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Why Valuations Matter (Third of a Series)

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“The value of a thing sometimes lies not in what one attains with it, but in what one pays for it – what it costs us.” – Friedrich Nietzsche

In last week’s installment of our continuing special series, we discussed how critical time is to driving value. This week we take a deeper look at strategies private equity sponsors use to give them the best chance to maximize value for their shareholders.

“The key is setting the right strategy to control the valuation dynamics in this market,” the capital markets partner of one top-tier firm told us recently.

“In this environment,” he continued, “sponsors need to employ bespoke strategies to communicate to sellers. It’s a carefully crafted message that says we are the kind of partner you want to sell to and work with over time to create more value.”

What’s changed most about your strategies, given how high purchase multiples have gotten? The managing partner of a leading Midwest sponsor had this answer: “We’re underwriting M&A more. I don’t think we’re alone in underestimating the M&A story.

“This is particularly true where there’s team-building required,” he said. “That becomes a cash flow discussion with the seller. Same if the C-suite needs a big upgrade. We should not have to pay for that. That also becomes a cash flow discussion.”

One leading healthcare banker has a ring-side seat to sponsors setting strategies. He seconded our opinion on the importance of timing. “You can’t assume multiples will remain high at exit,” he said. “Ebitda improvement needs to come quickly. Over time IRR goes down if you have to invest more equity capital to grow.

“Today’s valuation pressures mean the company can’t take a step back operationally or wait to implement synergies. Higher valuations compress the time you have before a liquidity event. So you have to begin executing your 100-day plan immediately.”

Of all the growth elements we’ve witnessed in the past five years, successful acquisition integration is the most vital to meeting valuation targets. And the most frequent stumbling block. Our investment banker agreed. “Operations – growing Ebitda – will determine whether the investment is successful or not.”

But the speed of today’s selling processes makes that a challenge. “It’s tough to do the necessary due diligence in the time frame you’re given,” the Midwest sponsor told us. “Sometimes you discover after the fact how much work is to be done.”

That naturally led to a question about Ebitda add-backs: How critical are they to meeting your exit targets?

“As a buyer, that means being less beholden to broad auctions and more focused on differentiated investing. That allows you to preempt processes and take the property off the market earlier.”

“If we can’t realize them in the first year, it pushes our effective purchase multiple up,” our capital markets friend concluded. “In that case, you need another plan.”