

March 2009

CEO Spotlight

**THOLONS**

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Valuations unfavorable,
PE exits likely to get
delayed

The ripple of the global economic downturn continues to impact the foundation of the outsourcing industry, both near and long-term.

Turbulent times and a depressed global economy are cascading through businesses, consumer spending, housing, government budgets, investments and how investors will behave over the next year. Light at the end of the tunnel appears to be dim as the tunnel looks at least a year long. A recovery is only expected towards the end of the year and hence the PE exits planned for this year will most likely be delayed.

Over the last 3 years, the EBITDA multiples have fallen considerably. Even the range of valuation multiples across the outsourcing industry has shrunk from a 9x range in 2006 to just about 4x range now. This leaves lesser room for variance in the valuation multiples and market perceptions.

The growth stage investments made around 2004-2006 at 10-11x EBITDA levels are nearing maturity and currently valued around 5x EBITDA. (Refer chart below)

Generally, good investments in growth stage portfolio company businesses witness a 30-50% CAGR in EBITDA over the investment horizon of a PE investor. Since the last year's EBITDA numbers were not strong enough, the EBITDA CAGRs would now be south of 40%.

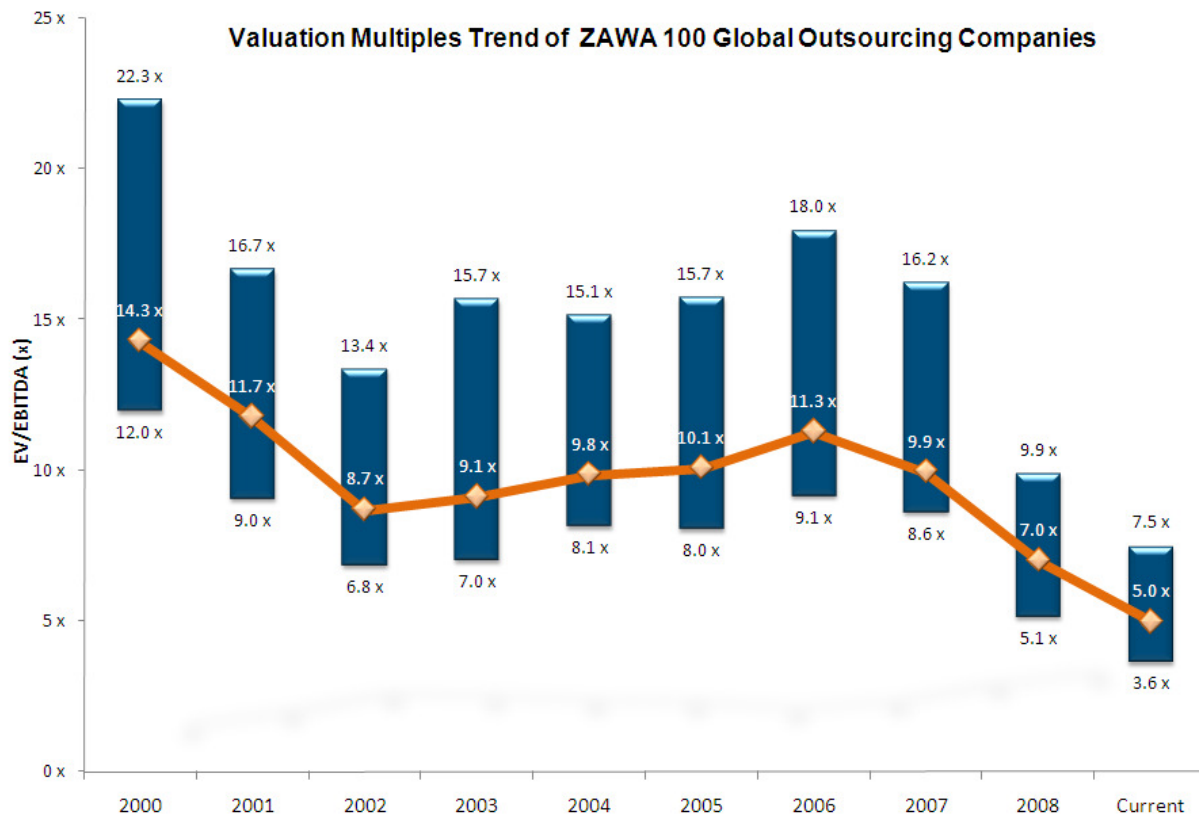
An exit now would provide only about 10% IRR on their investments in better cases. This being very close to the preferred/hurdle rate expected by the limited partners of the private equity funds, leaves the funds with little or no carried interest. The PIPE (Private Investment in Public Entities) would fare even worse as the EBITDA growth numbers have drastically been hit due to the scale/base factor. Most public companies in this space have had very low EBITDA growths in the last few quarters and some have even had negative growth EBITDA numbers.

Last year, the sentiments were quite bearish and the investors wanted to cut their losses. Also, the valuations were not as bad as they are now compared to the entry points of those investments. Hence there was a high exit activity amongst the PE players at about 25% IRR (well performing investments) despite an average cut of about 30% in the valuation multiples against the entry levels.

We believe, couple of quarters from now, the industry should see valuation curves moving upwards and thus it makes sense for most investors to wait and exit. A recovery is expected in both the valuation multiples and the EBITDA growth numbers from where they are now. This could potentially result in lesser IPOs and sell-outs by the PE backed firms this year, leaving them to focus more on their businesses.

The chart below displays the historical movement of EV/EBITDA multiples for the 100 companies that belong to the ZAWA Global Outsourcing Index.

Bars represent the half standard deviation range of the trading multiples of the 100 Outsourcing companies and the line represents the median multiple.



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