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Why Valuations Matter (Second of a Series)

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"Time is the longest distance between two places." – *Tennessee Williams*

One of the most important variables impacting valuations is how much time sponsors have to effect strategies to improve company performance. According to Preqin, the hold period for private equity GPs worldwide was 4.5 years last year – down from 5.9 in 2014.

The impetus to sell properties is influenced by many things: how buoyant financing markets are, the relative challenge of buying (vs. selling), and how motivated sponsors are to realize an investment based on timing of the next fund raise.

Business cycles also impact timing. It's no coincidence that as we get closer to the end of this recovery, hold periods are shortening. Buyout firms worry that a recession will overturn their best laid plans to improve performance, thus exit multiples.

Beyond buying at the right price, sponsors focus on creating platforms to build value. That's especially true when purchase price multiples are where they are (see *Chart of the Week*). As we covered in our special roll-up series ("The Art of the Add-On"), sponsors buy smaller companies at cheaper prices to lower effective entrance costs.

It's also why the velocity of acquisitions by private equity has accelerated recently. As one top healthcare banker told us, "You need to create a faster clip of layering in lower multiple companies just to keep pace with valuations."

He also noted that fund strategies with longer investment horizons affect valuations. A family office or real asset manager can make a lower growth company fit their return criteria. With investing periods of ten or fifteen years (vs. 3-7 years for traditional buyout firms), these firms have more time to see better IRRs and MoM multiples.

Dry powder is another powerful mover of purchase price multiples. As Preqin noted in a recent report,"PE valuations and dry powder levels…symbiotically feed off each other, driving investors to pay higher markups for deals and raise more capital to prepare themselves for more of the same going forward."

The problem isn't just high purchase price multiples. One partner at an East Coast firm said unreasonable seller expectations adds to the problem. "If you base your hoped-for value on public comps," he said, "you're setting yourself up for disappointment. There needs to be a middle market discount to your multiple. Otherwise you end up chasing price, which always ends badly."

Market volatility also drives expectations. How do sellers deal with turmoil in public markets? If the Dow drops to correction levels, as it did in December (a distant memory now), sellers worry their opportunity to sell is past. Today, with equities "lyfted" to record highs, will there be a rush to get into the action before the window shuts?

Next week we look more closely at how sponsors set up portfolio companies to maximize shareholder value.