Why Valuations Matter (Fourth of a Series)

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"Doubt is not a pleasant condition, but certainty is absurd." –Voltaire

The story of value is the story of private equity. How these firms have grown businesses and sold them for superior shareholder returns is about value creation. The paths to creating value and achieving these returns differ for each sponsor.

As we discussed last week, one of the key strategies for better valuations, in the current environment of high purchase price multiples, is the "buy-and-build." Incremental add-ons at lower multiples help reduce the effective multiple at exit.

In an excellent 2018 Bain study [link], add-ons are identified as enhancing valuations when interest rates and GDP growth alone are insufficient to reach desired returns.

Yet, as we covered in our special series on the topic [link], executing add-ons expertly is anything but straightforward. Our *Chart of the Week* highlights how more competition for deals has compelled sponsors to accelerate the velocity of these tuck-ins. That can lead to rushed due-diligence, botched integrations, and poor strategic planning.

Bain also cites "sector dynamics" as critical to success. Some industries present better value creation opportunities than others. Cyclicals have less predictable cash flows, for example. Retail and consumer electronics have proven more prone to disruption.

A Chicago-based PE partner noted to us recently that "being in sectors where private equity is active is helpful in setting valuations. The flip side, of course, is more activity can lead to higher multiples. But at least you have good comparable data."

The key is knowing what it will take to position the platform to successfully execute add-ons. Bain suggests buyers focus on the competence of the management team and their acquisition history: "PE firms are often buying someone else's starting point."

Certain high-growth arenas have seen prices skyrocket. That leads to a predicament, suggests one firm. "Let's say you bid 17x for a tech-enabled software shop," the principal said. "But your model shows 12x because you're counting on extraordinary ebitda growth. What are the leverage and value implications if you fall short?"

"You can't assume multiples will stay high at exit," another sponsor told us. "But that's what some are doing to justify bids. The result is they're overpaying for properties where we're being outbid." He laughed. "We know because *we* were paying too much!"

So how do you compete effectively, yet still meet return hurdles? Bain suggests private equity should be "focusing on their exit strategy from day one." Again, sectors can make the difference. If there are plenty of future add-on opportunities beyond what the current owner can manage, that can enhance perceived value for the

new buyer.

Our Midwest sponsor seconded that thesis. “At the right price it’s a lot easier to make money today on the buy-side than it is on the sell-side,” he said.