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Mid-cap valuations back to pre-crisis levels

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04 Oct 2011, Gregoire Gille, unquote

The uptick seen in the second quarter did much to raise hopes for a widespread recovery. But with the renewed confidence came a downside: namely a 15% increase in multiples, bringing them to 7.6x for mid-cap deals according to the recently released Argos Mid-Market Index - in line with those paid prior to Lehman's collapse, and a full tick more than corporates.

It would seem that the race to invest significant amounts of dry powder and the will to quickly snatch up top-quality assets led to heated competition among mid-cap GPs - thus contributing to escalating entry multiples. The second quarter was particularly busy, with buyers rushing to make the most of favourable market conditions: "It was really hard to find lawyers available just before the summer in Paris," notes Argos Soditic president Gilles Mougenot. "They were all working on at least three deals at the same time!"

In addition, GPs seem to have been optimistic regarding the growth prospects of their targets, with valuations only changing slightly in multiple of expected future results. "Fund managers seem to have been betting on a return to growth for mid-cap businesses - even more so than trade buyers," continues Mougenot.

According to the Argos Index, the median EBITDA multiple paid in European mid-cap private equity buyouts - here defined as businesses in the €15-150m range - rose to 7.6x in the first half of 2011. This marks a significant increase from the 6.7x recorded for H2 2010, and even more so from the historically low 5.7x witnessed in the second half of 2009.

Furthermore, the median multiple is now back to pre-crisis levels: mid-cap valuations in the Argos Index averaged at 7.6x for the 2005-2008 period. This highlights a strong recovery in the mid-market segment as witnessed by unquote" before the summer: dealflow in the €15-150m value-range increased by a third in volume and 47% in overall value when comparing H1 2010 and H1 2011, according to unquote" data (*see chart below*).

There is another notable trend revealed by Argos' index: for the second semester in a row, GPs have been willing to pay higher multiples than their corporate rivals. While trade buyers have historically been paying more than GPs for mid-cap assets, the median EBITDA multiple for corporate M&A transactions stood at 6.9x in the first half of 2011 - 10% less than in PE-backed LBOs.

Despite enjoying low debt levels, it would appear that strategic buyers remained cautious in the face of macroeconomic uncertainties stemming from the Eurozone crisis and lacklustre public markets activity.

What goes up...

This strong appetite for mid-cap assets - and the correlated high price-tags - displayed in the index could conjure up images of pre-crisis enthusiasm, but it is likely to be short-lived - for the market is now considerably different than it was six months ago. "Valuations will go down simply because there is less debt, if not none," warns Mougenot. "I can't see how they could stay at this level going forward."

Even if lower mid-cap transactions should be less impacted than larger deals by subdued lending levels, industry participants are still expecting dealflow to slow down considerably in the next few months. More sensible valuations will at least mean that GPs skilful enough to source - and finance - increasingly elusive mid-cap deals could be in for a bargain.

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