

July 12, 2010: My Favorite Word in the English Language

It's human nature to want something for nothing. This feeling is enhanced when what's offered for free is worth millions of dollars. Arbitrage (my favorite word) business strategies convert this feeling into reality. The word smells of money and it's frequently used in the same breath with words like "fortune," "boatload," or "killing." The dictionary defines arbitrage as the simultaneous purchase and sale of the same securities in different markets to profit from unequal prices. I define arbitrage as the ability to create wealth by taking advantage of inter-market opportunities. Managers create an arbitrated return when they understand capital markets well enough to discover and exploit a risk/return imbalance in the market. Properly implemented, arbitrage strategies enable a manager to receive a return that is greater than the underlying risk of the investment.

Arbitrage opportunities present themselves to managers who understand that capital markets are segmented. Capital markets are segmented based on a number of factors. The two most obvious are annual revenues and the return expectations of investors. The Exhibit below depicts this segmentation. The broadest market segments include the small business market, the middle market and the large company market. Within the middle market, further segmentation is possible into lower-, middle- and upper-middle markets. Each market is subject to different return expectations, as demonstrated by acquisition multiples based on earnings before interest, taxes, depreciation and amortization (EBITDA). Small companies typically sell for two to three times EBITDA, while large companies sell for more than 12 times EBITDA. Exploiting the market's notion that "bigger is better" can create substantial value for a business owner.

Market Segmentation by Sales and EBITDA Acquisition Multiples

Sales (\$millions)	5	150	500	1,000	
	Small Businesses	Lower	Middle	Upper	Large Companies
	M i d d l e M a r k e t				
EBITDA	2-3x	4-7x	8-9x	10-12x	>12x

Suppose a manager wants to realize a higher selling multiple for his company. One arbitrage strategy involves the manager consolidating his or her way there by paying acquisition multiples that are less than what the market would pay for his or her company. Thus, a manager of a middle-middle market company could acquire lower-middle market companies in order to eventually realize an exit in the upper-middle market (in other words, "buy left then sell right"). This creates an arbitrated return. In the vernacular of public companies, such a strategy would be accretive to shareholders. Not surprisingly, most arbitrage strategies depend on effective use of know-how, also known as intellectual capital.

Managers should be spending a fair amount of time creating and implementing arbitrage strategies. That's where the big bucks are. This is another of the not-so-secret things we do in MidasNation.

-Rob

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