

VALUATION

The New Math of Middle-Market M&A

by Rob Slee, CBA

According to a recent survey by the Association of Corporate Growth and Thomson Reuters, mid-market M&A (defined as deals involving firms with annual sales of \$5 million to \$500 million) fell by half from 2008 to 2009.¹ It feels worse for those of us in the intermediation business.

An ex-partner of mine used to say that M&A is more of a sport than a business. Sometimes you bag big game—but more often than not, the target runs away unharmed. Like real hunting, there are certain quantitative aspects to M&A. But right now, the math doesn't add up.

Multiples are Falling

My textbook, *Private Capital Markets*, shows that only one variable correlates well to lower-middle-market acquisition multiples: senior lending multiples.² 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 five to six 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 transfer cycle is predictable and discussed below.

Let's not forget about equity. According to a recent survey by Pepperdine University, the typical private equity group (PEG) deal employs about 48 percent equity in the capital structure.³ 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:

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

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 5 to 6 acquisition multiples, but the reality is they're facing these lower numbers in the foreseeable future. Obviously, sellers have a big math problem. Crafty advisors are starting to rely more on economic bridges (earn-outs, seller notes) to boost purchase prices. Assuming that the behavior

¹“9th Annual Middle-Market Roundtable Survey,” Thomson Reuters LPC, June 11, 2009.

²Robert T. Slee, *Private Capital Markets: Valuation, Capitalization, and Transfer of Private Business Interests*, John Wiley & Sons, Hoboken, NJ, 2004, pg. 318.

³“Pepperdine University Private Cost of Capital Survey,” Malibu, CA, April 2009.

of lenders stays the same or continues to retrench, which is 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 million to \$150 million).

Fewer Owners Creating Value

The majority of middle-market owners are not currently increasing the market value of their companies.⁴ Most owners are caught with their proverbial business pants down: They employ traditional, domestic business models in a time when conceptual, global models are required.

An appropriate metaphor for private business is that they buy nails from China and then sell them in Peoria; while multinational companies source nails from the cheapest place on earth, add value to them in Singapore, and then create a new market for the nails in Brazil. It's little wonder that Wall Street is doing much better than Main Street in the global economy (a Main Street "Dow" would be much further down by comparison).

Exemplary small businesses, by the way, change the rules as they enter the global markets. For instance, consider a small company that has developed a

new nail—with 30 percent less material, better binding power, and easier usability in a nail gun. This company is bringing intellectual capital to one of the world's oldest products to shake up a staid market. Talk about nailing the competition!

The composition of the middle market is not helping matters either, as Table 1 shows.⁵

Several industries, namely retail, construction, and wholesale, are not creating value now (in total) and probably will not create value in the foreseeable future. Yet these groups represent almost 50 percent of the companies in the middle market. As consumption continues at a slow pace in the USA, service companies will likely be forced to downsize. And manufacturing companies that are not making global markets are suffering from reduced demand and increased competition.

PEG Mania

According to CapitalIQ, a company that collects data on the financial services industry, there are roughly 8,000 PEGs in the USA. It seems that every MBA with a checkbook is now a PEG. And this group is still well funded. The Alliance of M&A Advisors recently reported that PEGs have about \$400 billion in equity to invest.⁶ This amount represents about \$1 trillion in spending power, assuming they can leverage equity by 2:1.

In his book *Middle Market Strategies*, Richard Trottier states that PEGs already own 35,000 or so middle-market companies in the USA.⁷ This quantity represents about 12 percent of the 300,000 companies that comprise the U.S. middle market. He suspects PEG ownership represents a far greater percentage of the capitaliza-

tion of the middle market—perhaps as high as 40 percent.

The math is not encouraging for PEGs, however. Let's assume that only 15 percent of the companies in the middle market are top performers (so-called A and B companies). PEGs already own 12 percent of the market. So 8,000 PEGs are fighting over 9,000 companies in total (3 percent of 300,000). These 9,000 potential PEG deals don't all hit the market in the same year. Plus, there's no guarantee that all 9,000 prospects are even amenable to dealing with private equity. These facts explain why the sharper PEGs are taking companies private and/or heading to the Far East for investment opportunities. Obviously, American-centric PEGs have a serious math problem.

Advisors

According to the Alliance of M&A Advisors, there are 4,000 to 6,000 M&A intermediaries in the USA aimed at the middle market. Assuming that 5 percent of middle-market companies intend to sell in the open market each year and only 50 percent of these companies engage an intermediary, there are about 7,500 prospects each year. So at least everyone gets to work on one deal or so per year. Thank goodness every deal closes (would that it were so). Obviously, advisors have a big math problem.

The Transfer Cycle

My 2007 article, "Now is the Right Time to Sell a Business," describes the 10-year transfer cycle that keeps repeating in the U.S. private transfer market.⁸ Basically, the first few years of every decade (think 1980 to 83, 1990 to 93, and 2000 to 2003) are down years for the private capital markets (i.e., recessionary).

Industry	Percent of Middle Market
Retail	16
Construction	10
Wholesale	20
Service	24
Manufacturing	13
Other	17

⁴Rob Slee, *Midas Marketing: How Midas Managers Make Markets*, Burn the Boats Press, 2009, Preface.

⁵Richard M. Trottier, *Middle Market Strategies: How Private Companies Use the Markets to Create Value*, John Wiley & Sons, Hoboken, NJ, 2009, Chapter 5.

⁶"U.S. Private Equity Overhang Reaches \$400 Billion According to AM&AA and PitchBook Data, Inc.," *Business Wire*, June 2, 2009.

⁷Trottier, *Middle Market Strategies*, op.cit., pg. 84.

⁸Rob Slee, "Now is the Right Time to Sell a Business," *Charlotte Business Journal*, September 28, 2007.

The fourth year of every decade is a transition year to profitability. Year five into year eight are the go-go years, when the private markets are open for business. During these years, we feel the need to over-build, over-leverage, and over-just about everything else. Apparently, our business memories extend only a few years. The economic house-of-cards starts falling in the eighth year (see 2008), and totally flattens by the end of the decade. Business owners had until 2008 to sell out, or they will need to hold their companies until 2015 or so before they can maximize a sale. Owners undoubtedly have the biggest math problem of all.

A combination of a restricted capital environment, a declining demand curve, and too few companies creating value has changed the math of middle-market M&A. And this change is happening as we enter the darkest part of the transfer cycle. It appears that our sport is becoming a most dangerous game. **VE**



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