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Private Equity’s Role in Mid-Market Transactions in North America

By Barry Critchley, Financial Post

All market participants have views on certain matters but until those views are researched they remain opinions without facts.

Toronto-based Crosbie & Co. Inc., which defines itself as a specialty investment banking firm, has now filled a potential void on the importance of private equity to the mid-market. The firm, which has been around for more than 25 years, recently published an analysis of 1742 North American transactions which have been completed over the past five years. The underlying data was compiled by GF Data Resources, a U.S. based firm that offers “a searchable proprietary database that provides private equity buyers, intermediaries, capital sources and valuation professionals with accurate and detailed information on business transactions ranging in size from $10-million to $250-million.”

Recently Crosbie published the results of that analysis.

“The document is powerful because it covers so many transactions over such a long period of time. One can draw some clear inferences for the broader M&A market from this unique data set, specifically for larger middle market transactions which attract higher calculation multiples,” said Colin Walker, managing director at Crosbie & Co.

Here are the highlights from the report:

• **When it comes to valuation, size does matter.** The data shows that for upper mid-market transactions (those between $100-million and $250-million) which have been completed by private equity groups “have consistently attracted premium multiples compared to smaller transactions.”

One key measure is the private equity total enterprise value divided by EBITDA: For the past years that multiple has been higher for larger transactions than it has for smaller sized transactions. In the first half of 2012, the multiple was about 7.9 times (compared with 7.8 for 2011) — or almost three percentage points above the comparable multiple for transactions between $10-million and $25-million completed over the comparable period.

Crosbie gives four possible reasons why size does matter: larger companies tend to have greater stability; are more able to attract greater leverage or debt financing; are in the sweet spot of the market (because more private equity groups are focused on larger transactions) and because larger mid-market companies have greater liquidity options including initial public offerings.

• **Some sectors have not shared in the overall trend of higher valuations.** For instance the report indicates that three groups — technology, healthcare services and distribution services "appear to be on a bit of an upswing." For instance multiples for technology companies have jumped by 180 basis points to 7.5 times in the first half of this year compared with 2010 while the multiple for healthcare services has jumped by 130 basis points to 7.9 times over the same period. On the other hand, valuations for manufacturing and business services have risen marginally or fallen respectively.

In its report Crosbie & Co. plays down the strategy of "waiting for a better economic outlook before selling."

It argues that selling "today may be more attractive than many think because, in addition to valuations currently being strong, there are other market conditions that are quite favourable for selling businesses." It then lists a number of reasons including strong competition for high quality companies; for the aggressive stance in relation to pricing and terms taken by senior debt providers; and very low interest rates.

• **A moderate approach to leverage.** While the glory days of 2003-2007 (when large companies could borrow more than four times EBITDA) have not returned, "leverage on buyout transactions has increased significantly as banks and other lending institutions have re-opened the taps," said the report. Noting that trends in Canada have tended to be different from the U.S., "while the process of credit markets re-opening after the crisis occurred relatively quickly in Canada, the U.S. took much longer but has now caught up. This increased leverage availability has helped to push up overall valuation multiples, particularly for transactions above $25 million," added the report.

• **Little variation in capital structures.** The report notes that since the financial crisis — a time when the amount of equity required for transactions rose — that "the level of equity capitalization in mid-market private equity transactions has gradually changed. In 2008, 47% of the capitalization was equity with 54% for debt with sub-debt's share being 17% and senior debt being 37%. The next year, 2009, the comparable numbers were 53%, 18% and 29%. For the first half of 2012, the comparable numbers were 50%, 17% and 34%