

Why your company may be worth more than you think!

The emergence of private equity (“PE”) firms as active buyers of private, lower middle market companies has not only increased purchase multiples for many types of manufacturers, but has also made the process of either selling or raising cash a lot easier than it used to be.

What are Private Equity Firms?

PE firms raise capital from public and private pension funds, insurance companies, wealthy individuals and other institutional investors seeking high returns. They most commonly use that capital to purchase or otherwise invest in private companies. PE firms invest in “baskets” of privately held companies in the same way that mutual funds own groups of publicly traded stocks. Cerberus Capital Management’s acquisition of Chrysler earlier this year was widely reported, but the hundreds of smaller “lower middle market” (defined as those with transaction values from \$10 to \$100 million) buyouts by smaller PE firms go largely unreported.

Increase in Multiples Paid for Manufacturers since 2000

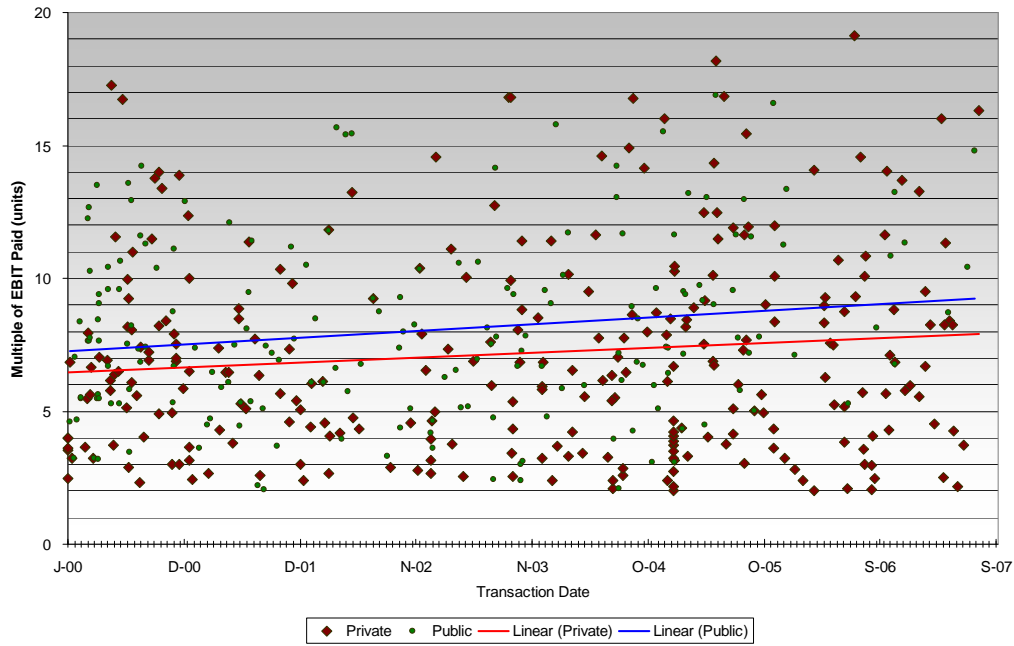
Provided they are profitable, most private manufacturing companies are valued by applying a “multiple” to their historic cash flow, or earnings before interest, taxes depreciation and amortization (EBITDA). We collected manufacturing transaction data ^(1.) from 2000 through September of this year. The survey showed that the average EBITDA multiple over the entire period for sellers being acquired by private buyers was 6.52. The average paid by public buyers was 8.04. The blue and red trend lines in the first chart below clearly illustrate the upward progression of EBITDA multiples since 2000 ^(2.).

What’s interesting is the effect that multiples for 2006 and 2007 had upon the averages. The average combined (public and private) EBITDA from 2000 to 2005 was 7.3 times. The average for 2006 was 7.83, an increase of 7%. The average multiple paid so far this year was 8.58 times, a jump of 17.5% over the 2000 to 2005 period! It is unlikely that this multiple creep is the result of inflation: inflationary pressure would have an affect on cash flows themselves, but not the multiples, unless buyers and sellers were trying to offset the effects of high expected inflation rates, which they aren’t.

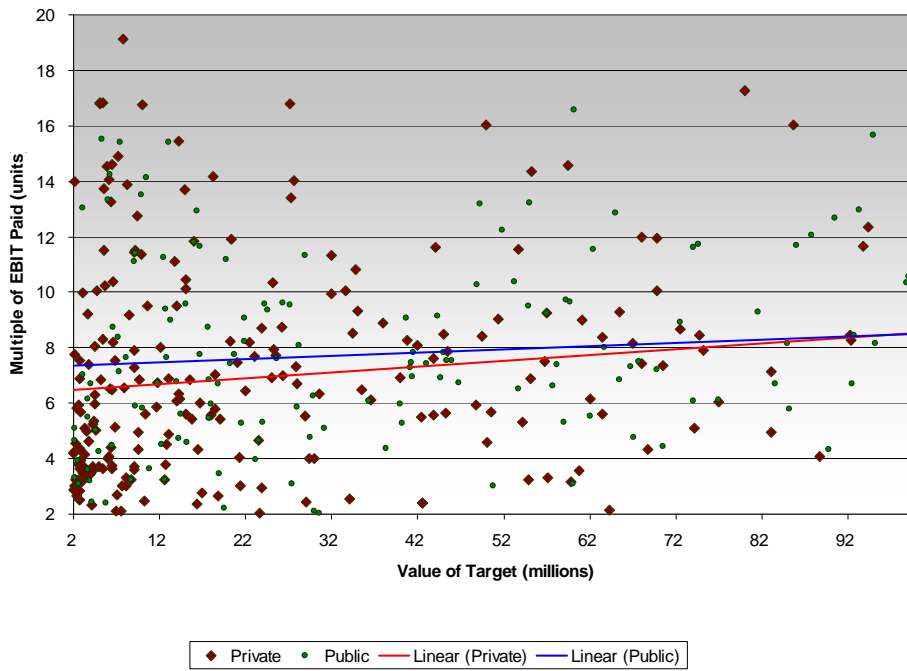
These multiples do not include, or are paid in addition to, lucrative compensation packages that are a part of many acquisitions by PE firms.

The second chart illustrates the effect that deal size has on transaction multiples. These trend lines show that as deal size goes up, so do transaction multiples. The fact that the smaller deals greatly outnumber the relatively larger deals is what keeps the average trend line from being steeper. It is clear from the clustering of transaction multiples toward the bottom left of the second chart that, although there are numerous exceptions, companies that are worth less than \$10 million command multiples of only 4 to 5 times EBITDA, on average. The lesson here is clear: it pays to be bigger.

Multiples of EBITDA By Transaction Date Paid for Manufacturers, 1/1/2000 to 9/30/2007
 Source: Mergerstat, IBA, Pratt's Stats, Adler & Co., Inc.



Multiples of EBITDA By Transaction Size Paid for Manufacturers, 1/1/2000 to 9/1/07
 Source: Mergerstat, IBA, Pratt's Stats, Adler & Co., Inc.



So why has the value of manufacturing companies increased so much since 2000? I believe there are three reasons: Private equity funds are flooded with cash, their favorite sellers are niche manufacturers, and many manufacturers are coming off of several good years in a row.

Show Me the Money

Cash has poured into PE funds over the last two years. In July of this year, the Private Equity Analyst, a Dow Jones publication, reported that “U.S. Private Equity firms raised a total of \$137 billion in 199 funds during the first half of 2007, a 42% increase over the \$96 billion raised in 147 funds during the first half of 2006 and on pace to best the record total \$261 billion raised last year”.

Not surprisingly, acquisition activity is up: according to Factset Mergerstat, during 2006 there were 5,744 acquisitions of privately owned companies with a total transaction value of \$110.5 billion. This represented a 5% increase in the number of deals, and a 9.7% increase in transaction value.

What they're looking for

Although acquisition criteria varies widely among Private Equity firms, many, including all of my firm's clients, are interesting in buying or investing in niche manufacturing companies with EBITDA of at least \$2 million, good profit margins, a defensible market position and a diverse customer base. Geography and industry focus are less important.

Niche manufacturers represent attractive investment opportunities because they usually have developed considerable barriers to entry and have tangible assets which can be used to secure financing.

PE firms are interested in finding companies that can be ‘scaled’ and that have the ability over time to become “best in class.” Some are leveraged buyout firms, and use debt to fund their acquisitions, others avoid debt and use mostly cash. After paying owners for their companies, PE firms also normally offer owners substantial employment contracts to continue to run their companies for several years following a sale.

PE firms make their money in three ways: 1. by taking distributions from the acquired company's current cash flow, 2. by “scaling” or growing the company's profits, and 3. by selling the acquired company after anywhere from three to seven years at a profit. To the extent that the PE firm has succeeded in scaling its acquisition, it can enjoy an “arbitrage” due to the fact that companies with greater EBITDA trade for substantially greater cash flow multiples.

The process has changed

PE firms represent a universe of buyers of middle market companies that basically didn't exist fifteen years ago. Since then, their importance as buyers has steadily grown. PE firms are arguably the best kind of buyers a seller can have. They are typically well funded, experienced and unemotional buyers who are in the business of structuring win-win transactions. They are so interested in “deal-flow” that they

contract with and pay hundreds of “buy-side” intermediaries (like my firm) to bring them deals. By working with buy-side intermediaries, sellers can avoid having to enter into expensive, restrictive and time consuming “sell-side” listing agreements.

As an example, in my most recent transaction the owner of a \$20 million precision metal fabrication company contacted me for assistance in selling his company. After introducing him to several of my clients, all private equity firms, one group, Kachi Partners, expressed an interest and visited the company. About four months later the transaction closed. This owner didn’t have to hire anyone or pay anything, since our fees were paid by our client, the PE firm. Neither did the owner have to participate in a lengthy search for qualified buyers.

Timing is Everything

PE firms are now flush with cash and manufacturers have had the wind at their backs for several years now. Sales and profits are strong for most manufacturers and most of the companies I talk with are projecting year over year increases for 2007. These factors taken together are important because buyers are comforted that they are not acquiring companies in decline, and sellers are comforted that they are not selling “at the bottom”. For many manufacturers, this is an excellent time to consider selling or raising equity.

About the Author

Jay Adler has been a practicing M&A and investment banking professional for the last 20 years. He is currently the President of Adler & Co., Inc., (www.adlercompany.com) a Boulder, Colorado based boutique investment banking firm that specializes in representing Private Equity firms.

Footnotes:

1. Source: Factset Mergerstat, Business Valuation Resources (Pratt’s Stats), Institute of Business Appraisers, Adler & Co., Inc. transaction data.
2. The data includes manufacturers with SIC codes from 2200 to 3999 and with transaction values between \$2.5 and \$200 million. Transactions with negative EBITDA multiples were omitted.