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INVESTMENT BANKERS

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Value Expectations in Cyclical Industries

Educating potential buyers about the future value of a cyclical business.

by Jay Schembs

The value ascribed to a dollar of future cash flow largely relates to the confidence in receipt of that cash flow. The process of valuing a business in a cyclical industry, as opposed to in a stable demand industry, is inherently the same; however, the greater challenge of predicting the future produces a wider range of value expectations in cyclical than in stable industries. Narrowing this range of value expectations requires the seller of a business to educate potential buyers.

Given the number of cyclical industries prevalent in the Pacific Northwest (e.g. aerospace, agriculture, seafood, building products, construction), understanding how buyers evaluate cyclical businesses can empower owners to present their businesses in the best light to maximize value.

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CYCLICAL INDUSTRY DYNAMICS

All businesses experience some level of cyclicality. At a minimum, exposure to broad economic cycles leads to ebbs and flows in demand for products and services that affect pricing and revenue streams, thereby impacting a company's performance. Certain industries, however, exhibit unique characteristics that lead to amplified performance relative to the general economy—both good and bad—over time. The primary difficulty in evaluating investments in these businesses relates to an investor's judgment on the duration and magnitude of these swings.

History has shown that cycles (e.g. interest rates, energy prices, or construction) are unpredictable, both in duration and amplitude. Generally, judgments about the future cause investors to err on the side of caution as a cycle matures, leading to lower multiples as financial performance improves. Conversely, as a cyclical downturn appears to near its end, investors are willing to view the future more optimistically, applying higher multiples even as financial performance worsens. In contrast, non-cyclical businesses exhibit more stable valuation multiples, indicating that individual company characteristics outweigh variations in the overall industry or economy.

USING EBITDA MULTIPLES TO UNDERSTAND INVESTOR EXPECTATIONS

The building products industry is a highly cyclical industry, and it provides an example of how valuations are affected by future expectations. Investors attempt to look past peaks and valleys, although not always with perfect vision. As illustrated in the graph below, the domestic homebuilding and commercial construction boom during the early 2000s drove rapid EBITDA growth. Valuations climbed roughly at the same pace, with EBITDA multiples trailing off moderately between 2001 and the peak in mid-2005, indicating that investors expected a mild downturn in the near future. As the market declined, so did valuations—although not quite as dramatically as did company performance. Even as operating performance fell, multiples started to climb and, when the carnage in the construction market finally appeared to settle in 2009, EBITDA multiples had climbed dramatically, raising overall industry valuations far in advance of actual company performance improvements.

Thus, over the last 15 years, EBITDA multiples were at their lowest while industry performance was at its strongest (2005-2006) and vice versa (2009-2010). Although multiples have declined since 2010, the fact that current multiples remain high relative to history indicates the market believes these companies will continue to experience superior EBITDA growth as the housing recovery continues.

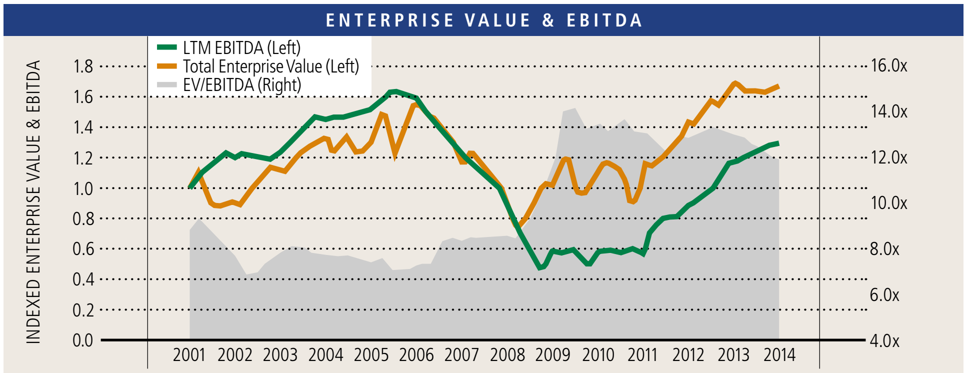
While the public markets can have episodes of manic behavior, these swings in EBITDA multiples tend to be the output of a sober view to valuing businesses, where the future will almost certainly look different than in the present.

THE CRYSTAL BALL QUESTION—WHERE IN THE CYCLE?

Whether or not an owner is contemplating a transaction, maintaining a viewpoint on the position of a business in its cycle is important. That view affects capital expenditure and cost structure decisions. Beyond the economics of the business, timing affects the potential market for the sale of a business. Absent special circumstances, strategic and financial buyers tend to present two distinctly different perspectives:

- *Strategic buyers* generally are long-term holders of businesses, often folding the acquisition into their own operations such that the two businesses ultimately become indistinguishable. As a result, strategic buyers can look out beyond the next cycle when thinking about the cash flows their investment will generate. Still, they generally view the upside of the cycle as the time to consider the "buy versus build" decision on additional capacity (both real and

ENTERPRISE VALUE & EBITDA



Source: Capital IQ & ZS Analysis

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human resources) to strengthen their market positions. When the cycle turns down, these companies often look inward to determine ways to reduce costs. Capital expenditures of all kinds are slowed.

▪ *Financial buyers* are generally interested in cyclical businesses only at one time in the cycle – early in the recovery. The reason is twofold. First, prices relative to the average value over the cycle are perceived to be lower. Second, there may be time to ride the cycle upwards and still sell the business (to a strategic party) before the cycle turns down. Many financial buyers have investment horizon constraints imposed on them strictly as a result of their agreement with investors in their funds. Buying late in the growth phase of the cycle presents the risk of a hold period that might take them beyond their allowed horizon.

WHAT CAN AN OWNER DO?

For any business owner, arming oneself with facts and data to create defensible projections is vital. Similar to investors in high growth businesses, investors in cyclical industries want to understand how the underlying drivers of demand will affect the business. Linkages between value drivers, demand, and company revenues need to be well understood. For example, a building materials company will benefit from a recovery in construction spending. However, if the company is part of a specific substitution trend within the industry, the amplitude of the recovery is enhanced. Buyers will place higher values on a company exhibiting market share growth regardless of where a company finds itself in the cycle.

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Owners of businesses operating in cyclical industries can help improve the value ascribed to their company in a sale or recapitalization through a number of actions. The very nature of the industry and its embedded economics can't be changed, but they are often not fully understood without serious investigation. It's the job of the owner and their investment bankers to build a credible case for the success of the business that spans multiple cycles. Although not conceptually different, the challenge of providing a sophisticated articulation of the rationale for a successful future requires more effort with a cyclical business. **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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