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Fuzzy Math

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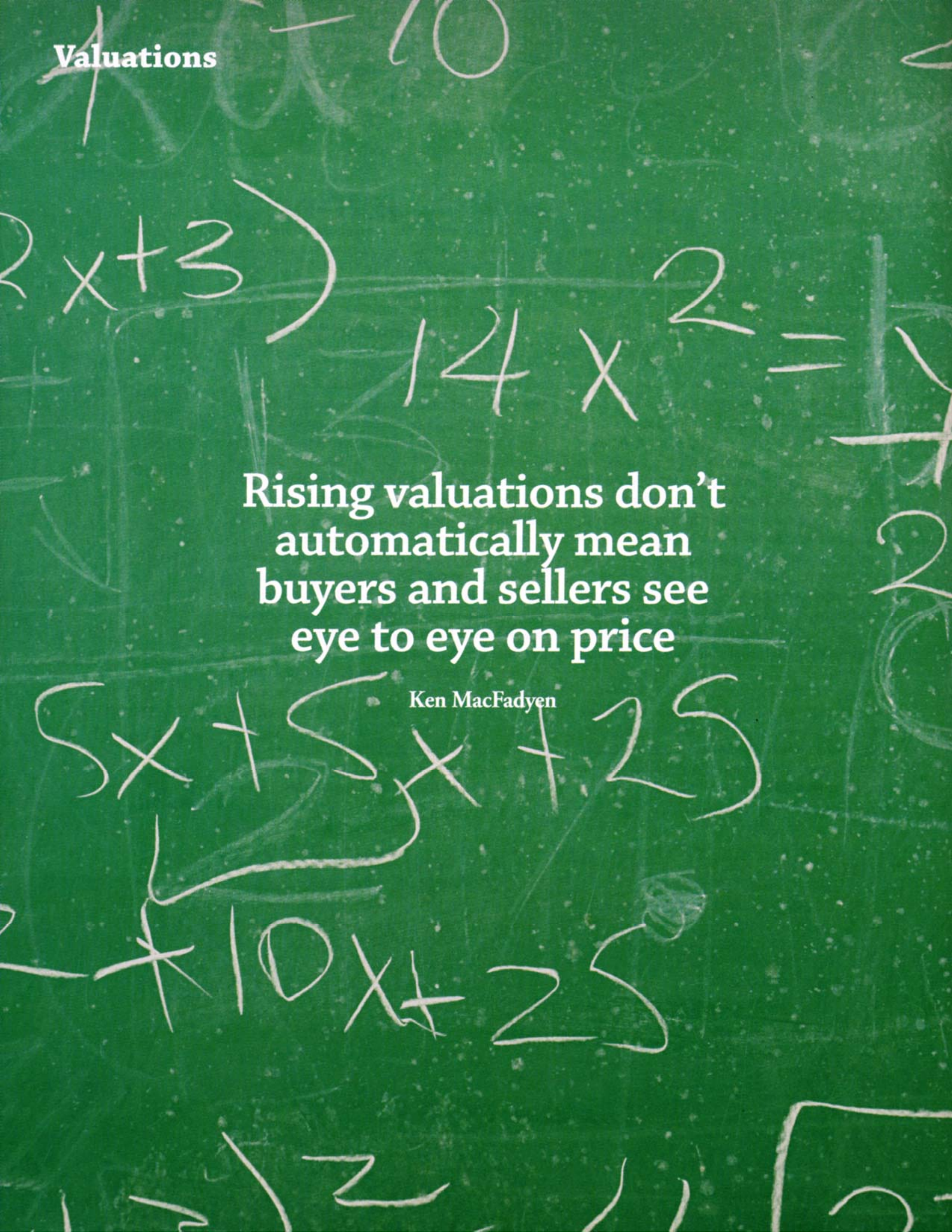


Rising valuations don't automatically mean buyers and sellers see eye to eye on price

Ken MacFadyen

Fuzzy Math

A little knowledge is a dangerous thing, even in M&A. The roots of the saying go back to the 18th Century, attributed to poet Alexander Pope, but the cliché has perhaps never been more appropriate than in today's era of Twitter and scrolling tickers. In the deal market, it's the purchase price multiple that qualifies as the sound bite that has the potential to wreak the most damage.

Google's $6 billion bid for Groupon, for instance, valued the 'deal-of-the-day' coupon site at roughly

Cover Photograph by Image Source / Getty Images

“Sellers are much more comp oriented.”

Google’s $6B bid for Groupon kickstarted M&A in the segment

10x the company’s estimated annual revenues. A forward-looking estimate projects Groupon’s revenues next year to be in the $1.5 billion range. Suddenly, the deal becomes a little more palatable for Google shareholders. That Groupon turned away the transaction suggests an even higher multiple could be viewed as the new market price. The deal, while it didn’t impress Groupon management, was enough to impel others into the market within mere days. Norwest Ventures-backed WhaleShark Media snapped up e-commerce coupon site RetailMeNot in an undisclosed deal, while direct Groupon rival LivingSocial accepted a $175 million investment from Amazon.com, valuing the company in the $1 billion range. Projected to reach $500 million in sales next year, LivingSocial appears to be a relative steal at 2x projected revenues.

According to **Andrew Greenberg**, managing director at investment bank **Fairmount Partners** and co-founder of valuations research firm **GF Data Resources**, most buyers tend to use multiples as a “checkpoint” in the process of bidding on a business. It can supplement a buyer’s view of value, Greenberg says, but “most don’t begin there.” Competitors and adjacent business, however, do take notice, which is how one transaction can, on its own, set off a run on comparable companies. “Sellers are much more comp oriented,” Greenberg says, adding the caveat that they also “tend to be selective with what they consider to be comparable [assets].”

Indeed, over the second half of last year, multiple segments within retail, tech, and aerospace and defense went through coruscating streaks in which a rich valuation instantly put targets on the backs of rival companies. Boeing’s acquisition of Argon ST, valued at 14x forward looking Ebitda, led other C5ISR providers such as Applied Signal and MTCSC Inc. to go on the block. The same thing happened when Hewlett Packard acquired 3Par, paying roughly 11x TTM revenue. Data storage firm Isilon quickly sold to EMC, while CommVault and Compellent were tagged as likely takeout targets. Retail may provide the best example, as Bain Capital’s Gymboree acquisition, as 8x TTM Ebitda, had every other retailer in the mall thinking M&A. J.Crew, a few months later, went private on the same day the Gymboree deal closed.

The robust multiples were just one component that helped spark the year-end M&A push. Some dealmakers, though, admit that multiples can be a source of recurring headaches.

Brian Buchert, senior managing director, strategy and business development, at **Church & Dwight**, notes he’ll occasionally butt heads with sellers that tend to get stuck on comparables. “We’ll come across these family businesses that may have $100 million in sales, but their flagship product may only account for 30% of that. They still think the whole business is worth ‘x’ times the richest comparable.”

RB Kiernat, a co-founder and managing director of Minneapolis investment boutique Quetico Partners, has also run across sellers whose expectations have been skewed by “industry chatter.”

“A lot of times it can be futile,” he says. “There could be an earnout or maybe the end markets differ. The same way we wouldn’t want buyers to be hanging on a low comparable, we don’t want the seller to be fixated on one price.”

To be sure, when it comes to valuations, dealmakers have enough metrics at their disposal to make the numbers say pretty much whatever they want. **Lloyd Greif**, president and CEO of **Greif & Co.**, says simply: "Figures lie and liar's figure," He identifies discounted cash flow as among the more malleable valuation models. "Any valuation that looks out beyond 12 months is tough to sell," he says. "You might be able to get a buyer to focus on the next 12 months if you're forecasting consistent growth and not projecting leaps of faith."

Public comparisons, adjusted present value and LBO valuation models are also thrown into the mix, while more elaborate models are also used, such as the First Chicago method, combining multiples-based valuations with the DCF approach, and the Schwartz-Moon model, designed for high-growth assets.

The LBO model typically provides a floor, but from there anything goes. Greif, for instance, cites that the valuation fetched by pet snack maker Waggin' Train, which private equity VMG Partners sold to Nestle Purina in September, may have caused some observers to scratch their heads. He says, however, that the target had a compelling growth story, great prospects and benefitted from a heated auction between Del Monte and Nestle. But the deal, at nearly 13x Ebitda, probably isn't applicable to others in the segment. That won't stop them from trying, though.

Size, for instance, almost always influences the numbers, as scale translates into higher multiples. This fact is what spawned GF Data in the first place, as Greenberg and co-founder Graeme Frazier, IV, spotted a need for consistent data tailored to smaller transactions.

William Sharpe, a founder and managing director at Quetico, cites that in the lower middle market, customer concentration and shallow bench strength are two factors that will also weigh on valuations. Other value killers might include contracted visibility or questions about earning quality. On the other hand, particularly attractive margins, a defensible market position, and of course synergies in a strategic deal can all improve the premium.

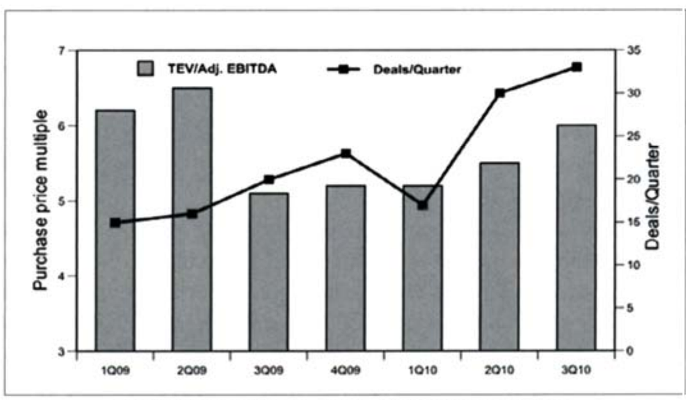
Jeff Rosenkranz, founder of **Metronome Partners**, adds that with strategic buyers, there can also be a defensive mechanism that pushes valuations beyond what might be considered reasonable. "You may have one buyer willing to pay $100 million for an asset and another value it at $110 million just to make sure it doesn't get in the hands of a rival," Rosenkranz says.

To be sure, volatility in recent years had made valuations harder to pin down. That speaks to the unbridgeable gaps that had characterized deal making in 2009 and early last year, when sellers wanted 2007 pricing and buyers had neither the clarity nor the confidence to compromise. The return of the debt market in the second half of last year, couples with improving corporate performance, has narrowed the chasm. Still, few would claim that the gap no longer exists.

"People see a deal in their industry involving a much larger competitor, trading at double-digit multiples, and similar companies in the middle market aren't going to trade anywhere near the same price," Rosenkranz says. "In this market, it's also hard to find two companies that are similar enough for you to hang your hat exclusively on comps."

Greif, though, notes that as deal flow picks up, multiples will become more reliable.

In terms of over-valuing an asset, it's not always the fault of the business-owner either. "If we've just completed a bunch of deals in a given category, and we know a set of assets could go for between 7x and 9x, it's one of our pet peeves to see another bank step in and win a mandate, promising 11 times," says **Michael Goldman**, a managing director with **TM Capital**.



Q3 Multiples Expand, Source: GF Data Resources

But the penalty for over-estimating a valuation can be severe. "You'll end up spinning your wheels," Greif says. "If you end up with a busted process, you'll need as many as three years to clear the air before you can pursue another sale."

It's a harsh reminder that no matter what the models say, ultimately the market resets on every transaction, forcing each deal to stand on its own. **M&A**

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