PE DEAL MULTIPLES REPORT

2016: III

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MEDIAN DEBT USAGE AT 51% IN 3Q

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MONITORING FEES FLAT QoQ

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MEDIAN EV/EBITDA MULTIPLE FOR BUYOUTS HITS 8.4X
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The PitchBook Platform
The data in this report comes from the PitchBook Platform—our data software for VC, PE and M&A. Contact sales@pitchbook.com to request a free trial.
Introduction

Each quarter we survey private equity investors to get a closer look at the changing dynamics present in the private equity (PE) marketplace. The most recent data, for deals completed during the third quarter of this year, show increasing prices and improved target company performance, yet lower than usual debt usage and continually decreasing monitoring fees.

Often times, the depth of information about private equity is limited to financial data. This survey, however, provides insights about investor expectations and specific deal terms that are hard to find elsewhere.

We hope this report is useful in your investment practice. As always, feel free to send any questions or comments to reports@pitchbook.com.

DYLAN COX
Analyst
Combining data from both our survey and the PitchBook Platform, we observed moderate price increases in PE deals during the third quarter. Median enterprise value (EV) increased to 8.4x EBITDA, up from 8.0x in 2Q and the highest EBITDA multiple we’ve observed in the survey since 3Q 2012. This increase, consistent with what we’ve seen in the wider M&A marketplace, is driven by the well-documented abundance of dry powder at PE firms, heightened competition from strategic acquirers looking for inorganic growth, and a limited supply of quality targets after the buyout boom of the last couple years. It’s our view that the current environment of high prices and less leverage on PE deals will cause downward pressure on future returns. With that in mind, firms have had an increased focus on diligence in order to limit their downsides.

Similar to EBITDA multiples, median revenue multiples also expanded this quarter. Median enterprise value came in at 1.5x revenue, up from 1.3x in 2Q. The largest jump came in deals with an enterprise value greater than $250 million, which sold at a median of 3.2x revenue during the quarter. These larger deals see the most competition from strategic acquirers, especially public corporates with large sums of cash on the balance sheet and limited return-generating opportunities elsewhere. If we see public company earnings continue to improve as they have in the last two quarters, corporate acquirers may start to invest more back into their own businesses, easing the multiple expansion we’ve seen in PE.

Interestingly, the only deal size for which the median revenue multiple did not increase in 3Q was the sub-middle market (EV less than $25 million). These smaller companies traded at 1.0x revenue for the second quarter in a row—still a lofty price for a market that has never seen multiples above 1.1x revenue. Initially, many firms had moved toward the lower middle market in order to find better value, however, if multiples keep expanding, the economics of these transactions start to make less sense.
As part of our quarterly survey, we ask investors about the trailing 12 month (TTM) revenue change at the acquired company, as well as the manager’s anticipated revenue changes in the 12 months immediately following a deal.

Overall, the health of newly acquired portfolio companies increased rather dramatically in 3Q. 77% of respondents said that target company revenues had increased in the 12 months immediately preceding acquisition—up from 66% in 2Q and the highest number we’ve observed in the last two years. Public company revenues also performed well in 3Q—sales grew 5% for the S&P 500, according to FactSet. The percentage of PE acquisitions for which TTM revenues were flat decreased by about half in 3Q, as many of these companies have been bumped into the “revenue increase” bracket. Furthermore, just 4% of acquired companies in the survey had TTM revenue decreases of greater than 10%, also the lowest figure in the last two years. The data here could be taken in one of two ways: First, the list of potential buyout targets is improving despite the recent dearth in quality acquisition targets. Second, PE managers are becoming more conservative in their deal sourcing processes, electing to invest in healthier companies with better growth prospects given the high valuation multiples currently present in the market. We believe the latter is more likely.

In addition to improved revenues prior to acquisition, buyout investors are also more optimistic about growth prospects in the 12 months following a purchase. 82% of survey respondents expect revenues to increase over the next 12 months, up from 79% in 2Q. Additionally, 52% of respondents anticipate revenues to increase by 10% or more, higher than any period since the first quarter of 2014. Though still a far cry from 2014 when nearly all buyout investors expected revenue increases immediately after acquisition, managers are certainly more optimistic about growth prospects at their newly acquired portfolio companies than they were last year.
Debt usage across PE remains significantly lower than it was in previous years. Our survey data combined with data from the PitchBook Platform show a median debt usage of 51% of enterprise value, up slightly from 50% in 2Q. In an industry that often relies on financial leverage to create alpha, lower debt usage and higher EBITDA multiples over an extended period will put downward pressure on future returns.

Our survey respondents reported average equity contributions of 53% of enterprise value in 3Q. Though a sharp decrease from the 61% equity usage we saw in 2Q, this is still the second-highest reported figure in our survey’s history. As PE groups increasingly pay higher multiples to compete with strategic acquirers for top tier targets, they must increase their equity contributions, measured as a percentage of enterprise value.

Lenders are often looking for a certain company profile and debt packages are limited by the earnings of the portfolio company, not the purchase price. Thus, PE groups are using more of their ample dry powder reserves to make up the difference.
Fees

Monitoring fees as a percentage of EBITDA remain historically low for PE investments. Driven by heightened pressure from limited partners and increased awareness around fee structures in general, median monitoring fees came in at 2.0% of EBITDA in 3Q 2016. This quarter marks the first time in our survey’s history that median monitoring fees were no greater than 2.0% for two consecutive quarters. As LPs look to work with fewer GPs and become more involved in the investment process, there may be more pressure from LPs to do away with monitoring fees. The cost of monitoring portfolio companies, the argument goes, should be covered by the 2% management fees that most firms charge—especially for larger firms with significant economies of scale at the administrative level.

Furthermore, 2016 has seen a decrease in median transaction sizes across PE, particularly in the middle market. As transaction sizes fall, we usually expect to see an increase in monitoring fees as a percentage of EBITDA, since smaller deals can often require a similar amount of managerial oversight as larger ones. That fees are falling despite a decrease in deal sizes, however, speaks to the strength of the trend.

After a significant drop last quarter, transaction fees are now closer to their historical mean. Median transaction fees across our survey population ticked up slightly in 3Q 2016 to 2.5% of enterprise value. The percentage of managers that reported transaction fees associated with 3Q deals rose to 90%, up from just 74% three months prior (For the purposes of this survey, transaction fees are defined as break-up, acquisition & disposition, advisory and accounting, or due diligence fees related to the transaction). As PE buyers waded into murky waters stemming from the plethora of well-documented macroeconomic concerns, managers had to exercise more caution in their pre-close processes, more often employing specialty diligence firms and advisors to ensure stability in case of a downturn.

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**Median monitoring fee as % of EBITDA**

**Median transaction fee as % of deal value**
On a quarterly basis, we did not observe much change in the time it takes to close PE deals. Median closing time, defined as the time from signing of letter of intent to final close, for our survey population increased by just half a week, to 12.5 weeks in 3Q. There was, however, a significant change in the distribution of those deals around the median. 38% of survey respondents in 3Q said their deals took 15 or more weeks to close, up from 23% in 2Q. We see this increase as being associated with the simultaneous increase in transaction fees that we observed this quarter, as firms spent more money (and therefore time) on third-party advisory and due diligence services.

36% of deals in our survey population included seller financing or earnout provisions this quarter, down from 40% in 2Q. This trend has stayed more or less steady over time and tends to bounce around the 40% range with no real rhyme or reason. Currently, financing for buyout deals (and for that matter, credit in general) is for the most part readily available. Therefore, the main reason to include seller financing in a deal would be to ensure that the seller still has some skin in the game after the purchase—an objective that can also be realized via earnouts or manager stock options.

Transactions (#) by weeks to close

Deals with earnout provisions or seller financing (#)

Weeks to close (#)
If your firm receives 100 Confidential Information Memoranda (CIMs) this year, for what percentage of that 100 will you:

- 25%
- 25%
- 18%
- 17%
- 0%
- 5%
- 10%
- 15%
- 20%
- 25%
- 30%

Statistics on CIM count in 3Q 2016:

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<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Minimum</td>
<td>0</td>
</tr>
<tr>
<td>Median</td>
<td>17</td>
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<tr>
<td>Maximum</td>
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<td>Average</td>
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<tr>
<td>Standard deviation</td>
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CIM flow relative to prior quarter:

- 64% Up
- 36% Down
We do EBITDA multiples, private comps, valuations, market trends, growth metrics.

You build a better portfolio.

See how the PitchBook Platform can help your private equity firm close your next deal.

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