Practitioner Perspectives

WOLF DEN ASSOCIATES, LLC

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Ten Forces Propping Up M&A Valuations

1. ***Despite headwinds, this remains a very large, fragmented sector with high free cash flow yields and barriers to entry***
2. ***Unrelenting investor growth pressures exacerbated by current organic growth torpor***
3. ***Established players scrambling to rebalance portfolios***
4. ***Abundance of cash on the sidelines and few alternatives to invest for attractive returns***
5. ***Persistent private equity interest***
6. ***Inexpensive credit available at relatively high levels and attractive terms***
7. ***Sellers control timing, rebuffing all but the most seller-friendly transactions***
8. ***Scarcity of quality targets on the market***
9. ***Opportunity cost being priced into valuations***
10. ***Increasing use of structure and contingent consideration to maintain higher notional valuations while sharing risks***

Inelasticity of M&A Valuations

- Maximum possible headwinds suggest now is the time to buy, but private company M&A valuations remain resilient
- M&A valuations are down slightly in some places and up in others, suggesting that factors beyond headwinds are at play
- With the exception of distressed situations, sellers control timing and will wait to exit if they do not get the valuation they want
- Larger federal market players must quickly realign their portfolios to meet current market demands
- Buyers have surplus cash on hand, as well as debt and equity available with few attractive places outside of M&A to invest
- Realization of asymmetric risks: opportunity cost of not growing is more costly than the risk of overpaying for an acquisition

Is Now the Time to Buy Federal Companies?

Conventional wisdom dictates that the time to buy is at the point of maximum possible headwinds. Demand wanes as buyers move on to greener pastures, supply surges as sellers rush to sell ahead of the proverbial falling knife, and valuation multiples over-correct. We have certainly reached a point of maximum headwinds in the federal sector and public companies are trading at 20-year lows; however, private company M&A transaction multiples have only come down slightly.

The Role of Portfolio Rebalancing

One of the biggest factors propping up private company M&A valuations in the federal sector is that the larger players must quickly rebalance their current portfolios. Vanishing OCO funding, adoption of COTS applications, cloud-based and mobile infrastructures, a cyber binge, and unrelenting pressures to cut prices and do more with less have laid siege to most established federal businesses. In order to turn their portfolios far enough, fast enough, companies rely on M&A to realign their business with current priorities. As they rush to "follow the money," companies already in those subsectors command premium prices.

	Buyer #2 Maintains Price Discipline	Buyer #2 Elects to Overpay
Buyer #1 Maintains Price Discipline	(4, 5)	(0, 3)
Buyer #1 Elects to Overpay	(3, -1)	(1, 2)

A sample coordination game depicting the relative payoff with each combination of strategies. If both Buyers adopt the first strategy (Maintains Price Discipline), they would each achieve the maximum possible payout. However, if either Buyer thinks that the other may adopt the second strategy (Elects to Overpay), then both Buyers achieve the next highest possible payout by both adopting the second strategy.

Embarrassment of Riches

Despite the pauper persona that gets portrayed on the Hill, the federal sector is currently awash with liquidity. Investment bankers have long marveled at the acquisition capacity of the sector and companies' under-levered balance sheets. Now more than ever there is significant cash piling up. These organic war chests are being augmented by a steady flow of other people's money in the form of relatively inexpensive credit and abundant private equity. Lenders and private equity investors drawn to the free cash flow yields and stability of the sector (especially as the broader economy continues to struggle) are contributing to valuation resiliency.

Game Theory Trumps Fundamentals

Frustrated buyers often complain that "sellers still have not reduced their valuation expectations to match the current market realities." While sellers control exit timing (so they do not *have* to do anything), the real reason for valuation inelasticity is that pricing discipline is not universally maintained. Far from a "greater fool" theory, the reality is that many buyers have severe consequences for not doing a deal and are pricing that opportunity cost into valuations. As illustrated in the sample payoff matrix at the left, all buyers receive the highest possible reward by maintaining price discipline. However, if any buyer can be expected to overpay, then a Nash equilibrium is established where all buyers elect to overpay. Said another way, many buyers rationalize that it is better to overpay than to shrink.

High Price Strategically Acceptable (HPSA)

HPSA M&A pricing philosophy – valuing M&A targets at the highest possible price that can be justified strategically – is analogous to the Low Price Technically Acceptable (LPTA) approach to competitive procurements. The first question in HPSA/LPTA acquisitions has to be "what price will it take to win?" and then play, or do not play, depending on the answer. What something "should cost" and the prices of other similar transactions have little bearing on the ultimate valuation. While headwinds may cause increased due diligence scrutiny and more busted deals, do not expect M&A valuations to decline significantly anytime soon.

8280 Greensboro Drive
McLean, VA 22102
wolfdenassociates.com

Barry Landew
(703) 477-7737
barry@wolfdenassociates.com

Kevin Robbins
(202) 841-1085
kevin@wolfdenassociates.com

Dave West
(917) 657-4525
dave@wolfdenassociates.com