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SNL NASHVILLE NOTES

Wednesday, January 04, 2017 10:28 AM CT

Gravity matters, especially for financial investors

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I spend most of my professional time working with financial institutions; however, I work with nonfinancial intuitions, too. Some involve leveraged transactions. One of the databases I use is compiled by GF Data Resources LLC, which chronicles private equity transactions among lower-middle market companies with an enterprise value of $10 million to $250 million. GF made what I thought was an interesting observation about the buyout market in the third quarter, describing "steady but not overpowering completed deal volume, record valuations, and unwavering debt support."

What risk assets are not near record valuations, aside from assets in a few sectors such as energy and retail? Investing when multiple expansion occurs over a holding period is a great thing, but multiples cannot expand forever; they also can contract.

Gravity is supposed to matter for private equity or financial buyers. Strategic buyers can pay up for an acquisition with publicly traded shares that may trade at lofty valuations. Plus, share exchanges are about relative valuations, and strategic buyers usually expect to achieve some amount of cost savings. Not so for private equity buyers, who acquire for cash with their capital and borrowed money and often cannot extract expense savings unless the acquisition is a bolt-on to an existing platform company.

Financial buyers have to be incredibly sensitive to the price paid because it is the most important variable a buyer controls that impacts returns once the investment is sold. Nonetheless, prices are up for all but the lowest tranche of the market. GF's data shows 20% expansion in acquisition multiples for deals with an enterprise value of $100 million to $250 million, to 8.9x year-to-date through Sept. 30 from 7.4x in 2012. Thomson Reuters' data indicates a similar trend for "institutional middle market" transactions with a current multiple of 9.7x, up from 8.4x in 2012 and 9.0x in 2007 at the peak prior to the crash.

So deal prices have been rising, what gives? One caveat is that multiples for the smallest deals with an enterprise value of $10 million to $25 million are little changed over the past five years at about 6x EBITDA. Maybe there is less of other peoples' money, or OPM, at work here. Plus, investors will and should pay up for size, quality and growth to a point.

One valuation factor is the cycle. Acquisition multiples tend to expand as the economy strengthens and memories of the last recession fade. Another is the "unwavering support" of debt providers. Thomson Reuters pegs debt financing for the institutional middle market at 5.2x year-to-date; GF calculates 4.8x for the $100 million-to-$250 million enterprise value deals that have closed this year. Both debt financing multiples are up a bit from 2012. The level of support for these deals is below the theoretical 6.0x limit that regulators placed on banks (but not BDCs and private credit funds) a few years ago when leverage lending guidelines were revised. As an aside, Thomson Reuters data indicates that the median leverage for large LBOs in 2015 and 2016 unsurprisingly approximates 6.0x.

Otherwise, equity capital has stepped up to the plate to push valuations higher. The math for financial transactions allocates returns to capital providers. Low borrowing rates leave more residual cash flow for equity capital. That may account for some of the EBITDA multiple expansion. Likewise, the private equity investors may suffer from too much capital chasing too few opportunities.

But I wonder if PE investors are rationalizing paying a higher price the same way public market equity investors tend to do, by ignoring a recurring string of "one-time" items to derive pro forma EBITDA. If so, pro forma EBITDA may be tethered to an alternate reality of what private equity investors need it to be (i.e., higher with better growth prospects) in order to justify the price paid and prospective returns.

He probably picked up the quote from someone else, but Caesar is credited with the truism that men will believe what they wish to be true. I would add that gravity has to matter. Multiples cannot grind higher indefinitely, at least not if financial buyers expect to produce acceptable returns.

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