BDO

2009

PCPIQ4

Private Company Price Index

EARLY SIGNS OF M&A RECOVERY?

Aggregate M&A activity declined for the eighth successive quarter to 445 – a 20 per cent fall on both Q3 2009 and the same period in 2008. Deal activity during 2009 was supported by the growth in 'distressed' transactions driven by pressure from the banks. More recently though there has been a fall in the level of bank-driven activity which has reduced the overall number of transactions.

The recovery in public market multiples particularly during the second half of 2009 has been pretty dramatic. The average public company price : earnings multiple for the FTNF (Financial Times Non-Financials Index) rose by 78 per cent to 15.1 times between Q1 and Q4 2009, and by 22 per cent in the final quarter alone. This is the highest level experienced since Q1 2007 – which interestingly was around the peak of the M&A boom in terms of transaction pricing.

Despite the low level of deal volume, the prices paid for privately owned companies, and deals involving private equity have seen limited increases – both by 3 per cent – during the course of 2009. This masks a sharp rise in prices paid for private companies and deals involving private equity since the trough in Q1 2009. The PCPI, which tracks price/earnings (p/e) multiples paid by trade buyers for private companies rose to 11.9 times, its highest level since Q1 2008, and an 18 per cent increase over the last three quarters. This is broadly consistent with the Private Equity Price Index (PEPI), which shows comparable multiples on sales to private equity, which was 12.0 times at Q4 2009. Whilst this was a marginal fall of 2 per cent on Q3 2009, it brought the PEPI in line with the PCPI. The recovery in pricing has been a function of a number of conflicting factors. On the positive side is (1) the rising public company valuations has given buyers greater confidence to pay higher prices, (2) a lack of supply of decent assets, and (3) a pent up supply of private equity capital. Countering this is the limited availability of debt, and general economic uncertainty. Whilst the availability of credit has improved during 2009, it is still only available for the very best assets, and even then at significantly higher margins.

What we may be seeing however, is a return to 'normality' on two fronts.

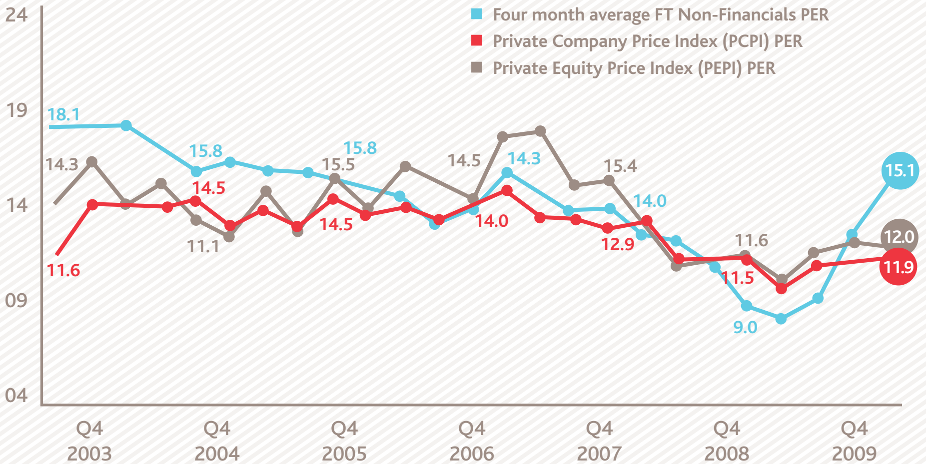
Firstly, in the past the FTNF traded at a premium to the PCPI by around 30 per cent reflecting greater liquidity within the public markets.

Secondly, trade buyers should be capable of paying similar or even higher prices for businesses than their private equity counterparts, by extracting synergies that enables them to pay a strategic price. The ability to access higher levels of acquisition debt (at competitive margins) between 2005 and the middle of 2008 fuelled the higher prices paid by private equity – allowing the PEPI to race ahead of the PCPI. The current rationing of debt has removed the advantage private equity had bringing them back in line with trade buyers.

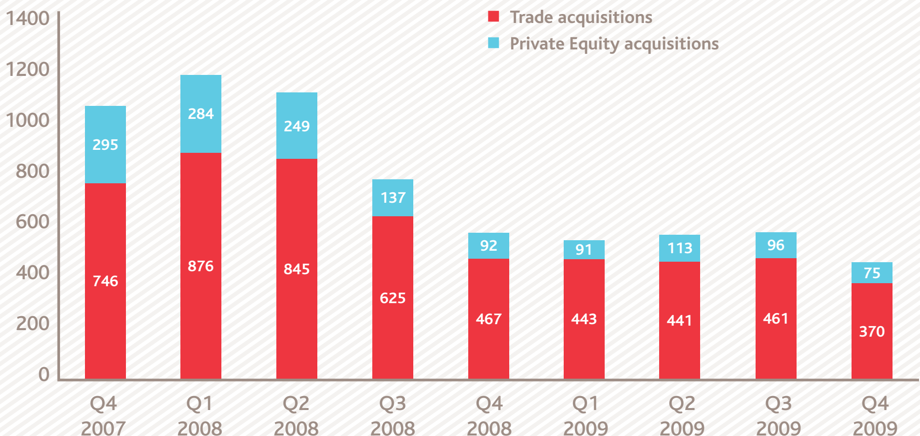
During 2010 we expect to see both the PCPI and PEPI continuing to recover, but only at a modest pace. Again there will be upward and downward pressure on business valuations. On the upside, improvements in the debt markets are likely to continue, as will inventory restocking following destocking during 2009. This will be countered, to a degree, by uncertainty as we enter an election year, and the need to address the public finances. Whatever the outcome of the election, cuts to public spending and tax increases are anticipated in the second half of the year, which will have downward pressure on the recovery.

Deal volumes are expected to rise more significantly in 2010 from stability in pricing that will help align the expectations of buyers and sellers. In addition, private equity houses, which in most cases have funds with predetermined investment periods, have for the most part lost 18 months of deal activity. They will be looking to deploy unspent capital, as well as realise value from their investments.

PCPI v PRIVATE EQUITY Q4 2003 – Q4 2009



Q4 2007 TO Q4 2009 VOLUME OF DEALS COMPLETED



Source: Corpfin

**Christopher Clark,
M&A Partner commented**

"During the debt-fuelled boom period, the PEPI raced ahead of the PCPI, and in 2010 we expect to see broad consistency between them as they pick up the pace of recovery. Buyers might be faced with election uncertainty, cuts to public spending and tax increases and their impact on the pace of recovery, but there are plenty of positives. Improvements in the debt markets are likely to continue, and there will be a degree of catch up following destocking during 2009. Also, stability in pricing will help marry up the expectations of buyers and sellers.

Finally, many private equity houses, which in most cases have funds with predetermined investment periods, have lost 18 months of deal activity. They will be looking to invest and make up for lost time, as well as realise some of their more mature investments."

MAKING THE MOST OF THE PCPI/PEPI

The PCPI/PEPI tracks the relationship between the current four month rolling average FTSE Non-Financials price/earnings ratio (p/e) and the p/es currently being paid on the sale of private companies to trade and private equity buyers. The FTSE Non-Financials p/e is calculated from the p/es published in the FT. The private company p/e is calculated from publicly available financial information on deals that complete in the quarter. At the moment, the PCPI indicates that, on average, private companies are being sold for 11.9 times their historic after tax profits. The PEPI indicates that, on average, private companies are being sold to private equity buyers for 12.0 times their historic after tax profits.

As private companies are generally owner-managed, reported or disclosed profits tend to be suppressed by various expenses that may be non-recurring under a new owner. This will have been factored into the price the purchaser paid, but may not be reflected in the profits declared to the public. The effect of this is that the p/e paid as calculated from the publicly available information may be over stated.

The PCPI/PEPI tracks the discount between how public and private companies are being valued. This discount enables us to use valuation techniques which are only relevant to public companies and apply them to private companies in the same sector.

The PCPI/PEPI is calculated as the arithmetic mean of the p/es for deals where sufficient information has been disclosed. Over the last six years, the included deals for the PCPI have had a mean deal size of some £13m and a median deal size of some £12m. And the included deals for the PEPI have a mean deal size of £37m and median deal size of £20m. Therefore, if a company is smaller than this, then a further discount should be applied.

The PCPI/PEPI is an average measure and guide, not an absolute measure of value, as there are many other factors that can have an impact on value.

If you would like to know more about how to use the PCPI/PEPI to value your company, please contact your local BDO representative.

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'Tax Team of the Year' 2009 and 2008
'Audit Team of the Year' 2008
'Corporate Finance Deal of the Year' 2008

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