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LITIGATION AND VALUATION ADVISER

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Game Changer: 2010 Valuation Trends

The economy has had a major impact on privately-held middle-market companies, with respect to their valuation, their activity in the merger & acquisition (M&A) market, and their outlook in 2010. Simply put, the financial crisis and current recession are game changers.

Even in these precarious times, the valuation community and financial markets rely upon traditional valuation theory and its three approaches to value – asset, income, and market-based approaches.

While these approaches are used as a construct to value – value is created and driven by three simple factors:

- a company's probable future cash flow;
- the predicted long-term growth of that cash flow; and
- risk in attaining that cash flow.

Those variables are the secret sauce of a valuable company.

The game changer is the unprecedented difficulty in quantifying those key valuation inputs. All of a sudden, a previously reliable predictor of future earnings and cash flow – a company's historical financial performance – was no longer relevant.

Private company revenues in 2009 plummeted. In particular:

Manufacturing sector:	-10.6%
Wholesale trade industry:	- 8.2%
Retail trade:	- 7.1%
Construction:	- 5.8%

With respect to the determination of long-term growth, measurement becomes difficult. Businesses are not focusing on long-term organic growth, but instead are trying to crawl out from the financial trough in which they find themselves. As valuators, the statistical data and forecasts upon which we formerly relied do not hold the same credence.

Another hurdle is deriving the measurement of a company's risk, which we use to develop our capitalization rates and market multiples. We had to adapt by modifying our quantitative models to adjust for lower interest rates and skewed measurements of systematic risk – known as Beta.

Fortunately, today's financial market is more certain than it was a year ago. We continue to work with the business owner to understand the company's SWOT (Strengths, Weaknesses, Opportunities, Threats) to arrive at an appropriate measure of risk .

The Middle Market M&A Environment

The impact of such uncertainty from the valuation community, the

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market, and business owners resulted in a deep freeze in the M&A environment for privately-held middle market companies.

The state of the M&A market in 2007 is drastically different than in 2009. In reviewing transaction data for private companies with sales of $5 million to $500 million, the number of closed transactions declined from 321 in 2007 to 59 in 2009.

EBITDA

Also, the closing price dropped from a multiple of 1.1X sales and 9X EBITDA in 2007 to .7X sales and 6.5X EBITDA in 2009. EBITDA – earnings before interest, tax, depreciation, and amortization – is commonly used as a financial metric to value companies because it levels the playing field among companies with different capitalization and asset structures. This drop in multiples indicates a decline in private company value of 30-40% from peak to trough.

	2007	2008	2009
# of Transactions	321	238	59
Sales Multiple	1.1X	0.9X	0.7X
EBITDA	9.07X	9.08X	6.5X

The silver lining is that due to the slowdown in M&As for middle market private companies, the marketability discounts available when gifting or selling a minority interest to the next generation are favorable.

Outlook for 2010

If you are looking to acquire a company, we expect there to be a good stock of inventory due to the pent-up supply from many business owners who have been sidelined and forced to wait out the economic crisis until credit and other markets improve.

If you are looking to sell a company, the outlook is favorable based upon the momentum of M&A activity, quarter after quarter, for companies with a deal size under $250 million. The number of transactions increased by 28% from the third quarter to the fourth quarter of 2009 and the median multiple of EBITDA increased slightly.

Here is what we know:

1. Buyers tell us that they jumped into the market to make a compelling strategic play or because they expected a superior return (in other words – they bought companies cheap).
2. Buyers indicated they are committed to high-quality deals.
3. The M&A outlook appears favorable in 2010 due to pent-up supply.
4. Sellers will maximize value by targeting strategic buyers and focusing on increasing cash flow and growth and minimizing risk.
5. Opportunities exist to sell or gift minority interests in private companies to the next generation at significant discounts.

This brief overview of the private middle-market environment and the game changing factors should give you a game plan for 2010.

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