Zachary Scott
INVESTMENT BANKERS

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# Tapping on the Valuation Ceiling

## Middle-market valuations are running out of headroom.

*by David Working*

The past eighteen months have been healthy and productive for businesses both public and private. Valuations of businesses are at a 5-year high as performance is being rewarded in how the public values a dollar of earnings. However, our readers understand that business is by its very nature cyclical, and we like to reinforce that understanding through the words of the late economist Herb Stein: "trends that can't continue, won't." A closer look at recent data sheds some light on just how close to the peak of the value cycle we might be.

### CLIMBING PUBLIC VALUATIONS

The top adjacent chart displays the collective valuation of non-distressed middle-market US public companies over the last ten years. The bands represent a standard deviation on

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either side of the middle line, which is the average valuation over the displayed time period.

The last quarter in which valuations climbed over a standard deviation above the mean was the second quarter of 2007. Immediately afterwards, valuations cratered due to the recession. We expect the second quarter of 2014 to be the first period since the recession started to see valuations climb back above the band of normal variation.

We caveat this discussion with the admission that we are not analysts of public securities, nor are we in the business of projecting stock prices. We are, however, observers of historical business activity. High valuations alone are not predictors of decline; on the contrary, high valuations are representative of investors' confidence in the future strength of companies' earnings. But, an historic upper limit on earnings valuations does

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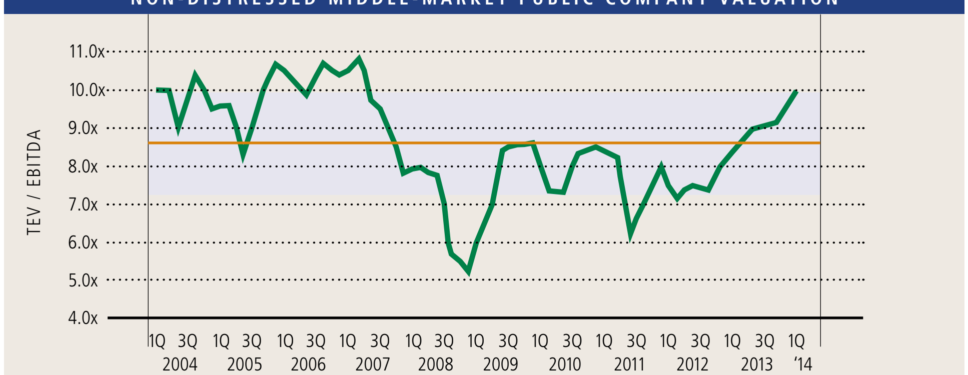
### PUBLIC TRANSLATES TO PRIVATE

Although this phenomenon occurs in the public markets, we have observed the same effects translating to private valuation. As stated in our Winter 2014 article, "Market Heats Up for Private Company Sales," we observed a link between the volume of private transactions and the valuation of public companies. The bottom adjacent graph shows the similarity in valuation between middle-market public companies and private transactions, when indexed to their own averages over the last six years.

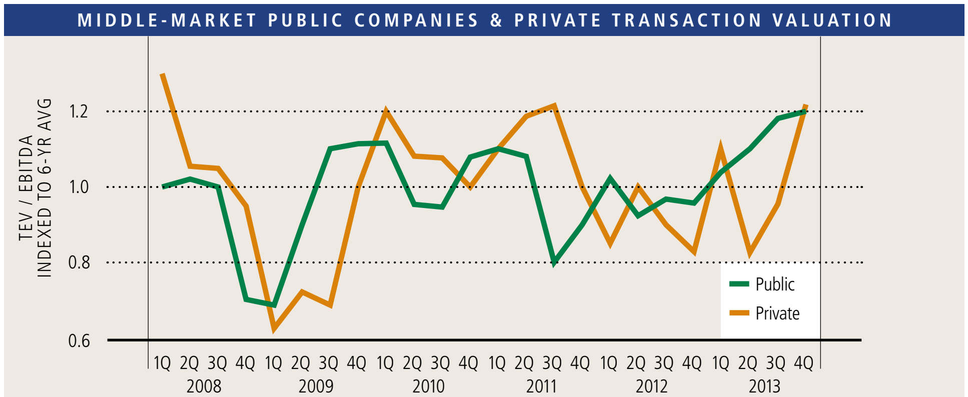
The magnitude and direction of change in valuation in the private transaction market very closely mirrors the valuation of public companies of similar size. Anecdotally, this matches what we've seen and heard from our contacts and clients—valuations of private companies in the middle market have been rising for several quarters.

While the trends we have observed are robust in both direction and duration, they are by no means a predictor of imminent future activity. A quick look back at mid-2005 through mid-2007 reveals that the market supported extremely high valuations of companies of this size for the better part of two years, so today's market conditions do not automatically

NON-DISTRESSED MIDDLE-MARKET PUBLIC COMPANY VALUATION




MIDDLE-MARKET PUBLIC COMPANIES & PRIVATE TRANSACTION VALUATION

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represent a looming decline. What we can say is that when viewed against the last decade, there is little room remaining for valuations to continue to grow on a market-wide scale.

Individual business owners know that market conditions are one factor among many that make up the overall value of the business. That said, it is when things are going well that business owners should measure their own appetite for risk, so they can decide whether they want to chance letting another business cycle pass before capitalizing on their success. The technical ability, market knowledge, and years of experience of a capable advisory firm can greatly assist in creating a framework to answer these questions. **ZS**

Zachary Scott
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1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

## ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

**Mark D. Working**
206.224.7382
mworking@zacharyscott.com

**William S. Hanneman**
206.224.7381
bhanneman@zacharyscott.com

**Frank S. Buhler**
206.224.7383
fbuhler@zacharyscott.com

**Michael T. Newsome**
206.224.7387
mnewsome@zacharyscott.com

**Ray D. Rezab**
206.224.7386
rrezab@zacharyscott.com

**Doug Cooper**
206.224.7388
dcooper@zacharyscott.com

**Jeffrey Cleveland**
206.838.5521
jcleveland@zacharyscott.com

**Jay Schembs**
206.838.5524
jschembs@zacharyscott.com

**Michael J. Black**
206.838.5526
mblack@zacharyscott.com

**David Working**
206.838.5527
dworking@zacharyscott.com