

Understanding How Private Equity Groups Approach Value

How PEGs Value Your Company

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It behooves Private Equity investors (PEG's) to work with business owners who understand a deal from the PEG's perspective. We hope this article helps any potential seller better understand the mindset of Private Equity Groups.

Obviously, the end analysis of value is driven by the Internal Rate of Return (IRR) a PEG wants to receive and that they have touted to their Limited Partners. Understanding how they work through that analysis is helpful to a business owner thinking about selling to, or taking equity dollars from a PEG.

How do PEGs build their IRR models?

First, many will assume a five year holding period. They will plan to sell the company in about that time frame, so they will build a model that looks at current EBIDTA and cash flow and build their perception of growth on top of that. This is a different approach than a corporate buyer; since a corporate buyer will

- have synergies he believes will impact the future profitability, and
- will plan on merging that into his current operations, with no defined exit strategy.

The Return (R) in IRR will be generated primarily by the exit value they believe

they can get in five years. A secondary consideration is the cash flow generated by the company during the holding period.

Valuation Driver

The exit value is all crystal ball gazing, but it is the foundation of their valuation process. If purchased at a fair price today, and sold at a fair price in five years, a company that grows at only 15%, and uses all of its cash flow for growth and debt repayment, still generates a healthy 40+ % IRR to the PEG's investors, plus a very healthy return to the General Partner. Sellers can and should participate in that return by reinvesting a portion of their newfound liquidity. That is why a buyer will spend so much time asking about a seller's growth potential.

Looking Back, Going Forward

So, if the future is where the value comes from, why does everyone talk about "multiples" of current earnings? There are several reasons:

- It determines the amount and structure of debt a company can reasonably support. This impacts the leverage they can use to maximize their return by minimizing the Investment (I).
- The lenders tend to lend a certain multiple of EBIDTA on each deal, so any increase in the multiple demands that the difference be all equity. This can have a significant impact on IRR.
- Using a multiple of earnings (usually EBIDTA) tells the prospective buyer whether he can buy this company at a valuation range that will allow him to hit his IRR targets with reasonable growth.

Another Piece of the Puzzle is Risk.

Riskier investments require higher returns, so a company with a low risk component will command a higher multiple. Risk comes in many forms. Some are internal, such as the risk of customer concentration; some are external, such as being in a cyclical industry. While PEG's are not typically in the risk business, there is always an acceptable range of risk that is simply a value question, not a deal killer. Having digested all of that, what can a business owner do to get a higher "multiple" than the next company with the same earnings?

- Develop research and support a plan for growth after the acquisition. Give your prospects the ammunition they need to

build an exciting growth model. Be specific about how you will grow and what it will cost.

- Make the analysis of your company simple. Give them a concise package of information that whets their interests, but also gives them an easy understanding of what you do, how you do it, and for whom do you do it. The quicker they can get through this, the faster they can focus on the future.
- Analyze the risk factors of your business. Address and repair those you can impact and explain and minimize those you cannot. Remember that they will see your risks differently than you, so look at those risks through their eyes. An example is audited financial statements. You are confident your books are right, so why get an audit? A buyer cannot "take your word" that your

books are right, so an audit reduces their risk, raising your multiple. For those risks that cannot be eliminated, address them early and openly. Risks you explain seem much smaller than those the buyer finds on his own.

- Do your homework. Find buyers with synergies that enable them to project higher growth in their internal models. PEG's with synergistic holdings may be the best prospect.
- Plan your exit timing. If you wait for the peak of a growth curve to approach buyers, how can they build a growth model that maximizes your value?

In summary, demonstrate how a PEG can maximize his IRR, and you can have a significant impact on how Private Equity Groups value your company.

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