Exploring buyout multiples

Where can PE firms find attractive valuations?

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Key takeaways

- We observe a premium for larger buyout acquisitions. The smallest buyout targets trade at an EV/EBITDA of 5.6x, compared to the largest at 12.3x.
- Early-cycle vintages are likelier to pay lower multiples and generate higher returns.
- Emerging markets provide an opportunity for investors due to their relative affordability. Eastern European and Latin American buyouts trade at 5.8x and 6.9x, respectively.

Introduction

"Buy low, sell high." It's one of the oldest platitudes in finance, but one that is especially relevant in today's PE landscape. Multiple expansion between entry and exit prices has long been known to be one of the main drivers of PE returns[1], particularly during times of economic growth. Indeed, median buyout multiples have hit 10.2x in 2017, more than four turns higher than the 5.7x recorded in 2009. To achieve multiple expansion, PE firms must begin with the first half of the adage: buy low. But where are lower multiples and consequently higher returns to be found? We examine three sources: smaller enterprise values, early-cycle investing and emerging markets.

1: Froland, Charles G.; The Fortunes of Private Equity: What Drives Success?; 2008

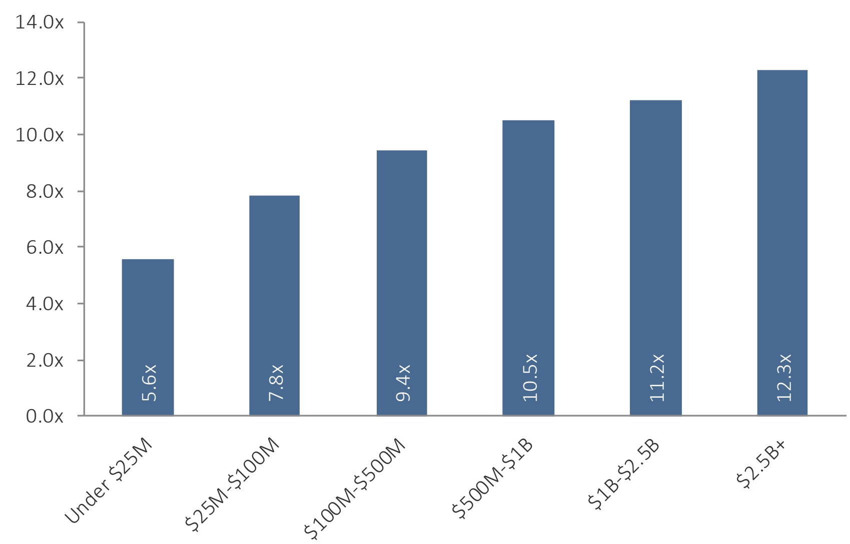
Source smaller

To find companies trading at lower multiples, PE firms need to do nothing more than search for smaller targets. The median global EV/EBITDA multiple for portfolio companies with less than $25 million in EV is just 5.6x, less than half of the 12.3x we observe for mega-deals worth more than $2.5 billion. Granted, these companies are not targeted by the same class of acquirers, whether they be financial or strategic, since the dynamics of operating a small, regional business and a multinational entity differ substantially. Even so, the same dynamic holds true within the middle market. For example, by moving from buyout targets in the $100M-$500M range to the $25M-$100M range, the median firm could pay 7.8x EBITDA rather than 9.4x.

These smaller companies trade at lower multiples for a few reasons. They often pose more risk to an investor due to the lack of barriers to entry in their market, or over-exposure to one geography, client or product line. In addition, companies of smaller size will often lack institutionalization in back-office processes, distribution channels, marketing approach or supply chain management. It may take years of add-ons and plenty of operational elbow grease to achieve the desired multiple expansion. But, after all, isn't that exactly the type of expertise in which PE firms take pride?

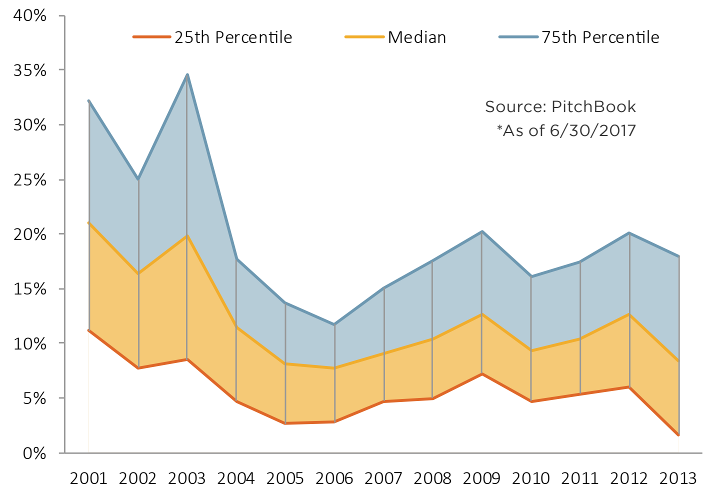
Due to a lack of fund economics at smaller enterprise values, as well as existing limited partner agreements that restrict investment sizes, many firms will be unable and/or unwilling to chase smaller portfolio companies. In some cases, it simply doesn't make sense to spend that much time and energy to achieve liquidity by doubling or tripling the size of a smaller business. But that's exactly the point. For buyout investors who don't have specific mandates, perhaps those with fund-less sources of capital (such as family offices making direct investments or managers who can call upon a pool of investors on a deal-by-deal basis), the opportunities at the lower end of the market are even more enticing due to the lack of other competition.

Median global buyout multiples by enterprise value



Source: PitchBook
Data scope: global PE buyouts, 1/1/2006-6/5/2017

Invest early



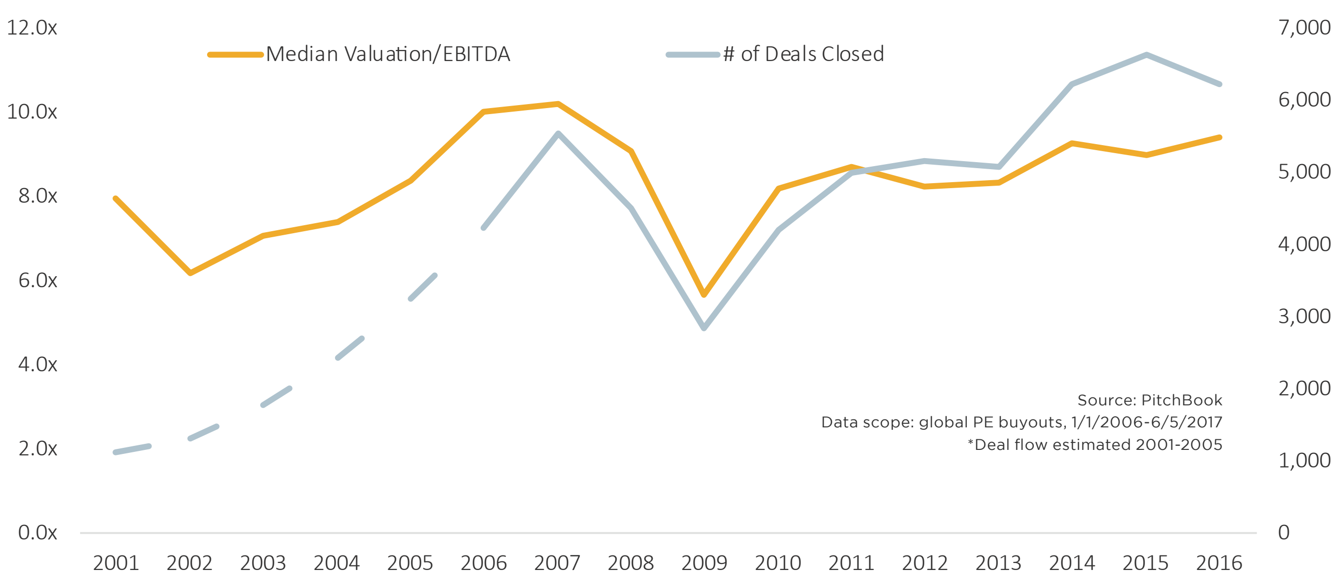
Another way to find lower PE valuations is by investing earlier in the cycle. During an economic expansion, multiples are pushed higher by escalating public equity prices and competition from other buyout firms. Compounding this phenomenon, easy credit often incentivizes PE firms to overpay for deals[2], causing further escalation in prices, but providing easy exit opportunities for those funds that bought early in the cycle.

Research suggests that PE funds which start deploying capital early in an expansion perform better than their later-to-market peers[3]. More recent PitchBook data shows a similar trend, with median IRRs peaking from 2001 to 2003 before falling from 2005 to 2007, and then picking up again starting in 2009. These returns directly coincide with EBITDA multiples at the time of investment. When returns to PE have been the highest, for vintages 2001 through 2003, buyout multiples were some of the lowest we've seen in the last two decades—below 8.0x in each of those years. Similarly, when median returns have been the lowest—for vintages 2005 through 2007—buyout multiples were at record levels, exceeding 10.0x in 2006 and 2007. Simply put, economic expansions lead to more buyout competition, which leads to higher prices, which leads to lower returns. Furthermore, early-cycle investing insures that better buyout targets are still available, in terms of the ability to carry more debt. Those who arrive early to the party will have an easier time enjoying it.

We don't yet have enough returns information to judge performance for the "late-cycle" vintages (2014-2017) of the current expansion, but global buyout multiples of 9.4x in 2016 do not bode well for the industry. In addition, regulatory caps on lending and increased strategic M&A will force larger equity contributions from PE firms, likely suppressing returns moving forward.

2: Axelson, Jenkinson, Strömberg & Weisbach, 2012

3: Kaplan & Schoar, 2005



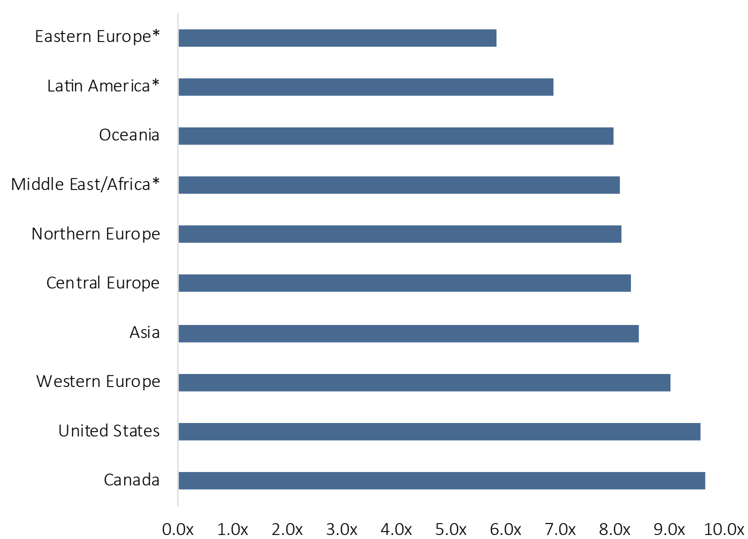
While waiting to deploy capital until multiples have subsided might be ideal, it is not always realistic. As of June 26, buyout funds have raised $337.7 billion across 394 vehicles since the beginning of 2016, while dry powder across all PE strategies sits at $872 billion globally. These firms didn't raise funds to sit on their hands and wait for the economy to fall apart, but PE buyers would be wise to be as patient as possible, modeling lower exit multiples into their pro formas and stretching investment timeframes if need be. We expect to see more buyout vehicles with longer investment lifecycles in the future, as flexibility in capital deployment and exit timing will outweigh illiquidity concerns.

Emerging markets

Emerging markets are the new frontier of PE. In many ways, the buyout markets in these countries resemble that of the US in past decades, excepting often far greater political and inflationary risks. There are far fewer competitors in these regions and fewer deals that get passed around on investment banking circuits. Target companies tend to be smaller and, similarly to lower-middle-market companies in more developed countries, lack the institutionalization expected by many potential buyers. Capital markets are not as mature in these economies; businesses often lack access to proper financing. This creates opportunities for PE across the capital structure, but is particularly well-suited for minority growth investments, which can fill the financing void but don't necessitate the niche expertise needed to run a business in many developing economies.

Buyout targets are most affordable in Eastern Europe and Latin America, where historical EV/EBITDA multiples are 5.8x and 6.9x, respectively. They are least affordable in Canada, the US and Western Europe, where M&A markets are thicker and access to financing more plentiful. We expect PE activity in emerging markets to accelerate in the coming years, as traditional markets become overcrowded.

Median global buyout multiples by region



Source: PitchBook
Data scope: global PE buyouts, 1/1/2006-6/5/2017
*Eastern Europe n=18, Latin America n=26, Middle East/Africa n=21