



HOW MUCH IS THAT DOGGIE IN THE WINDOW?

Components of Business Valuation at the Lower End of the Middle Market

Based on everything one reads, prices paid in middle market M&A transactions over recent periods have reached or exceeded historic highs. According to FactSet Mergerstat, LLC the median enterprise value to annual EBITDA (earnings before interest, taxes, depreciation and amortization) multiple among middle market transactions in 2006 was 10.2 times. Private equity is plentiful, leverage is readily available and prospective buyers are numerous; it is easy to understand why prices are high.

So, does this mean that your \$40 million revenue business, or that competitor you've been eyeing for the last several months, is worth 8, 9 or even 10 times the cash it generates annually? Maybe; maybe not. The metrics you see in articles and press reports are derived from publicly announced transactions and can involve businesses as large as \$1 billion or more in sales, including many publicly traded companies. In contrast, there is very little data to support average price multiples or other deal measures for private and closely held companies operating at the lower end of the middle market, those generating annual revenues of less than \$100 million.

Bulkeley Capital represents both buyers and sellers across a broad range of industries and throughout the United States, and nearly all have revenues of between \$25 million and \$100 million. In these situations, we approach the valuation question as a team, working with our clients to develop a reasonable estimate for the specific company in question, based on its particular circumstances. While market multiples may or may not be applicable, the best approach is to view a company objectively, from the perspective of a buyer; beauty is, after all, in the eye of the beholder.

When you buy a company, you are investing in the future. An attractive transaction is one in which the future returns to you as buyer (in the form of incremental cash flow and enhanced equity value) exceed the price you pay today. Obviously, the risk inherent in any deal is that future profits will not materialize. To limit risk, buyers look for a number of characteristics in a target which together support the investment hypothesis and provide assurance that future earnings will in fact be achieved.

For the acquirer, these characteristics serve as a set of criteria and should be referred to frequently in the course of analyzing potential targets. It is important to remain disciplined throughout the process since the wrong acquisition can quickly undo an organization. For the potential seller, understanding the perspective of suitors helps in preparing a company for sale, setting realistic expectations, and anticipating any impediments to a successful sale.

Cash (flow) is king. As textbooks and our own checking accounts teach us, a business is ultimately worth the future cash flow it will generate for its stakeholders. It is this cash that will repay the investment made by the acquirer and build equity value through

retained earnings. A buyer seeks to determine the true cash flow of the business (after capital investment needs, working capital and taxes) and assess the strength of those earnings. Does the company produce higher cash flow margins than its competitors? If so, why? Has ownership reinvested adequately in the business?

Crystal ball not required. Aligned to the relative strength of a company's cash flow is the predictability of its future financial performance. The more assured a buyer is that the target's cash flow will be present post-purchase, the less risk he or she perceives, and the more aggressive he or she can be on price. There are many factors that when combined demonstrate predictability, including: sales diversification (not too great a proportion of earnings tied to a single customer or single product that could theoretically be lost); recurring revenue streams (business models that ensure ongoing payments from customers); extended contracts (clients committed to multi-year agreements); a stable cost structure (limited volatility in the pricing of ingredients or components necessary for the product or service being delivered); and, of course, consistent historical performance (steady sales, margin and expense patterns over recent periods).

Dominating the field. Successful niche businesses exhibit the essential characteristic of competitive advantage. Those companies have intellectual property, business know-how, reputation, regional footprint, equipment, customer lists or manufacturing capabilities that give them an edge in the market over competitors. The stronger a company's competitive position, the greater its ability to control pricing, invest in growth and enhance value. A quick look at a target's gross margin (and a comparison with similar businesses) gives the buyer an indication of the value placed on the product or service by customers and the extent to which competitive offerings exist. "Marginal" suppliers don't usually produce attractive profit margins or command premium sale prices.

An all-star roster. Strong management is critical to the success of any business. A good team ensures sales are made, employees are productive, customers are satisfied, and profits are realized. What has this team achieved? Are there any gaps that need to be filled? Where the selling owner holds a managerial role and will be exiting at the transaction, what bench strength lies behind him? As well as strengths and accomplishments, personality and compatibility with his own organization and people is important to the buyer. We refer to this aspect as the "chemistry" of the deal. We often ask sellers to consider instituting retention or other compensation arrangements to ensure key executives are with the company upon the sale. Similarly, a buyer might condition the acquisition on securing acceptable employment agreements with certain managers.

Blue skies ahead. For most buyers, interest in a target is greatest when they see an opportunity for growth or profitability beyond what the seller has been able to achieve. This can be in the form of untapped geographies, cross-selling opportunities, access to new customers or markets, cost savings attainable through a combined platform, greater critical mass allowing for more aggressive expansion, valuable functional capabilities, or needed production capacity. If the buyer doesn't believe he can run the business more effectively or profitably than the seller, he is unlikely to pay a premium for the company. Consider the basis of the traditional discounted cash flow approach to valuation: the greater a company's projected future earnings, the higher its corresponding value today. At the same time, of course, a buyer must be realistic; simply assuming you are smarter than the previous owner without clear supporting evidence can be a slippery slope.

What of the company that falls short in one or more of these areas? In many cases, significant improvement is possible over a relatively short period of time, given appropriate investment and management focus. Absent extraneous pressures to sell, an owner might decide to spend six to twelve months making these changes before beginning the divestiture effort. We frequently work with company owners who are considering a sale. In these situations, we help them review their businesses in an objective manner and determine, as part of an overall plan to maximize value, whether additional work is warranted before taking the company to market. When it comes to selling a business, planning ahead is critical.

Ultimately, a company is worth what an interested and qualified buyer is willing to pay. The question the business owner should ask, therefore, is: how will a suitor view my company? How do I stack up against the five key subject areas outlined above?

A company that meets these criteria has a more compelling story to tell.

Founded in 1985, Bulkley Capital, L.P. (www.bulkleycapital.com) is an investment banking and financial advisory firm based in Dallas. The company works with owners and management teams across a wide variety of industries to design and execute capital financing, growth and exit strategies.