CALABASAS CAPITAL

CalCap Viewpoint: Growth & Timing

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Dear David,

The financial performance of many lower mid-market businesses has finally returned to or exceeded the level prior to the most recent recession. With the benefit of a crystal ball, those owners already near retirement would have sold in 2006 or 2007. Some have in fact sold their businesses in the past 12 months or are in the process of selling now. Why not? Multiples are now back to pre-recession levels and in some industries are even higher than that. But many owners have not yet capitalized on current market conditions. Many have good reasons for not doing so, some do not.

Here are common reasons why some business owners are not pulling the trigger despite the frothy M&A environment:

- **Well Executed Succession Plan:** Over the past few years, some business owners have taken the sage advice of their trusted advisers. They have executed a well-thought out succession plan by building a deep management bench allowing the owners to work much less if at all while their businesses run smoothly by experienced hired guns. In some family businesses (not many you must admit), the next generation has done a good job preparing themselves to take over the business and continue its growth.

- **Lack of Attractive Investment Alternatives:** With volatility in the stock market, low returns in the bond market, and historically low cap rates in real estate, many business owners simply do not see any investment alternatives that could even come close to the returns they are generating from their own businesses. Take into consideration the knowledge they have about their own businesses and industries, and on a risk-adjusted basis the analysis is even clearer.

- **Desire to Realize Growth:** When business is going well it's simply hard to let go. "Everything is going great, why should I sell now? I can wait another year or two, grow my business another 10% to 20% and then sell."

Admittedly, the first reason noted above is difficult to argue against. Reason number two can likely be addressed by speaking to different types of investment advisers. As far as the last reason, however given where we are in the cycle, I would argue against waiting to eke out a little more growth.

Let's look at an example of a $30 million revenue business generating $5 million in EBITDA growing revenue at a 10% annual pace over the past three years. Assuming no major warts, and depending on the industry of course, it's safe to say this business (with strong margins and strong historical growth) could be sold today at 8x EBITDA. Just three years ago, in a pretty busy year for M&A in 2012, this business would have traded at around 6.5x EBITDA so it's valuation multiple has increase by approximately 25%. Using these figures, its value today would be $40 million.

Multiples are high today for a number of reasons but the most obvious reasons are supply and demand (too much money chasing too few good deals) and low interest rates (which has led to very high leverage multiples allowing buyers to pay more without putting up more equity). I would argue however that over the next 12-24 months both trends will at least begin to reverse and multiples will come back down.

Let's get back to our example and feel free to refer to my analysis below. In one year, if the business can grow Revenue and EBITDA by 10% per year and multiples stay constant the business could be sold for $44 million. In two years over $48 million.

$000s	10% Annual Growth			15% Annual Growth			20% Annual Growth		
	Today	1 Year	2 Years	Today	1 Year	2 Years	Today	1 Year	2 Years
Revenue	$30,000	$33,000	$36,300	$30,000	$34,500	$39,675	$30,000	$36,000	$43,200
% Growth		10%	10%		15%	15%		20%	20%
EBITDA	$5,000	$5,500	$6,050	$5,000	$5,750	$6,613	$5,000	$6,000	$7,200
% Margin	17%	17%	17%	17%	17%	17%	17%	17%	17%
Scenario I									
Constant Multiple Scenario									
Multiple	8.0x	8.0x	8.0x	8.0x	8.0x	8.0x	8.0x	8.0x	8.0x
Value	$40,000	$44,000	$48,400	$40,000	$46,000	$52,900	$40,000	$48,000	$57,600
Increase from Today		10%	21%		15%	32%		20%	44%
Scenario II									
Multiples Give Back Half of Recent Pop									
Multiple		7.25x	7.25x		7.25x	7.25x		7.25x	7.25x
Value		$39,875	$43,863		$41,688	$47,941		$43,500	$52,200
Difference vs. Today		0%	10%		4%	20%		9%	31%
Difference vs. Constant Scenario		-9%	-9%		-9%	-9%		-9%	-9%
Scenario III									
Multiples Give Back All of Recent Pop									
Multiple		6.5x	6.50x		6.5x	6.50x		6.5x	6.50x
Value		$35,750	$39,325		$37,375	$42,981		$39,000	$46,800
Difference vs. Today		-11%	-2%		-7%	7%		-3%	17%
Difference vs. Constant Scenario		-19%	-19%		-19%	-19%		-19%	-19%

If the business can grow by 15% per year and multiples stay elevated, the business would be worth $46 million in a year or $53 million in two years. Finally assuming 20% growth, the value would increase to $48 million in just one year and nearly $58 million in just two years. Wow! If I thought multiples were going to stay elevated for the next year or two and I could at least maintain if not increase my margins, admittedly I would not sell at today's $40 million value either.

But what if things change? Industry trends, competition, pricing, GDP contraction, interest rates, etc. Let's assume the business continues to hum along but in one year multiples drop just halfway back to where they were a few years ago (say from 8x to 7.25x) or in two years they drop all the way back to where they were just a few years ago (from 8x back to 6.5x).

Let's look at the resulting values if multiples drop. Regardless of the growth rate in the business, if multiples drop halfway back to where they were, that would be a 9% drop (from 8x to 7.25x) so the value in a year for example would be 9% lower than if multiples did not drop. In two years, the drop would be 19% regardless of the growth rate.

But what's more interesting is if you look at the resulting values compared to today's $40 million value. Under a 10% growth scenario, if multiples only drop halfway back in one year the value of the business would essentially be flat at $40 million. In two years, the value would actually drop by 2%. Not much of a drop admittedly but no increase. Is it worth the risk to wait?

Under a 15% growth scenario, if multiples only drop halfway back, in one year the value of the business would increase by 4% as compared to today's $40 million value. In two years, the value would be higher by 7%. Is it worth the risk to wait? I can think of safer investments that generate 3.5% to 4% per year.

Under a 20% growth scenario, if multiples only drop halfway back, in one year the value of the business would increase by 9%. In two years, the value would be higher by 17%. Okay now it's not that clear of a picture I admit. Maybe it would be worth it to wait if the business can grow at a 20% annual rate even if multiples go back down.

Some businesses not only see top line growth ahead but also higher margins from operating leverage, realizing scale efficiencies through acquisitions or utilizing technology to become more efficient. Strong growth coupled with higher margins could very well justify waiting to sell. A business owner would need to be very confident about the prospects for growth and improving margins. This outlook would need to be supported by solid reasoning not simply unfounded optimism.

You'll notice I have not touched on taxes. Can federal taxes go down? I suppose they could, depending on the political landscape. What about California? Let's not go there...

About Calabasas Capital

Calabasas Capital is a boutique investment banking firm focused on serving lower middle-market privately-held companies. Our services include:

- Sell-Side and Buy-Side Mergers & Acquisitions Advisory
- Private Equity & Debt Capital Raising
- Acquisition Financing
- Financial Restructuring
- Sales of non-core assets/divisions of larger public and private companies

Our principals have significant investment banking and private equity experience working with companies in a broad range of manufacturing and services industries with particular expertise in:

- Consumer products and services (i.e., food, apparel, footwear, electronics, household goods)
- Retail (including restaurant chains)
- Business & Industrial Services (i.e., facilities maintenance, commercial printing, equipment rental, marketing services, entertainment and IT);
- Technology (i.e., eCommerce, software, telecom, digital media, hospitality)
- Healthcare Products & Services
- Leisure & Entertainment
- Industrial Manufacturing

Thank you for continuing to keep us in mind for opportunities.

Regards,

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