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Why Valuations Matter (First of a Series)

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“Anything that just costs money is cheap.” – *John Steinbeck*

At the PartnerConnect conference in Boston last week, three panelists (including your correspondent) held forth on trends in middle market sponsor finance. One audience question caught our attention: “Given the current market, does the level of valuations concern you?”

Of course, it depends what side of the transaction you’re on. It’s natural to complain about how *other* firms are paying toppy prices. “We don’t understand how they can make their returns work,” goes the commonly stated view.

But if you’re a seller in this market, sponsors have benefited by unloading portfolio companies at high multiples, sometimes years before expecting to do so.

Indeed it’s been a challenging buying environment. As our *Chart of the Week* highlights, purchase price multiples have climbed steadily since the credit crisis. In part, this is due to the decade-long bull loan market that’s afforded leverage multiples to climb. It’s also thanks to a favorable rate climate, and a tailwind from the wider US economy.

Only a minority of middle market exits are IPOs. But when equity indices reach record levels, public comps provide a visible window on larger enterprise values.

To be sure not all companies are created equal. Purchase price data represent averages; there are haves and have-nots. Valuations differ dramatically sector-by-sector. Each carries with it different growth and risk prospects, and contrasting valuation characteristics.

High-margin defensives, such as software firms, can reach prices of fifteen times ebitda or more, while plumbing fixture distributors struggle to escape mid-single-digits.

Timing is also critical. In terms of where we are in the cycle, buying a company today isn’t the same as buying one in 2010. Turnarounds represent an entirely different challenge than a company that motored through the recession unscathed. Or as Jamie Dimon once put it, “Buying a house is not the same as buying a house on fire.”

Over the next several weeks in this special series we’ll examine the key variables that impact equity valuations, and the strategies sponsors use to address them. We’ll take a look at how private equity tackles “buy-low, sell-high,” when competitors are seeking to do the same thing.

We’ll also discuss how lenders look at loan valuations, how high purchase price multiples both help and hurt those values, and what private credit providers predict for valuations this year, and the foreseeable future.

Finally, we’ll discover what valuation firms themselves think about today’s climate, and how they help lenders and sponsors evaluate risk to their own returns.