The Most Reliable Valuation Data On Private-Equity Sponsored Middle Market Transactions

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Trough love?

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By Andy Greenberg, CEO GF Data

The GF Data third quarter report on middle-market deal activity, which was released the week before Thanksgiving, had an interesting "story behind the story."

The headline was that the activity we chart – transactions completed by private equity groups in the $10-250 million enterprise value range – had rebounded to an extent not seen in more than a year. Completed deal volume was more than double the anemic levels reported in the first half of 2009. Average valuations reached 6.0x times adjusted Trailing Twelve months EBITDA, the highest in five quarters.

The subtext is this: Many financial buyers believe that the point in the economic cycle at which the market pushes out of a trough is a prime buying opportunity, the time at which many private equity groups historically have made some of their most profitable investments. Closer analysis of our data suggests that hasn't happened this time around – at least not to the extent many investors expect.

The thinking, of course, is that buyers' visibility on the recovery and easing in the credit markets lead the recovery, while seller expectations tend to lag just a little bit. Get the moment right and you can feel comfortable that you are investing into a strengthening situation, getting a little more debt support and maybe buying at five and a half times EBITDA a business that would be valued at six or six and a half times in a year.

GF Data analyzes the premiums accorded to "above-average" financial performers in buyouts, versus the rest of the market. "Above-average" is defined as TTM EBITDA margin and revenue growth both in excess of 10 percent, or one of those metrics in excess of 8 percent while the other is greater than 14 percent. It's somewhat arbitrary, and we always point out that most of the other businesses are good companies which, after all, in each case, got to a closing with a sophisticated non-distressed buyer.

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In the past few reports, we've highlighted the fact that the quality premium has never been higher. "Above-average" financial performers in 2010 have been valued at an 11 percent premium to lesser performers, the most pronounced differential in the yea years included in our data base, which goes back to 2003.

But look at what has happened as the market has warmed up:

	1H 2009	2H 2009	1Q 2010	2Q 2010	3Q 2010
Above average performers	6.1x	5.2x	5.1x	5.6x	6.0x
Lesser performers	6.2x	5.1x	5.1x	5.0x	5.8x

Over the course of this year, valuations rebounded first for the stronger performers. In the third quarter, though, average values for the lesser performers perked up to an even greater extent. The quality premium is still there -- 6.0x versus 5.8x -- but it looks like the window for bargain hunting has dramatically narrowed.

Why did this happen?

A number of market forces are receiving a lot of attention right now – continued scarcity value of good businesses; quicker-than-expected recovery in lending, at least in some sectors of the middle market; desire to capitalize on sellers motivated at least in part by uncertainty over future tax rates.

It's also clear that prices are being driven up for at least some good-but-not great businesses by dynamics within the private equity universe. LP-based funds that have not been active over the past couple of years are feeling increasing heat to put money to work.

Rob Newbold, a managing principal of Graham Partners here in suburban Philadelphia, makes the point that a number of funds raised during the boom days of four-five years ago are reaching the end of their investment cycles. At the end of the investment cycle, management fees get calculated based on invested capital net of writedowns as opposed to based on committed capital. So, less active funds face the intermediate range pressure of investor expectations, but the more immediate issue of compression in their fee income.

We'll see how these forces play out over the balance of this year, but our impression is that the B or B+ properties being offered for sale have now joined the As in benefitting from a recovering market, and that is not likely to change any time soon.

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