PitchBook

Exploring Buyout Multiples: Part III

Measuring price differences between deal sourcing strategies

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Key takeaways

• **Secondary buyouts (SBOs) have transacted at a premium to non-SBOs since the global financial crisis (GFC),** a reversal from the previous trend. We hypothesize that the premium paid for SBOs since the GFC is due in large part to the changing profile of sponsor-backed companies, which have become much larger—and therefore more expensive—in the last decade.

• We find that **club deals do not transact at a premium to sole-sponsor transactions.** At EVs less than $1 billion, club deals transact at a median EV/EBITDA multiple of 7.8x, essentially the same as the 7.7x for sole-sponsor buyouts. At $1 billion and above, both club deals and sole-sponsor transactions trade at a median of 11.1x EBITDA.

• Contradictory to previous research, we find that **add-ons trade at a premium to non-add-on transactions of similar size.** This premium exists in four out of five periods between 2000 and 2018.

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Introduction

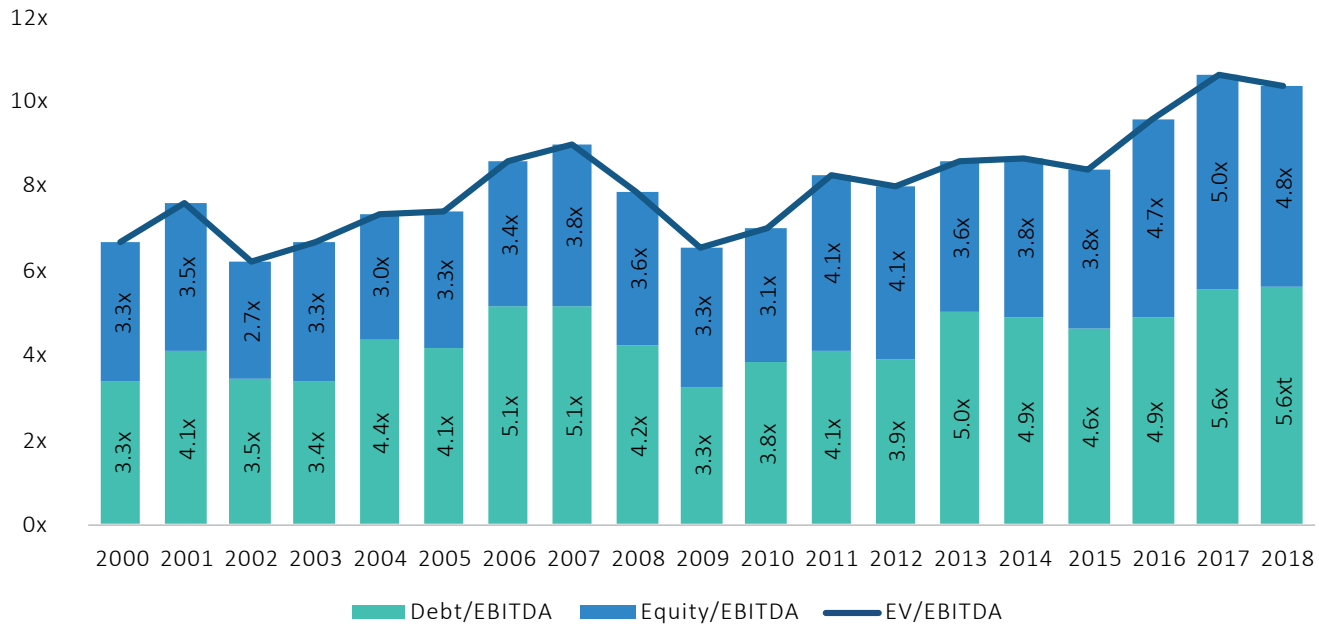
In past editions of this note (Part I and Part II), we've assessed how buyout prices vary based on geography, market timing, size of target company and sector. Building off our recent research that delves into the drivers and performance effects of different sources of deal flow, this note will assess how various deal sourcing trends (including add-ons, SBOs and club deals) affect pricing—measured by EV as a multiple of EBITDA.

Setting the stage

The median global EV/EBITDA multiple hit 10.6x in 2017, the first year on record to finish in the double digits.

Buyout multiples have been on the rise in recent years across all major geographies and deal sizes. The median global EV/EBITDA multiple hit 10.6x in 2017, the first year on record to finish in the double digits.[1] Multiples have remained elevated since, with the median coming in at a lofty 10.3x through the first three quarters of 2018. Even in the run-up to the GFC, buyout prices did not reach such heights, peaking at 9.0x in 2007 before falling for the next two years.

Median global buyout multiples



Source: PitchBook
*As of November 2, 2018

1: While this figure is global, 88.5% of the data represents transactions taking place in North America or Europe.

A note on the EV/EBITDA multiple

The EV/EBITDA multiple, or enterprise value to earnings before interest, taxes, depreciation and amortization, is the most commonly used valuation multiple in private equity and has a few advantages over other valuation metrics such as price-to-earnings (P/E). In the numerator, EV accounts for both the debt and equity financing of a company, whereas price only considers equity value. In the denominator, EBITDA accounts for differences in taxation, leverage and asset classification (i.e. depreciation schedules) that are hidden when using net income, the more traditional measure of earnings. EBITDA is a closer, albeit flawed, proxy for free cash flow. "Pro forma" adjustments are made to EBITDA to account for one-off events and any planned synergies post-acquisition. These adjustments are meant to "normalize" financials but have come under criticism in recent years as they have become more commonly and aggressively used.

There are many reasons for the increase in valuations since the GFC, including an abundance of PE dry powder, a continuously low interest rate environment, laxed regulations on leveraged lending and increased competition from strategics due to the plentiful cash on corporate balance sheets. In addition, PE firms have begun targeting larger portfolio companies, which tend to trade at higher multiples in both public and private markets; median deal size has grown from $28.5 million in 2009 to $100.0 million in 2017. PE firms have also developed an appetite for companies in fast-growing industries, such as enterprise software, shedding their reputation as distressed specialists in more mature sectors. These fast-growing companies tend to command higher multiples because their future earnings and cash flows are assumed to be significantly larger than current figures.

In addition to these private-market phenomena, ballooning public market multiples have also contributed to private-market multiple expansion. The cyclically adjusted price-to-earnings ratio for the S&P 500 surpassed 30x in mid-2018. That level has been reached on only two other occasions: immediately preceding the Great Depression as well as the dot-com crash. Take-privates have seen a resurgence in recent years, and even non-take-privates use public market multiples as comparables, thus contributing to the recent valuation growth in private markets.

Drilling deeper than the headline figure, both the equity and debt portions of the capital stack (expressed as a multiple of EBITDA) have expanded to meet the higher prices in the marketplace. On the equity side, PE fund sizes have swelled, meaning that sponsors can (and often must) write larger checks to effectively allocate the fund. Concurrently, due in part to post-financial crisis banking regulations, non-bank lenders (e.g. direct lending funds) have emerged as a prominent source of buyout debt financing. These lenders, some of whom cater exclusively to financial sponsors, are beholden to fewer leverage restrictions and lending guidelines. Most notably, in the US they can provide debt facilities past the 6.0x-EBITDA mark, the previous guideline for banks.[2]

So we know that the market is more expensive and that deal sourcing strategies have adapted, in part, to combat this competitive environment. But which of these sources and strategies might benefit investors due to there being a discount relative to the rest of the market?

2: These guidelines were rolled back in late 2017, but direct lending funds are still considered to have more flexibility than bank lenders.

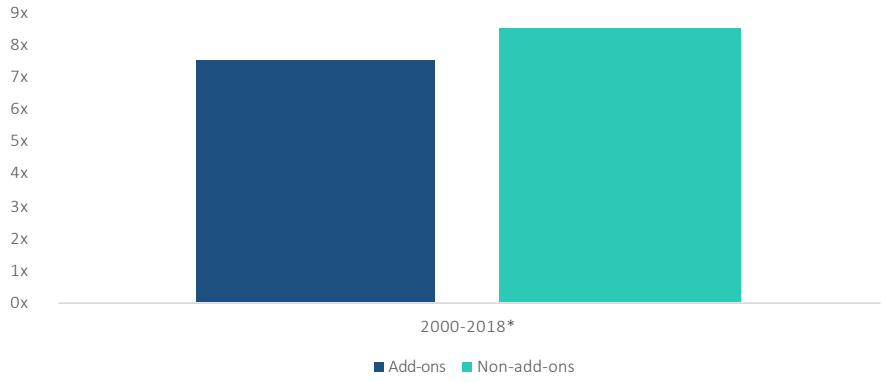
Add-ons: The buy-and-build strategy

Add-ons have become a ubiquitous part of the PE industry, accounting for more than half (57.6%) of all buyouts globally last year. GPs often tout their buy-and-build strategies as a differentiating factor, allowing them to combine smaller portfolio companies with a larger platform, thereby "blending down" the platform-wide acquisition multiple and allowing them to consolidate operations and cut costs across the platform. We recently released research linking the prevalence of add-ons in a GPs portfolio with higher fund performance. From that note: "36.3% of add-on funds beat the top-quartile hurdle rate, while just 10.0% of funds fell into the bottom-quartile, indicating that funds that employ the buy-and-build strategy generate superior returns."

But are these superior returns due more to the synergies created by combining two or more portfolio companies, or are they more attributable to the lower multiples paid for those add-on portfolio companies? If add-ons do trade at lower multiples, is it because there is something unique about those transactions, or simply because they tend to be smaller companies?

At first glance, it appears that add-ons transact at a discount. Add-on deals completed between 2000 and 2018 transacted at a median EV/EBITDA of 7.5x, a full turn lower than non-add-on deals. But the median add-on deal is also 65.0% smaller over that time.

Median global EV/EBITDA multiples by deal type

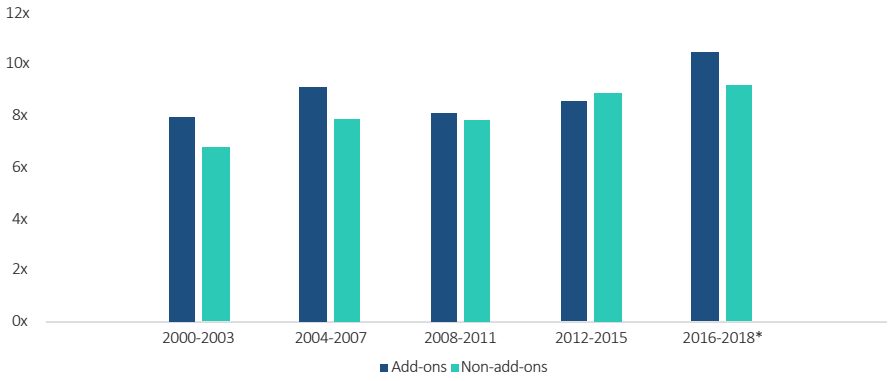


Source: PitchBook
*As of November 2, 2018

Add-ons transact at a premium to non-add-ons in all periods except one

Limiting our sample to middle-market deals (EV between $25 million and $1 billion) to account for some of the size differences between deal types and separating transactions by close date to account for changing multiples throughout an economic cycle, we find the opposite trend in terms of pricing. Add-ons transact at a premium to non-add-ons in all periods except one. PE firms can justify higher prices for add-on transactions due to the cost savings expected post-acquisition, similar to how strategic acquirers have traditionally viewed M&A. Nevertheless, the size of add-ons is relative, so a financial sponsor may still be getting a discount compared to what they paid for the platform. The fact that add-ons tend to be smaller and less developed has always been part of the cost-saving thesis. With that in mind, the buy-and-build strategy can still be a valuable one given that there are other benefits—such as cost-cutting, revenue growth and/or multiple blending—to justify a higher multiple.

Median global middle-market EV/EBITDA multiples by deal type



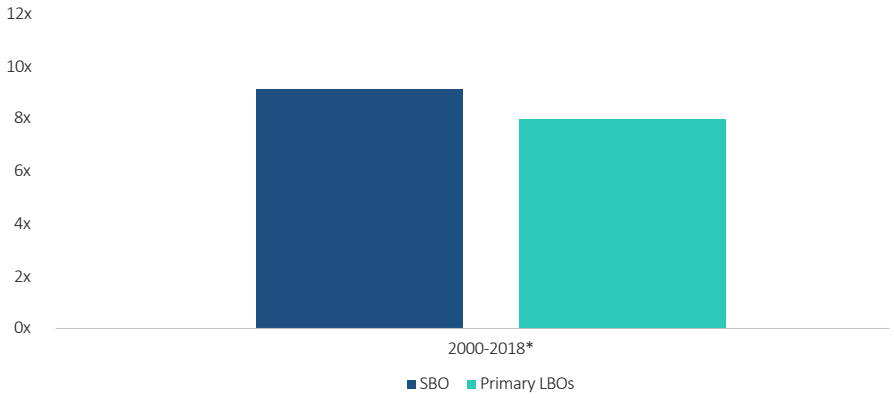
Source: PitchBook
*As of November 2, 2018

SBOs: Are sponsor-to-sponsor deals so bad?

Sponsor-to-sponsor buyouts often come under criticism as "pass the parcel" deals, whereby a PE firm recycles an investment without adding any operational alpha after the first round of PE ownership. The traditional worry is that GPs sourcing from another sponsor's portfolio must lack alternative deal sourcing capabilities and are likely overpaying for an asset that has few operational improvements to be made. Yet, SBOs have become increasingly common in recent years, accounting for 17.0% of buyouts in 2017, up from just 9.8% in 2009.

Our recent note on the topic shows that certain investments are more likely to be recycled more than once (dubbed "echo buyouts"), while another failed to find a clear relationship between the prevalence of SBOs in a firm's portfolio and fund performance. Given the latter of these two findings, we wouldn't expect to find much difference in the prices paid for SBOs and non-SBOs. But the data shows a 13.8% premium (1.1x additional turns of EBITDA) for all SBOs over nearly the last two decades.

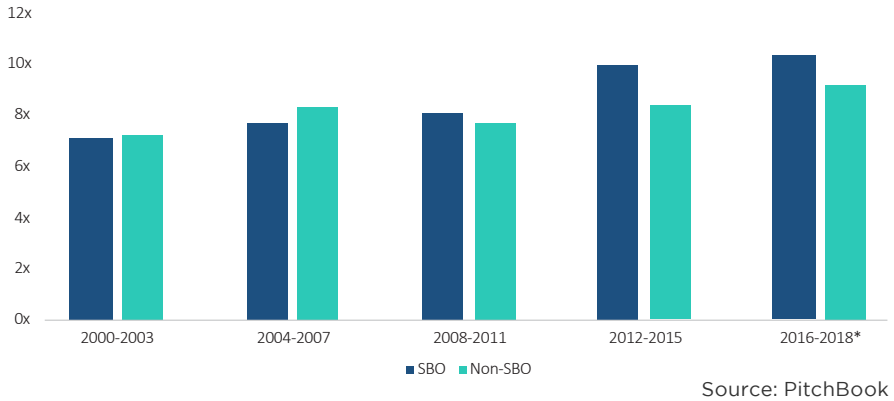
Median global EV/EBITDA multiples by deal type



Source: PitchBook
*As of November 2, 2018

Looking a bit closer—and once again limiting the sample to middle-market transactions to account for some of the difference in size—we find that SBOs have traded at a premium since 2008. But that wasn't the case in 2007 and prior, when SBOs were more likely to trade around par with other LBOs (2000-2003) or about a half turn below non-SBOs (2004-2007). We hypothesize that the premium paid for SBOs since the GFC is due in part to the changing profile of sponsor-backed companies, which have become much larger in the last decade due to growing PE fund sizes. Indeed, the median SBO deal size grew at a CAGR of 21.7% from 2009-2018, above the 13.8% CAGR recorded for non-SBOs, while the median step-up from one PE fund to the next over the last decade has ranged from 1.3x to 1.7x.

Median global middle-market EV/EBITDA multiples by deal type



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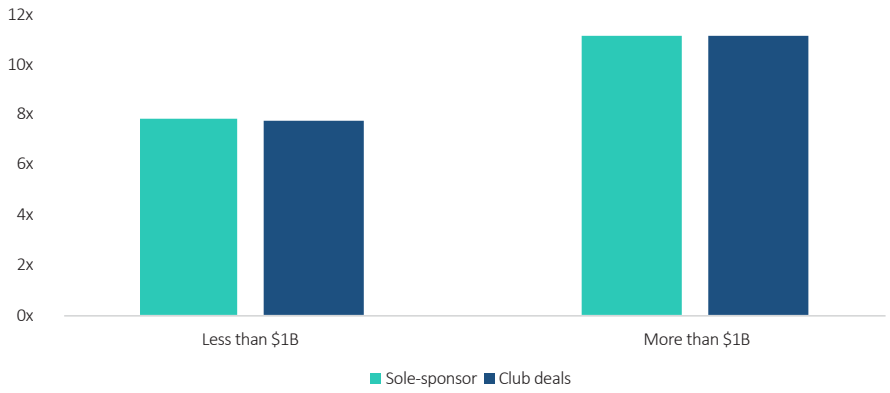
Club deals: Does partnering with your competitors affect price?

Due to a series of high-profile bankruptcies, including those of TXU and Toys R' Us, club deals—in which multiple sponsors "club up" to buy a single portfolio company—became associated with the widespread irrational exuberance exhibited more broadly prior to the GFC. However, our recent research showed that club deals are less likely than other buyouts to enter bankruptcy or go out of business and are more likely to see larger increases in EV through the course of the holding period. They are also more likely to undergo dividend recapitalizations, which take risk off the table for investors, but are often criticized as leading to underinvestment and future bankruptcy or layoffs.

Club deals transact at near-equivalent multiples as sole-sponsor deals of similar size.

Although the stereotypical club deal is viewed as GPs overpaying for (and overleveraging) assets at the peak of a cycle, this perception may have more to do with the prevalence of club deals near the last peak, rather than the nature of club deals themselves. Indeed, club deals transact at near-equivalent multiples as sole-sponsor deals of similar size. At EVs less than $1 billion, club deals transact at a median EV/EBITDA multiple of 7.8x, compared to 7.7x for sole-sponsor buyouts. At $1 billion and above, both club deals and sole-sponsor transactions trade at a median of 11.1x EBITDA. Separating transactions by close date to account for changing valuations through economic cycles, we again find no clear trend in over- or underpricing, with club deals trading at a relative discount in some periods and at a premium in others.

Median global EV/EBITDA multiples by number of sponsors and size bucket



Source: PitchBook
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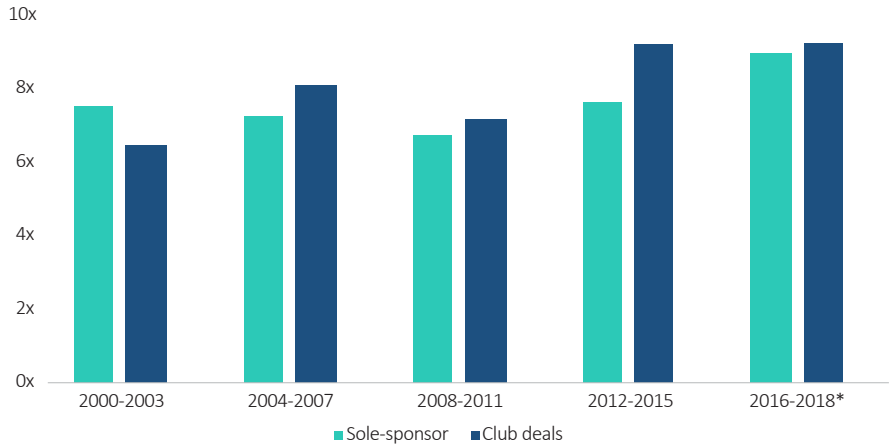
Median global middle-market EV/EBITDA multiples by number of sponsors



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Implications for investors

Given the above data, we can draw a few different conclusions relevant to fund managers and their investors. First, add-ons tend to transact at a premium to non-add-ons of similar size, which may be disconcerting to those GPs who have sold investors on a buy-and-build strategy. But that shouldn't foil the approach, so long as the add-ons supply ample benefit, through cost cutting, revenue growth, multiple blending or a combination of these. Second, LPs may be right to worry about valuations for SBOs, especially given the swift growth of both funds and deals since the GFC. Last, while club deals have been associated with mismanagement and blockbuster blowups, the notion that they should be avoided based solely on price is not supported by the data. In any case, while they may be an important factor, the relationship between deal structure and valuation multiples should not be the only consideration from either a GP's or LPs' perspective.