The Metrics of Mergers & Acquisitions

PART 1

by **Brian T. Deveaux**, Leaders LLC

With so much recent merger and acquisition activity occurring in our industry and nationally, we thought we would take the opportunity to share a few thoughts with the readers of *CryoGas International* on the often discussed, but typically misunderstood topic — M&A metrics — which include, among other things, purchase multiples. When we discuss this subject with business owners, the question most often asked is, "What are multiples at these days?" The answer of course is, "It depends." But what surprises us most is how few people ask the logical follow up question, "What does it depend on?" The purpose of this two-part article will be to address that question and to dispel some of the myths regarding what a "good" multiple is for a buyer or a seller.

In Part I, we define some commonly used M&A terminology; highlight some of the factors that are driving today's active M&A market; and discuss some of the factors that drive the M&A metrics involving public company transactions. In Part II, we will contrast this by focusing on some of the factors that drive the M&A metrics involving private company transactions.

THE CURRENT M&A ENVIRONMENT

The current market for mergers and acquisitions is very active, nationally, internationally, and within the industrial gas industry. Recently announced transactions involving UIG, Mittler Supply, Linweld, Aeriform, and other large regional distributors seem to have taken a number of people by surprise … but they shouldn't have. As I highlighted in a letter sent to GAWDA members following the 2006 GAWDA Spring Management Conference in Chicago, we at Leaders LLC, believe that we are nearing a peak in the M&A cycle — a peak that we expect will not be repeated for many years to come. (For a copy of this letter, please contact the author.) General economic conditions, particularly in the industrial gas industry, have been solid for several years. Sellers have solid operating performance (i.e. income statements) to sell, and buyers have strong balance sheets with which to make acquisitions. Interest rates are still relatively low and capital is readily available. The current tax environment is favorable for sellers, and it's anyone's guess what the future holds with respect to capital gain and dividend tax rates. In our opinion, those owners that have recognized this, and timed their exit from the business based on market conditions, rather than personal conditions, have made wise decisions.

Of particular interest is the recent entrance of several new private equity players into the industry with the announced acquisition of Valley National Gases by Caxton-Iseman, and a major investment in Acme Cryogenics by Gladstone Investments. We believe this trend will continue as more private equity players come to understand some of the attractive characteristics of the industry. This relatively new dynamic should continue to favorably push the metrics for those companies that are large enough or unique enough to attract private equity buyers, and who have access to the private equity markets.

DEFINITIONS

Before we talk too much about what drives the metrics, let's first define a few of the terms most commonly used when discussing the metrics of M&A.

- Revenue — While this may seem like an obvious metric that everyone would agree on, many companies in our industry generate revenue from sources that are not related to the operations of the business, and thus should not be considered when defining revenue for transactional purposes. For example, proceeds from the sale of assets, loss of cylinder use, real estate income, and other non-operating revenue should be excluded when calculating revenue-based metrics.
- EBIT — Earnings Before Interest and Taxes is often used as a proxy for Operating Income. However, this metric can be misleading when comparing public companies to private companies, or even when comparing private C-Corporations to private S-Corporations. Most privately held businesses are operated in such a way as to minimize the overall tax consequences to the shareholders. Particularly for owners of C-Corporations that

					Multiples		LTM Results	
Acquirer	**Seller**	**Business**	**Date**	**Price**	**Sales**	**EBITDA**	**Sales**	**EBITDA**
Air Liquide	Linde	Minority Interest in JAG	December 21, 2006	738	1.4	9.5	523	78
Airgas	Linde	8 US LOX/LIN/LAR Plants	November 27, 2006	495	2.9	8.1	169	61
Linde	BOC	Whole Company	January 24, 2006	13,700	1.6	10.1	8,519	1,359
Praxair	Air Liquide	Messer German Assets	October 7, 2004	596	2.7	7.9	217	75
Taiyo Nippon Sanso	Air Liquide	Messer U.S. Assets	September 6, 2004	155	1.8	8.6	84	18
Praxair	Home Care Supply	Homecare	June 10, 2004	245	1.4	5.8	169	42
Airgas	BOC	U.S. Packaged Gases	April 2, 2004	200	0.8	6.3	240	32
Air Liquide	Messer	Most of Messer	January 20, 2004	3,216	2.6	10.1	1,248	318
Air Products	AHS	Homecare	October 1, 2002	165	1.5	5.5	110	30
Airgas	Air Products	U.S. Packaged Gases	January 3, 2002	236	1.1	6.1	223	39
Linde	AGA	Whole Company	May 9, 2000	4,680	2.5	10.9	1,872	429

Table 1 (provided by Mark Gulley, principal of Soleil Securities/Gulley & Associates LLC) illustrates some of the commonly reported metrics for several public company transactions that have occurred in the industrial gas industry in the past several years.

are subject to double taxation, this often results in the owner taking an “above market” salary and benefits. Compounding this problem in the past several years have been tax rules allowing accelerated depreciation of fixed assets, which have lowered the EBIT of many businesses based simply on an accounting change. Without adjusting for these expenses, any metric based on the EBIT of a private company may not be very meaningful.

- EBITDA — Earnings Before Interest, Taxes, Depreciation and Amortization is often used as a proxy for Cash Flow. For the same reasons noted above, analysis of this metric without considering the tax objectives of the company’s owners is often misleading at best.
- Adjusted EBITDA — For transactions involving private companies, this metric is often the most meaningful indicator of the value of the business, but only if it is developed in a meaningful way. The litmus test for making so-called “owner-related” adjustments should be whether or not the expense will truly go away after a transaction is completed. The difficulty in tracking this metric, however, is that it is not widely reported, and thus any metrics based on Adjusted EBITDA are difficult to ascertain.
- Post-Synergy Adjusted EBITDA — From the buyer’s perspective, this metric is probably the most important in considering any transaction. After all, it is how the business is expected to perform in the future that is most important to the buyer, not how it performed in the past. While most buyers will realize some level of synergy from any transaction, the perceived risk in achieving the synergies may dictate whether or not they are willing to pay for those synergies.

PUBLIC COMPANY TRANSACTIONS

Table 1 (provided by Mark Gulley of Gulley & Associates LLC) illustrates some of the commonly reported metrics for several public company transactions that have occurred in the industrial gas industry in the past several years.

To understand what drives these metrics, you need not look much further than the statistics that are most commonly used as indicators of the value of a public company’s stock, namely the price to earnings ratio or price to cash flow ratio (EBITDA multiple). For acquisitions to make sense for these companies that are subject to the scrutiny of Wall Street analysts and outside shareholders, an acquisition almost certainly must be accretive to earnings and cash flow. A review of the ratios as reported in Fred Siemer’s Wall Street Views (See “Wall Street Views,” *CryoGas International*, December 2006) shows a relatively consistent Price/Cash Flow ratio in the 9.5 to 11 range. A review of the statistics reported in Table 1 shows an EBITDA multiple range that is quite similar.

While readily available and widely reported, even these statistics can be misleading if taken at face value. When commenting on acquisitions in its annual reports and quarterly filings, Airgas states, “The Company negotiated the respective purchase prices of the businesses based on the expected cash flows to be derived from their operations after integration into the Company’s existing distribution network” in other words, Post-Synergy Adjusted EBITDA. What you don’t see in any of these reports, however, is what that Post-Synergy Adjusted EBITDA figure is expected to be.

Compounding this difficulty in establishing meaningful metrics for public companies is that the financial period upon which the met-

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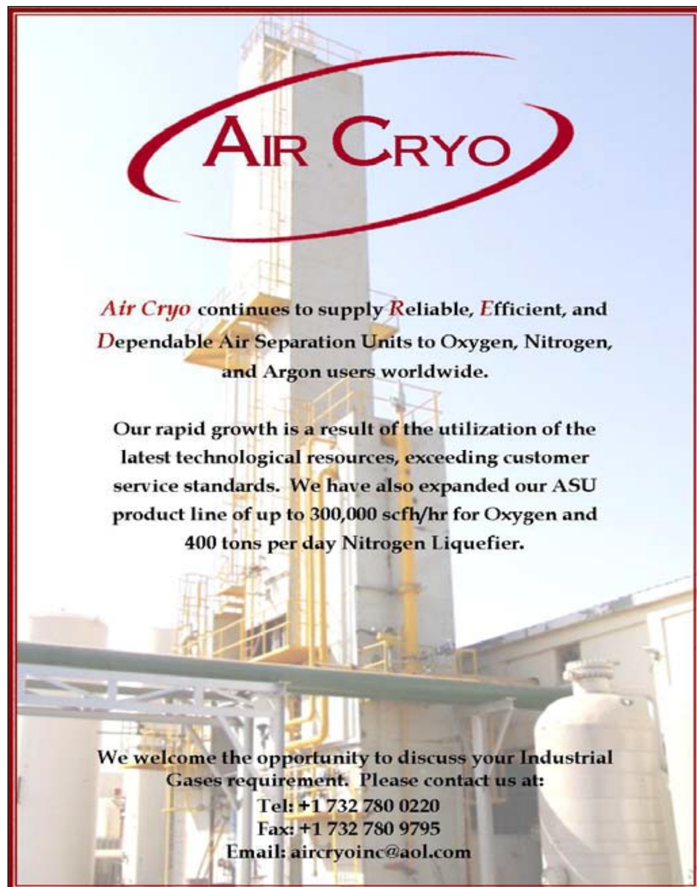

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rics are being calculated is not always clearly defined, and may depend on the person reporting the numbers. Take for example, the recently announced planned acquisition of the eight Linde air separation units by Airgas that is expected to close this quarter. The first figures reported in the press releases announcing the transaction were as follows:

Purchase Price	$495M
Fiscal Year 2005 Revenue	$154M (3.2 multiple of revenue)
Fiscal Year 2005 EBITDA	$ 55M (9.0 multiple of EBITDA)

Looking a little deeper into the numbers, however, shows that revenue through nine months of the then current fiscal year was up 10 percent. Assuming a constant EBITDA margin of 35.7 percent suggests an EBITDA of close to $61M for 2006, which would result in an EBITDA multiple of 8.2. Rolling these growth figures forward another year (i.e. the first year under Airgas' ownership) drives the multiple down to 7.4. Furthermore, what you do not see reported anywhere, is the anticipated Post-Synergy EBITDA, which will surely drive that multiple even lower. So, when someone asks what multiple Airgas has agreed to pay for these assets, the answer of course is, "It Depends!"

PUBLIC COMPANY VS. PRIVATE COMPANY METRICS

When you realize how difficult it is to make sense out of the publicly available transaction information, consider how much more difficult it is to make sense out of the transaction metrics involving private companies. Much of what you hear regarding private company transactions comes through the rumor mill. Someone at a cocktail party whispers, "Did you hear that Charlie got an 8 times multiple for his business?", while on the other side of the room someone else is whispering, "We just bought Charlie's company at a 5 times multiple." What is rarely disclosed or discussed by either party is what that multiple was applied to. Was it EBIT, EBITDA, Adjusted EBITDA, pre-synergy, post-synergy, last year's EBITDA, this year's EBITDA, etc., etc. The truth is that the multiple being "reported" is probably the one that reflects best on the person who is "reporting it."

We will continue this discussion of the Metrics of M&A in Part II. In that article we will focus on the factors that we see driving private company transaction metrics and why the determination of what constitutes a "good" multiple is ultimately in the eyes of the beholder. ❑

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