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Why Valuations Matter (Last of a Series)

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“There are two times in your life when you shouldn’t speculate: when you can’t afford to, and when you can.” – Mark Twain

Intergrowth 2019 this week in Orlando came at a propitious time, at least as far as our lender survey on valuations goes.

One long-time NYC-based middle market practitioner weighed in with a view on enterprise value: “We look at historic EV rather than just where current levels are,” he said. “For most of the businesses we lend to that means 7-9 times ebitda, not 10-12.

“And we look closely at other private comps. It’s helpful to research other sponsors who have invested in similar borrowers. What have those valuations been? Then when we set covenants, we’re doing so within realistic equity multiples.”

Another midcap lender blamed inflated sponsor expectations for IRRs. “They sell investors on 20 or 25%,” he said, “when the reality today is well inside that. Then they’re ponying up 10x-plus multiples on the buy-side. The math just doesn’t work.”

As a senior lender, are all equity transactions created equal? “Our experience over the past two decades is that the first investments in a given fund are the best,” he said. “These are the ones that will be realized earliest, so the sponsor wants them to shine.

“The opposite is true for the last deals in a fund. There can be a rush to put money to work. Sometimes the quality isn’t up to the same early standards. Blame it on the ‘use it or lose it’ phenomenon. But over time, the best sponsors do perform.”

As we mentioned in the first installment of this series, timing plays a key role in valuations. Early cycle deals fare better than later cycle ones. Hence the fixation on when the next downturn will occur. Which is anyone’s guess. (See *Chart of the Week*.)

But industry observers worry more today about ebitda adjustments. At an Intergrowth panel session led by S&P’s Ruth Yang, your correspondent and two other veterans of the game detailed how sketchy add-backs inflate ebitda, thus valuations.

Ebitda is *the* valuation lever. It flows through everything: purchase price, leverage, even the credit agreement. Ebitda adjustments are the blueprint for how sponsors plan to reach the desired valuation – given time, expertise, and lenders’ cooperation.

From the lenders’ perspective, if the adjustments are discrete and measurable they accrue to the sponsors’ credibility. If vague and ill-defined, the suspicion is add-backs become safety nets for poor execution. “Potential customer wins,” “contemplated synergies,” and “expected product launches” should include possible negative outcomes as well.

We leave the last word on valuations to Andrew Kahn at BVA Group: “For lenders, where you are in the capital structure drives recovery. And ebitda performance establishes the guard rails. But we dig deep into the sponsor’s underlying business model. Do their assumptions make sense? That’s not an easy question to answer.”