Beyond EBITDA: 5 Other Factors That Affect How Private Equity Buyers Value Companies

It is no secret private equity firms are focused on the bottom line. Profit margins, EBITDA, and growth all impact the value of a business. However, objective measures aren't the only drivers of valuation. Here's a look at five subjective variables that play roles in how investors value smaller companies because of their potential future impact on the business.

1. Who Runs The Shop... And How Well?

A strong, savvy management team with a well-articulated vision for business growth drives a premium valuation. The investor can handicap the future opportunity when a team is in place and able to provide a large amount of upfront information to chart the company's course. That said, not every seller has developed a complete team or can recruit the talent it needs. In fact, most entrepreneurs tend to run lean organizations, which can create management gaps as the company grows. Be candid about management needs, since those will affect the buyer's investment calculation. Know, for example:

- **How deep is the team?** Is the company dependent on its owner or is the team seasoned, stable, and well-rounded in its functions and responsibilities? If the owner drives the business and wants to leave soon after close, that likely will affect the type of transaction or transaction structure proposed by the buyer, which wants to protect the downside risk of the owner's departure. In that case, to mitigate the risk, consider establishing some "stay on" parameters.
- **Is there a succession plan?** If the owner seeks to leave the company at close or shortly thereafter, what does the succession plan look like? Is it thoughtful and strategic? For example, are there suitable, interested family members, or other members of the management team? What does the transition process look like, and over what time period?
- **Has the owner invested in people in the key areas of the business?** What does the organizational chart look like? For example, is Finance led by a seasoned CFO or by, say, a part-time bookkeeper?

Private equity firms can help companies recruit and expand their executive lineup to implement the business plan, and often welcome the opportunity to do so; just realize that key staffing needs will increase your client's labor investment and therefore may affect valuation. Further, some sellers may not realize they have an opportunity to recapitalize their business (rather than sell it outright) and work in partnership with a private equity firm to enlarge their team and implement their growth plan. The recapitalization structure may allow for a much smoother transition and ultimately deliver more value to the seller over time.

2. What Does The Market Look Like?

The industry trends that impact a seller's business also will impact valuation. Yet owners sometimes have selective hearing. They "heard" their buddy sold his business for two times revenue but ignored the fact that the business was a unique technology company growing at 300 percent annually. When talking to your clients, educate them on the importance of market factors. These include a big-picture profile of the company's industry, industry trends, and opportunities for growth. Also assessments like:

- **Is the business growing faster or slower than its market?** Metrics here might include the market's projected growth, the company's position within the market (is it a leader or a follower?), and how quickly the company is improving market share.
- **How is growth being driven?** Buyers will want to understand if the company is rising with the tide or growing because of sustainable strategic leadership that will help boost value over time. Is the company's growth the result of good execution or the result of a me-too approach and/or capitalizing on a fad?
- **Is growth sustainable?** Buyers want to know if the recent great year was a one-time event or the beginning of a trend. Helping the seller clearly articulate, in as much detail as possible, the factors driving growth can result in a better valuation for the business.

- **How cyclical is the end market?** While all industries experience cyclicality, some are more susceptible to swings. Buyers want to understand the extent to which the company's success is determined by the ups and downs of its customers' market(s). What factors drive demand? How cyclical are those needs? And how do changing dynamics in the economy and other external influences affect the need for the company's goods or services? How did the company perform during the last downturn? Where in the cycle does the company currently reside? Also, what other factors play an influencing role? For example, is the company a project-based business that relies heavily on customer ability to spend capital dollars?

3. What About Concentrations?

Concentration metrics also influence valuation, since high concentration issues can increase risk. Customer and supplier concentrations are obvious issues buyers will want to understand. When high concentration issues exist, sellers able to explain what gives them confidence about their customer and supplier relationships can make a big difference in getting a buyer comfortable with them, too. Two other related concentration issues worth understanding are:

- **Relationship concentration?** Does one person – say, the owner – manage all or most of the company's customer relationships or supplier relationships? If this individual is committed to remaining with the company, a high relationship concentration may not be a big near-term concern. The seller will benefit, though, if there is a plan to transition or share leadership of these important relationships with other team members.

- **Market segment concentration?** Does the company have a large share of customers in a single sector (e.g., home-building), and is that sector susceptible to market cycle swings? Even if a company serves a diverse customer base within one industry segment, a cyclical sector will be valued differently than a growing sector. Therefore, it is a good exercise to understand whether your client's sector is cyclical (and how cyclical) as well as how the company is performing in the current cycle.

4. How "Full" Is The Business?

Prospect Partners occasionally observes businesses whose growth potential is limited by current operational constraints. For example, a prospective seller recently told us he could double his sales. Yet he was running two shifts at capacity and had no ability to add to his facility. Now, that company still could present a tremendous investment opportunity – as long as both buyer and seller both understand the amount of effort and capital required to double sales by doing something about the facility constraints. Private equity buyers typically are eager to support capacity growth projects, but the seller should realize that today's business valuation will not fully account for that future initiative. Work with your client to examine the extent to which the company is "maxed out" – not just on its building, but also on its equipment, and its people.

- **The building?** Know the building's ideal capacity, and where business operates now. If, for example, the company operates at 95 percent of capacity, it may face growth constraints unless it invests in additional space, or moves to a different building. Both require significant investment.

- **The equipment?** If your client runs an equipment-intensive business, what is the state of that equipment – its age, its functionality, its capacity? Be prepared to discuss the history and patterns of the capital investments your client has made – as well as projected equipment needs.

- **The people?** Look at the organizational chart: How large is the team? Do a small number of people run the business? What is their capacity to take on more work? Will the private equity firm need to invest in labor (which adds to the cost structure) to achieve the type of future growth the company seeks?

5. Are There Any Human Resources Concerns?

The HR area of buyer scrutiny is relatively new and is prompted by changes in the regulatory environment, driven primarily by the federal government. Taking some time to ensure that the seller has an understanding of how these issues may affect the business, and working with a specialist as needed, can go a long way in heading off buyer concerns. Toward that end, be able to discuss hot-button topics that can add layers of cost, like:

- **Employee documentation in order?** Employee documentation rules have become increasingly rigid. With all of the talk in Washington about immigration reform, the scrutiny around I-9 employment eligibility forms is more intense than ever. Has your client established good processes for maintaining employment records and for completing required government documentation?
- **Minimum wage impact?** Many states are working to increase the minimum wage. If your client employs minimum wage workers, to what extent will rising wages affect business operations?
- **Labor pool availability?** With unemployment rates at historically low levels, access to labor often is a significant issue at all levels of the company. Is the company able to attract and retain qualified labor or does it have trouble doing so due to its location or other issues?

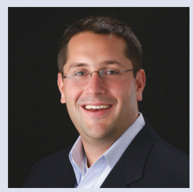
Hopefully, some of these observations can help you and your clients prepare for conversations with prospective investors. Private equity firms are eager to support great investment opportunities led by strong management teams. By better understanding subjective drivers of value and communicating those clearly to the buyer, sellers can encourage investors to reach higher on valuation and increase their chances of closing the transaction, which is good for all involved. At Prospect Partners, we are very impressed when sellers are highly knowledgeable and conversant in all the nuances of their business. Prepared sellers will command higher valuations because they instill confidence in the buyer about where they can take their business.

About Prospect Partners

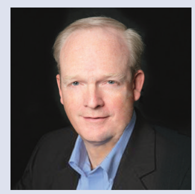
Prospect Partners is a leading private equity firm investing in smaller lower-middle-market companies. We focus exclusively on management-led leveraged recapitalizations and acquisitions of niche market leaders with revenues typically under $75 million. Since 1998, Prospect Partners has completed more than 150 transactions in the building of over 50 platform companies in widely diverse niche manufacturing, distribution, and specialty service markets. Prospect Partners manages $470 million in committed capital across three private equity funds.

Reach Out To Our Team

If you know about an interesting company you think will interest us, please call us today at 312.782.7400, visit www.prospect-partners.com, or contact a team member:



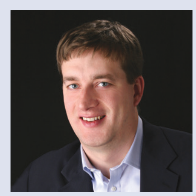
Brett Holcomb
Principal



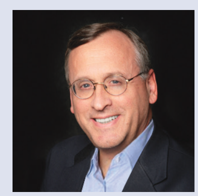
Lou Kenter
Founding Principal

Erik Maurer
Principal

Mike McInerney
Vice President



Brad O'Dell
Principal



Rick Tuttle
Founding Principal

Prospect Partners
Private Equity Expertise. Small Company Focus.

200 West Madison St., Suite 2710 • Chicago, IL 60606
312.782.7400 ph. • 312.782.7410 fx.
www.prospect-partners.com