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"8" is the New "6"— For Now

Lenient credit has contributed to higher prices paid for businesses.

by Mark Working & David Working

We have long proclaimed that EBITDA multiples are derived from the value of a business, not the other way around. However, in aggregate, EBITDA multiples can shed light on how capital providers, whether buyers or investors, change their view of the value of a sector over time. The numbers show that markets currently value a dollar of EBITDA more highly than at any time since the end of the recession in early 2009. We hear our private equity friends express the new value paradigm with the phrase, "8 is the new 6." As discussed in the accompanying article, "What's In a Multiple?" value is a function of many judgments about the future prospects of a business, with each of those variables being a function of many other interconnected factors. While acknowledging that complexity, we analyzed many of these factors as they have changed over the past five years and zeroed in on an analysis of how the changes in credit standards and capital pricing have contributed to expanding multiples.

Changes in the capital markets alone can move a business from a 6x EBITDA multiple to an 8x multiple value, even after holding constant growth, leverage, and overall interest rates. Specifically, the shift can be explained by the contraction of both senior credit spreads and mezzanine pricing, and the increasingly accommodative credit structures of senior leveraged lenders.

LEVERAGE, CREDIT LENIENCE, AND RATES

A business allocates its cash flow, not its balance sheet, to capital providers. Therefore, if cash flow is constant and the cost of capital falls, the same amount of cash flow can service a greater amount of debt. The leveraged lending market has largely followed this pattern—the proportion of the cash flow stream allocated to debt service has remained relatively stable, and the overall effective cost of debt capital has declined due to declining interest rates and extended amortization. As expected, total debt relative to cash flow has increased. Over the past five years since the end of the recession, we've made the following observations:

- Senior credit spreads have declined – whereas, a senior leveraged loan used to be priced at 6.5-7.0%, the rates in today's markets could be 300 basis points lower;
- Mezzanine interest rates have fallen – driven by comparisons to the public high yield market and lack of demand, mezzanine rates have shrunk by close to 6%; and
- Senior credit amortization has become much more lenient, leading to total debt amortization being extended – a blended amortization of a debt capital structure of 60% senior debt and 40% mezzanine where the senior was amortized over seven years and the mezzanine was interest only, equated to a 12-year schedule. Today, senior lenders are allowing amortization of closer to 12 years for senior, driving the blended term to close to 20 years.

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The combined change in these three variables has driven down the effective cost of debt from over 10% to less than 6%. Along with the extended amortization, credit capacity, as measured as a ratio of "debt-to-cash flow," has increased by two full turns of cash flow without any further leveraging of the cash flow stream. The relationships among cost of debt, amortization duration, and debt-to-cash flow are illustrated in the adjacent exhibit.

ADDITIONAL CREDIT AFFECTS ACQUISITION PRICES

The availability of credit in and of itself does not increase value or cause prices for businesses to rise. However, it does arm buyers with the ability to leverage their existing capital to pay higher purchase prices. Absent some additional factor, buyers would not willingly agree to pay more for the same earnings—but, that additional factor is competition. In the current environment, where there is more capital and fewer opportunities to employ that capital, equity investors have been willing to use their new-found bag of money to stretch further on price in order to win the deal.

Paying more for a business is not without cost, even if interest rates are lower. The equity investor is simply making a decision to allocate a greater portion of the company's cash flow to creditors than to themselves. Because the amortization of the debt is extended, creditors will lay claim to the cash flow stream for a longer period of time. In short, the reduced amount of cash flow to equity investors depresses equity returns from what would otherwise be expected. Unless economic prospects rapidly improve for the purchased businesses to compensate for the higher prices, the potential to earn equity returns in the historic mid-20 percent range has noticeably declined. Anecdotally, we've heard this effect reflected in

Debt / Cash Flow		Δ in Combined Interest Rate: 0	-1%	-2%	-3%	-4%
Δ in Amortization	0	**3.5 x**	3.8 x	4.0 x	4.3 x	4.5 x
	+2 Years	3.8 x	4.0 x	4.3 x	4.5 x	4.8 x
	+4 Years	4.0 x	4.3 x	4.5 x	4.8 x	5.0 x
	+6 Years	4.3 x	4.5 x	4.8 x	5.0 x	5.3 x
	+8 Years	4.5 x	4.8 x	5.0 x	5.3 x	**5.5 x**
			2009		**2014**	

(continued p. 2)

the expectations of private equity firms: investors in funds that were once promised returns above 20% are now expecting returns in the mid-teens.

The only reason to believe the benefits of the favorable credit environment would accrue to the seller of a business is that the only other choice for capital providers is to not invest. It is the relative short supply of opportunities to employ capital relative to the amount of capital available that determines who receives the benefit. Currently, the relative shortage of opportunities has resulted in most of the benefit of the credit markets being passed on to sellers in the form of higher prices of businesses - ergo "8 is the new 6."

STATIC ANALYSIS CAN LEAD TO DISAPPOINTMENT

The reduction in the cost of capital is the only reasonable response to the current flood of capital liquidity. If business performance continues as expected and rates in the capital structure are fixed, the higher multiple-equation works. Presently, competition for investment opportunities is stiff, rates remain historically low, the economy muddles along, and credit problems are largely not being observed. All is good.

Of course, rarely do conditions remain constant. If we've done nothing other than raise awareness that the conditions we observe in the market today are a result of many complex factors, it is worthwhile. We are experiencing credit spreads, general interest rates, and credit leniency on the beneficial side of historical averages. Movements in any of these factors, not to mention general business conditions, can change the equation.

It would be imprudent to ignore the current advantages to be garnered from today's capital markets conditions. An advisor knowledgeable about the markets and how they affect a specific business situation can help plan for the most advantageous course of action. **ZS**

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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.**

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