on these transactions have been regional banks (or the handful of national institutions) that were not exposed to bad mortgages, derivative instruments or excessive leverage.

Debt levels have receded, spreads have increased and loan covenants have become tougher. But data contributors around the country who are getting deals closed tell us either they are providing all or nearly all of the equity with the expectation of financing out when conditions normalize or their transactions are being financed by banks that remained stable by avoiding the various missteps of larger banks or of publicly traded business development companies (BDCs).

It certainly appears that 2009 will continue to be a year of pain and consolidation for our industry. However, many middle-market private equity funds and lenders remain in business because they made more good judgments than bad in the years heading into the current downturn.

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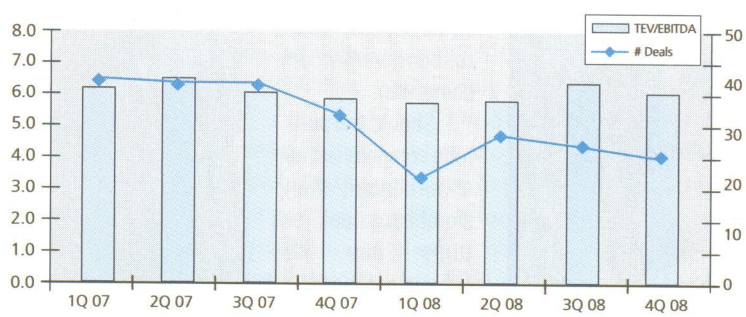
Deal Multiples and Deal Activity 2007-08



Source: GF Data Resources LLC

Private Equity Snapshot– 2Q 2007

	2Q '07
Number of deals	39
TEV/Adjusted EBITDA	6.4x
Total Debt/Adjusted EBITDA	3.9x
Avg. Equity Contribution	41.2%

Source: GF Data Resources LLC

Private Equity Snapshot–Year-end 2008

	2Q '07	4Q '08
Number of deals	39	25
TEV/Adjusted EBITDA	6.4x	5.9x
Total Debt/Adjusted EBITDA	3.9x	2.4x
Avg. Equity Contribution	41.2%	59.9%

Source: GF Data Resources LLC