September 6, 2010: A Word on Acquisition Multiples

Many owners are confused about acquisition multiples; about where they come from and what they mean. This is an important topic, so let's clear it up.

An acquisition multiple is a buyer's expression of risk of the likelihood of realizing the benefit stream that the subject business generates. Benefit streams can be expressed in a variety of ways, such as net sales, gross margin dollars, recast EBITDA, etc. Over time every industry settles on the appropriate stream to use. For instance, CPA firms typically transfer using net sales as the stream; whereas, box converters are valued by using recast EBITDA. The acquisition multiple is then chosen by buyers to indicate how many years they expect to receive the stream after the acquisition closes.

For example, if a company is generating a benefit stream of $1 million, and there are three prospective buyers, each buyer may have a different perspective about the appropriate multiple. This explains why any businesses can have a fairly wide range of market values at any point in time.

The multiple can also be viewed as the riskiness of achieving the stream post-closing. In this case the reciprocal of the multiple generates the risk factor. For example, an acquisition of '5' converts to a 20% (1 divided by 5) risk rate.

My textbook – *Private Capital Markets* – shows that only one variable correlates well to lower middle market acquisition multiples: senior lending multiples. In broader terms, availability of capital determines private business valuation (at least for 'market' purposes) – and senior lenders provide most of the capital structure. In good times, senior lenders get caught up in the moment and aggressively engage in cash flow lending. At the peak of the lending cycle, these lenders will lend 5 to 6 times EBITDA. At that point, acquisition multiples are at their zenith. Ultimately, the economy cools and lenders head for cover, eventually retreating to mainly asset-based lending. At this low-point lending multiples are not used; rather, margined collateral of the borrower's assets determines the loan amount, which usually results in dramatically less that can be borrowed. This is what has happened in the US economy over the past 18 months.

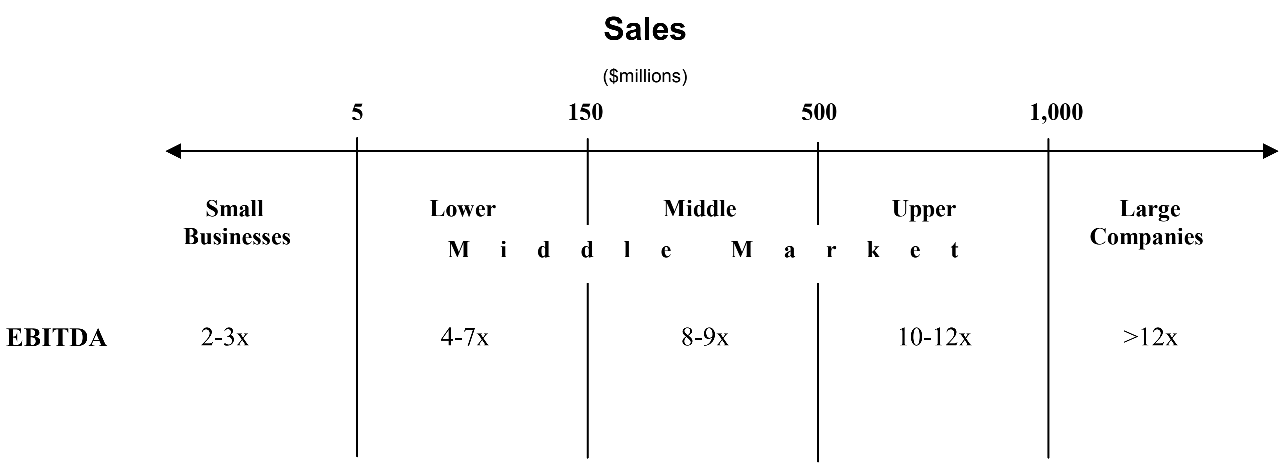
Let's not forget about equity. According to a recent survey by Pepperdine University, the typical private equity group (PEG) deal employs about 48% equity in the capital structure. This percentage, by the way, represents an all-time high equity investment level by PEGs. The Pepperdine survey reports that in the current market, senior lenders have moved down to about a '2.5' run-rate EBITDA on total debt. This combination of debt and equity yields an equation that derives acquisition multiples, as follows:

$$\begin{aligned}\text{Acquisition multiple} &= \text{Senior Lending Multiple / (1-Equity Investment)}\\ &= 2.5 / (1-.48)\\ &= 4.8\end{aligned}$$

Thus, when senior lenders retreat to a ‘2.5’ lending multiple and equity represents almost half the capital structure, acquisition multiples fall to below ‘5’. Owners just hate selling for less than a 5 acquisition multiple, but the reality is they’re facing these lower numbers for the foreseeable future. Crafty advisors are using economic bridges (earn-outs, seller notes) to boost purchase prices. Assuming that the behavior of lenders stays the same or continues to retrench, which is highly likely, acquisition multiples will continue to fall – as will the total number of deals completed in the lower middle market (companies with annual sales of $5-150 million).

Finally, acquisition multiples tend to group themselves based on company size, as the chart below depicts. In effect, capital providers cause these multiple groupings because they lend/invest differently to each segment.

Segmented Capital Markets



Your goal as a business owner is to be “viewed” by the capital providers as a larger company. For instance, it’s possible to be generating $3 million in annual sales, but be valued by the market as a “5-6x” company. This is accomplished by demonstrating a scalable business model, sound strategies and tactical capabilities, and a high intellectual capital leverage ratio. In other words, by living the Midas Way.

-Rob

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