Exploring Buyout Multiples: Part II

Analysis of opportunities via add-ons and sector sourcing

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Credits & Contact

Analysis
DYLAN COX Analyst II
BRYAN HANSON Data Analyst
KORY HOANG Data Analyst

Contact PitchBook
pitchbook.com

RESEARCH
reports@pitchbook.com

SALES
sales@pitchbook.com

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Key takeaways

- Add-ons are an effective way to find buyout acquisitions at lower multiples. Often smaller and less institutionalized than platform buyouts, add-ons have transacted at a median valuation/EBITDA multiple of 8.4x globally since 2006, compared to 9.0x for platform buyouts.

- The financial services and healthcare sectors are currently the most expensive for buyout investors, given public comps trading at 51% and 23% premiums to their 10-year averages[1], respectively. Both have experienced a wave of consolidation after the global financial crisis, causing multiples to increase substantially.

- Public comparables in the B2C and materials & resources sectors are currently the most affordable, trading at just 13% and 14% premiums to their 10-year averages[2], respectively. Their relative affordability can be partly attributed to e-commerce disruptions and a prolonged downturn in commodity prices.

Introduction

In the first installment of Exploring Buyout Multiples, we discussed the relationship between multiple expansion and private equity returns. To help PE investors find opportunities for attractive entry pricing, which is paramount to achieving multiple expansion (and thus higher returns), we identified and examined three main sources of lower buyout multiples: smaller enterprise values, early stages of an economic expansion and emerging markets. In this edition, we examine two more:

1. Add-on strategies

2. Sector selection

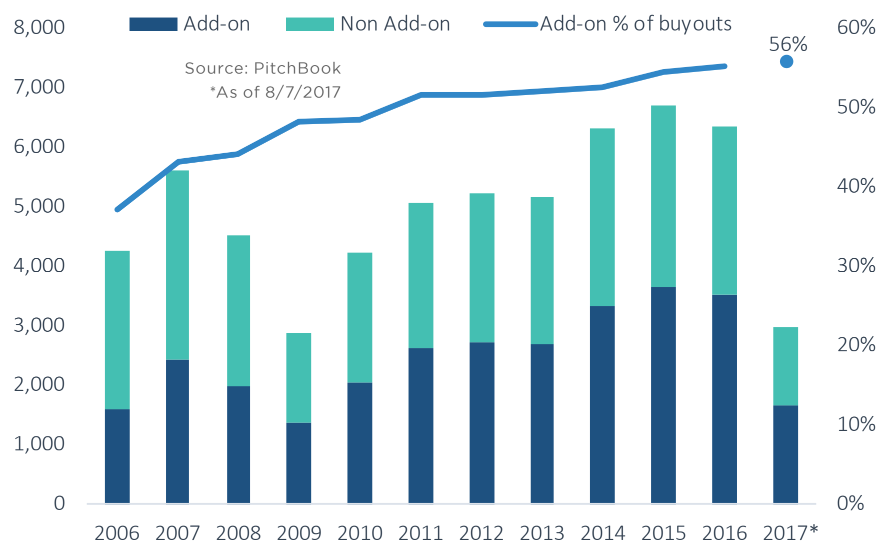
1 Reflects premium above 10-year average TTM EV/EBITDA
2 Ibid.

Add-ons

Well over half of all buyouts are now add-on transactions[3]—a proportion that has grown steadily in the last decade. As recently as 2006, add-ons (also known as bolt-ons or tuck-ins) accounted for hardly one third (37%) of buyouts.

3 YTD as of August 7, 2017

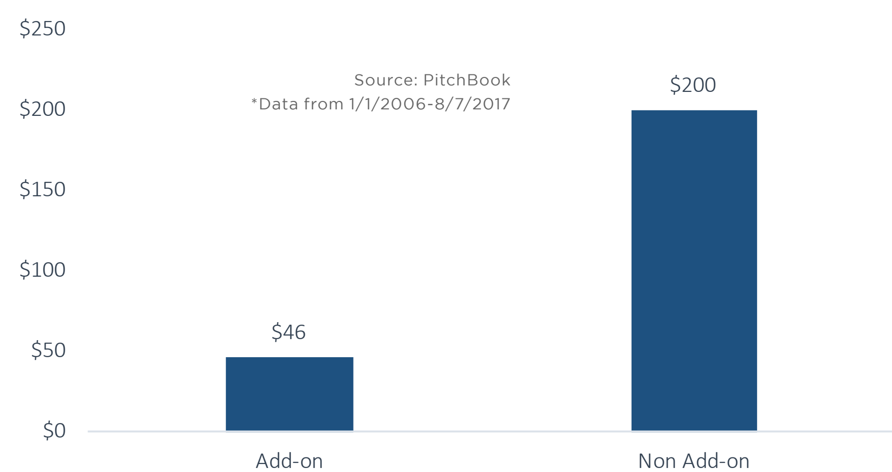
Over half of all buyouts are now add-ons, the highest proportion ever
Global add-ons (#) as percentage of buyout activity



One reason general partners have gravitated toward add-ons is that they tend to be smaller companies and thus transact at lower multiples. Since 2006, the median deal size of an add-on is $46 million[4], compared to $200 million for platform buyouts.

4 Ibid.

Global median add-on size ($M)

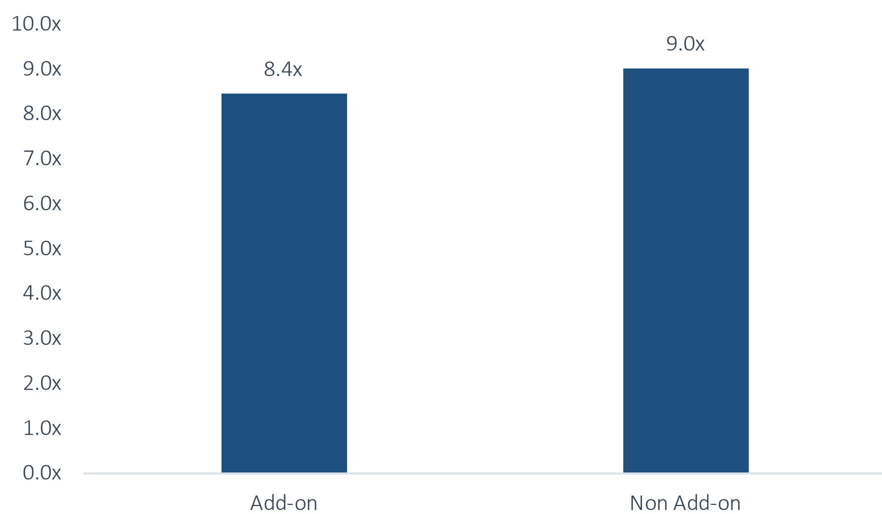


As we've previously written, there are a multitude of reasons for the discount on smaller companies. They can pose more risk to an investor due to over-exposure to one geography, client or product line. Furthermore, smaller companies often lack institutionalization in back-office processes, distribution channels, marketing approach or supply chain management.

The typical add-on target also attracts less competition from other sponsors. Auctions are less common and achieving proprietary deal flow is a more realistic prospect. However, as more firms seek opportunities through this strategy, it's likely that prices for add-on targets will rise accordingly. Regardless of size, add-ons transact at a median valuation/EBITDA of 8.4x globally, compared to 9.0x for platform buyouts[5].

5 January 1, 2006-August 7, 2017

Global median valuation/EBITDA multiples by deal type



Source: PitchBook
*Data from 1/1/2006-8/7/2017

In addition to trading at lower multiples, add-ons also provide greater revenue growth than standalone strategies, according to BCG[6]. The same attributes that contribute to lower multiples can also fundamentally benefit the platform company. Add-ons often bring new capabilities, geographical exposure, distribution channels or product lines, all of which help grow earnings when implemented correctly.

6 How Private Equity Firms Fuel Next-Level Value Creation

Once add-ons are folded in and operational improvements are made, the resulting company is ideally larger and growing at a faster pace than were the independent companies prior to acquisition. The increase in enterprise value and growth rate should not only lead to higher EBITDA, but also eventually fetch a larger multiple of that EBITDA upon exit.

Simplified example of blending transaction multiples

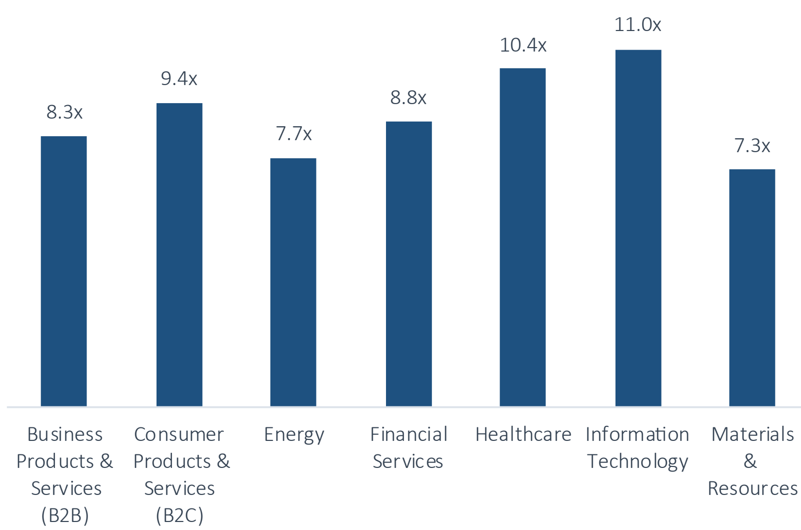
METRIC	PLATFORM BUYOUT	ADD-ON	BLENDED
EBITDA	$100	$50	$150
Entry EBITDA Multiple	9.0x	7.0x	8.3x
Entry Price	$900	$350	$1,250

Source: PitchBook
(For illustrative purposes only)

Sector selection

As in public markets, companies in high-growth sectors tend to demand the highest multiples in the private markets. Over the last decade, median valuation/EBITDA multiples in the healthcare and IT sectors have been 11.0x and 10.4x, respectively—higher than figures seen in any other sectors. However, the fact that these sectors tend to be more expensive doesn't necessarily mean that they are cheap on a relative basis.

IT & healthcare mark the highest multiples by a fair margin
Global median valuation/EBITDA buyout multiples by sector



Source: PitchBook
*Data from 1/1/2006-8/7/2017

To identify which sectors may be relatively affordable now, we measure the difference between a sector's current price (average TTM EV/EBITDA for publicly traded firms) and a historical average of its price (10-year average EV/EBITDA). By that measure, the financial services and healthcare sectors are currently the most expensive, trading at 51% and 23% premiums, respectively. While financial stocks have benefited from a sustained recovery in the global economy and unprecedented easy monetary policy, heightened regulatory costs after the global financial crisis have led to consolidation within the sector. Meanwhile, the passive investing revolution has put pressure on traditional fee structures, incentivizing asset managers to grow AUM.

In healthcare, aging demographics, new regulations and stable revenue streams have contributed to a similar wave of consolidation in the US, which has led to a sharp increase in multiples. The current uncertainty regarding potential changes to the Affordable Care Act, even if only on the margin, has increased the risk profile of many potential healthcare investments. It should be noted that strategic acquirers (which are often able to outbid PE firms) have played a large role in this valuation growth.

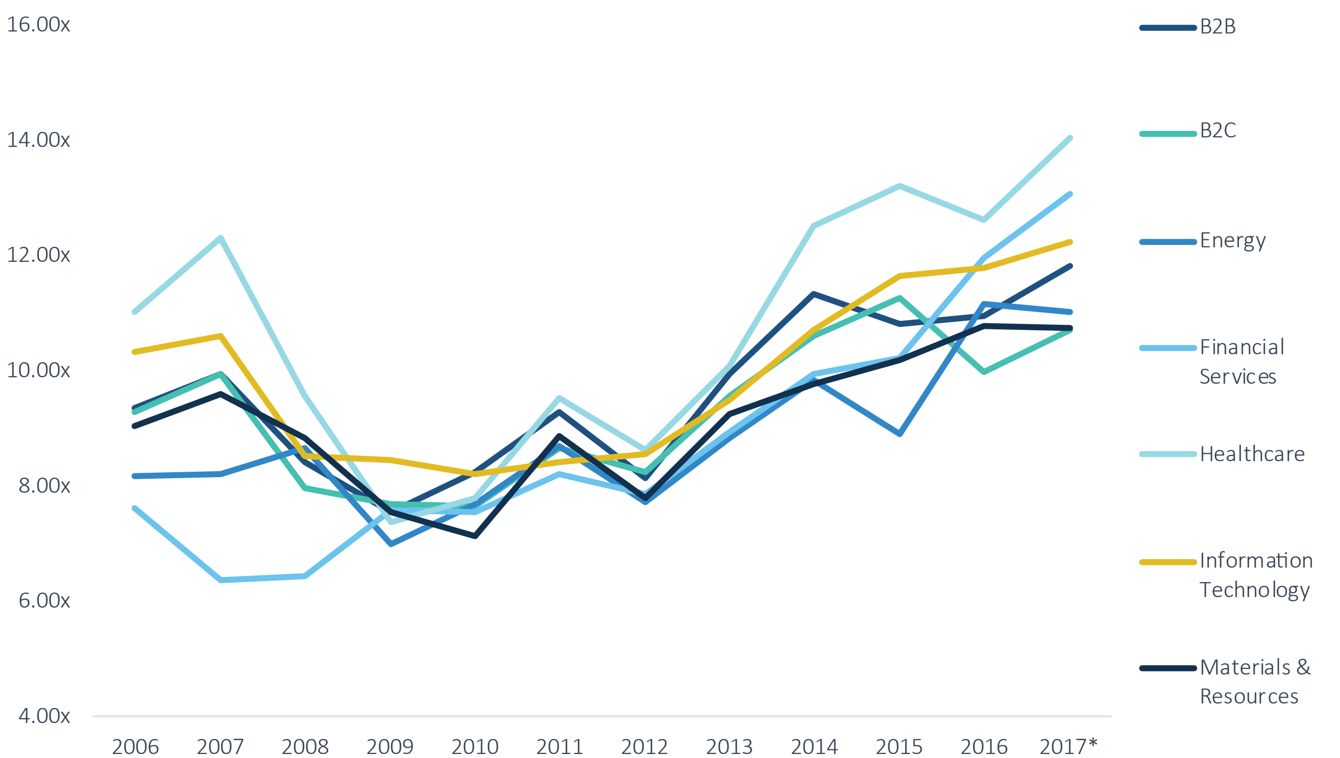
SECTOR	10-YEAR AVERAGE EV/EBITDA (US PUBLIC COMPANIES)	CURRENT TTM AVERAGE EV/EBITDA (US PUBLIC COMPANIES)	% DIFFERENCE
B2B	10.7x	12.6x	18%
B2C	10.2x	11.6x	14%
Energy	10.0x	11.5x	15%
Financial Services	10.5x	15.9x	51%
Healthcare	11.5x	14.1x	23%
Information Technology	10.9x	12.9x	18%
Materials & Resources	10.0x	11.3x	13%

Source: PitchBook
Data scope includes more than 2,500 publicly traded companies tracked by PitchBook with US headquarters.
*As of 8/7/2017

While every sector is currently trading at a premium to its 10-year average, two sectors stand out as being relatively affordable. B2C and materials & resources firms currently trade at just 13% and 14% premiums, respectively—the lowest of any sectors. There is good reason, however, for the relative discount. The former has seen its business model completely upended by Amazon and other e-commerce competitors, while the latter has struggled in part due to a prolonged downturn in commodity prices (notwithstanding the rally over the last year).

No matter a firm's strategy, entry multiples will serve an essential role in the success of a PE fund. Add-on strategies and sector-specific variables will be key determinants in pricing and should be top of mind when formulating a strategy and making investment decisions.

Healthcare companies moved higher over past few years
Median US public TTM EV/EBITDA multiples



Source: PitchBook
Data scope includes more than 2,500 publicly traded companies tracked by PitchBook with US headquarters, with the cited figures representing median company values. *As of 8/7/2017