



INSIGHT

Where Is All that Private Equity Money?

Business owners seeking capital will find private equity funds highly selective and discriminating.

by Mark D. Working

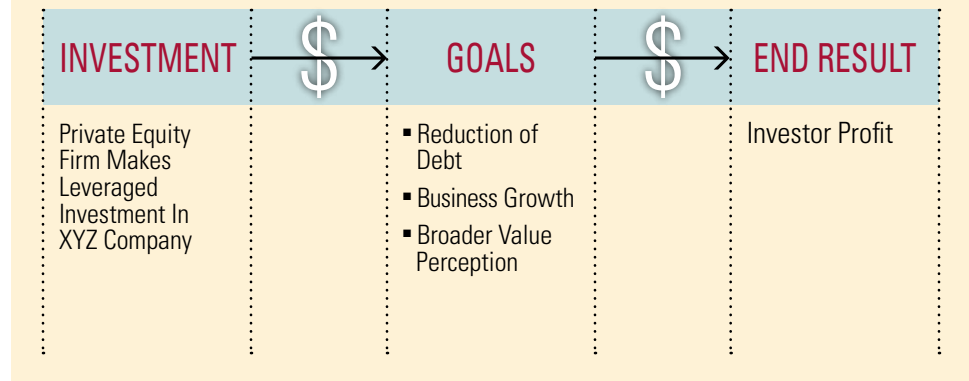
We've written in previous issues of Insight about the growing role of private equity investment in middle market businesses. Many sources observe that a significant and growing percentage of middle market private businesses are at least partially owned by private equity firms. How is it then that individual business owners can be frustrated in efforts to attract capital? The truth is that the private equity market is very specialized and fragmented. Because private equity investors are highly selective and their investment preferences vary widely, the job of finding capital for a specific company can be a challenge.

Private equity firms exist to serve their investors by originating attractive opportunities to apply capital. Their prime motivation is to earn a favorable long-term return for their investors. Firms have different strategies of finding and/or creating those opportunities, but there are some common traits of businesses that define them as attractive.

THE ROLE OF LEVERAGE

A private equity investment generates a return for investors as a result of: 1) taking on financial risk, 2) stimulating profitable business growth, and 3) arbitraging markets. When equity is invested in a business with a leveraged capital structure, equity value increases when the cash flows generated by the business are applied to reduce debt. Even if the enterprise value of the business is unchanged, when debt is reduced the value of equity increases, thereby assuring a return on the investment. Because adding financial leverage to a business increases risk, the equity investors have an opportunity to earn a higher return. Therefore, in the eyes of a private equity firm, an attractive investment candidate is one that exhibits cash flow stability and the consequent ability to support debt capital. In only the most unique of circumstances will a private equity firm fund the acquisition of a business only with

Generating Return for Investors



equity capital. Reliable markets for products, competitive barriers to entry and/or substitute products, and high gross margins are indicators of stable businesses that can support debt. Even though building a better business is the ultimate objective of a private

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equity investor, the fundamental aspect of a leveraged buyout, which is to add financial risk to the operating risk already inherent in the business, and then remove it, provides a significant component of a private equity firm's return.

BOOSTING BUSINESS VALUE

In addition to the effect of reducing leverage, gains in enterprise value can boost equity value. Attractive businesses compete

in markets where there is inherent growth in demand for products and/or services, either from predictable increases in basic demand or substitution for other less favorable alternatives. Growth can also be achieved through consolidation of a fragmented industry, so long as the cost to consolidate is less than the value created from combining the businesses. According to Brad Creswell of Northwest Capital Appreciation, "fragmented industries offer a great opportunity for value creation as redundant functions are eliminated and facilities and management are used to their greatest efficiency. Some of our best returns have been earned as a result of a successful consolidation strategy led by a capable management team."

Stephen Babson, general partner at Endeavour Capital, is even more specific about the importance of management, "Management is so important to the successful growth of a business that we will pass on an investment, even within our target industries, unless there is an experienced team in place or we are bringing the team into the transaction. We look for a team that has succeeded with the business model being employed and has the capability and energy to complete

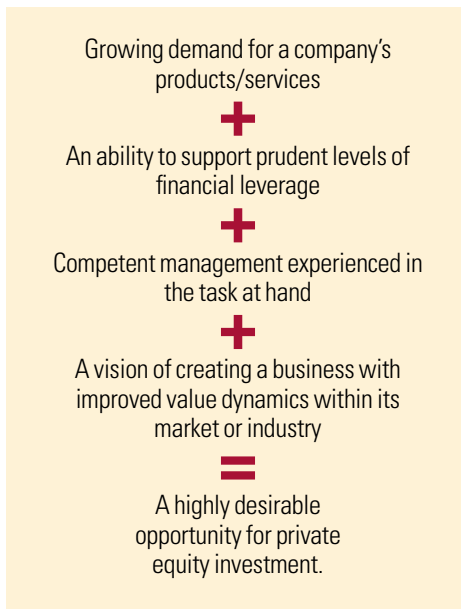
the business plan. To that equation we can add the capital and strategic support necessary to clear the decks for them to move the business forward.”

GREATER VALUE STRATEGY

Sometimes the result of management’s good work can create a business that has characteristics that fit a new market, like the public market, or provide a critical component to a greater value strategy being pursued by another business (see Value—In the Eye of the Beholder). When that occurs, an arbitrage of sorts in business value can occur and much greater value may be realized. This is exactly what happened in the case of Zumiez (NASDAQ: ZUMZ), when Brentwood Associates teamed up with management to expand the firm’s geographic footprint by adding stores in many new markets. By expanding the reach of the business and demonstrating the efficacy of its business model, Zumiez was able to access the public equity markets at a very attractive valuation. TJ McGill, managing partner of Evergreen Pacific Partners, believes that his firm’s recent purchase of Gene Juarez Salon and Spa is the kind of business platform that could result in the same opportunity for his investors.

FORMULA FOR ATTRACTING FUNDING

Because of the fragmented nature of the private equity market, there are no absolute standards that qualify a business to attract investment capital. We can say with some authority that the following formula equates to an attractive investment opportunity:



Owners of an existing business cannot change the industry conditions in which their business competes, but they should be ever vigilant in searching for opportunities to improve the nature of the business through growth or consolidation. If it becomes necessary to attract external capital to transition the enterprise to the next level, a private equity firm may deserve consideration. ❖

Value—In the Eye of the Beholder

Not everyone looks through the same economic lens.

by William S. Hanneman

Businesses are worth different amounts to different owners. This seeming anomaly is the result of different owners’ abilities to influence the amount, timing, or predictability of the free cash flow generated by the operation of the business.

FREE CASH FLOW

Far from valuing businesses using multiples applied to historic EBITDA, sophisticated investors assess value based on the present value of expected future free cash flow. Free cash flow is the cash that is available to pay suppliers of capital.

The equation (top of facing page) specifically says that free cash flow is the product of sales times the operating profit margin, less taxes and the incremental investments in working and fixed capital necessary to grow the business (capital expenditures in excess of depreciation).

Discounting all future free cash flows to the present at a rate that reflects the blended returns demanded by capital providers yields a measure of the value of the enterprise—commonly referred to as Enterprise Value (“EV”).

Readers may recognize this equation as the “Discounted Cash Flow” approach to company valuation. All future cash flows (shown in the numerator of this DCF equation) are discounted to the present (“PV”) by the Weighted Average Cost of Capital, (“WACC”), a measure of the riskiness of the free cash flows. Lower costs of capital are associated with less risky (more predictable) businesses. Often times, this means the business can support greater financial leverage and, because debt is cheaper than equity, the weighted average cost of capital is lower. Less predictable cash flows require financing with a higher proportion of more expensive equity, which results in a higher cost of capital.

Deducting the amount of debt from the enterprise value leaves the value remaining for the shareholders. Shareholder value grows as Enterprise Value increases and as debt is reduced.

The Enterprise Value equation serves as the Rosetta Stone for deciphering why businesses have different values depending on who the owners are. In using the variables in this calculation, one can contemplate various ways to influence value based on possible changes in the amount, timing, or risk of future free cash flows.

INCREASE CASH FLOW

An increase in free cash flow is the most common way to create value. This can be accomplished in a variety of ways, from consolidating back office or sales functions,

cross-selling product lines or improving asset utilization by eliminating excess capacity. Some buyers may, for example, be able to increase production without as much capital spending. Others may be able to reduce the cost of production inputs.

ACCELERATE THE TIMING

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a meaningful impact on value. Accelerating free cash flow creates value, delays destroy value. Buyers may be able to accelerate cash flows by, for example, rolling out a regional product through an existing national distribution system or by speeding product development.

REDUCE THE RISK

Reducing the risk of the free cash flow is a bit more complicated. However, it can be accomplished by improving the predictability of the cash flows. Ways to accomplish this may include converting customer relations from invoices to contracts, diversifying the customer base, or hedging input costs.

VALUE DRIVERS

When selling a business we are always assessing how the value equation could be changed for each of the prospective buyers in a manner that would add value. Understanding how a buyer may be able to influence cash flows helps determine how that particular buyer will value the business (or at least, what value the buyer could justify).

AN EXAMPLE

We represented for sale a privately-held business that manufactured and marketed a branded food product distributed in the Pacific Northwest. Although demand for the product was growing rapidly, pursuing national markets was a slow and expensive proposition. The owner was concerned that if he did not move more quickly, more agile competitors would emulate his product to fill demand. He

CALCULATION OF FREE CASH FLOW

Free Cash Flow = [(Sales X Operating Profit Margin) (1-tax rate)] + depreciation — incremental working and fixed capital investments

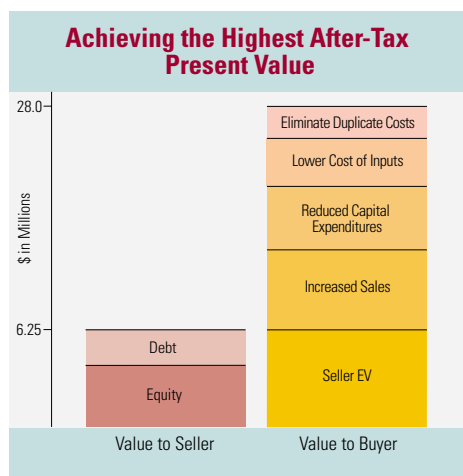
CALCULATION OF ENTERPRISE VALUE (“EV”)

EV = PV [(Free Cash Flow) / Weighted Average Cost of Capital]

CALCULATION OF SHAREHOLDER VALUE

Shareholder Value = EV — Debt

reached the conclusion to sell the business to a national food company that could plug the product into its existing national sales force. In addition to increasing revenues, the buyer had the infrastructure to reduce operating and administrative costs. Customers that would have taken our client years to cultivate were already customers of the buyer thereby meaningfully accelerating revenue generation. The buyer also already had factories in multiple markets that could process the product with little incremental capital spending. In addition, the buyer, a much larger diversified branded food products company, had access to much cheaper sources of raw material and capital. Incorporating all of these attributes



into the value equation resulted in the buyer's ability to justify a value four times what the business was worth as operated by our client.

CONCLUSION

The buyer who can justify paying the most is the one that can best increase the amount, accelerate the timing, or reduce the amount or cost of capital employed. Bear in mind that while different buyers may be able to justify paying higher amounts, they still won't pay more than they have to. Therefore, achieving the highest shareholder value requires that a sale process be conducted that brings all logical, financially qualified buyers to the opportunity simultaneously. ❖

The Bank Covenant Primer

Understanding the trigger points of financial covenants may head off future problems.

by Michael T. Newsome

Loan covenants are hardly a top of mind concern these days, when most businesses are reaping the rewards of a robust economic climate. It is easy to forget that the seeds of tomorrow's workouts are being blithely sown with the best intentions as lenders and borrowers hustle to put capital to work. Times and markets change. There is value to be realized in negotiations with lenders by understanding the aims and mechanics of the financial tests that are a central part of most credit agreements.

Apart from the amount and terms of credit availability, the timing of its repayment, and its cost, there are a host of important, but generally boilerplate, provisions that are built into any credit agreement. The boilerplate includes representations regarding the condition of the borrower and the authority to enter into the agreement, as well as promises (covenants) to provide timely and accurate information, comply with relevant laws and regulations, and act in a manner consistent with the business' best interests. These terms are not particularly controversial and require little negotiation. But hidden amongst the boilerplate, there are generally a handful (two to six) of financial covenants that set the borrower's standard of performance and place limits on management's flexibility. They form

the ultimate tipping point of power between the lender and the borrower over the life of the credit.

Financial tests are generally aimed at addressing reasonable lender concerns in a couple of areas:

- **Performance**—generation of adequate earnings / cash flow to sustain the business and meet its obligations as they come due. Sufficient earnings must be produced over time to pay all of the costs of current operations, replace obsolete assets, fund growth, and pay agreed returns to lenders.

- **Liquidity**—access to enough cash resources (liquidity) to meet the business' obligations as they come due. Lenders understand, as do most owners / managers, that there is only one asset that a business cannot survive without—cash. It's akin to oxygen; a business that doesn't have it, dies.

Earnings oriented financial tests are derived from a borrower's P&L statement for a period of time such as the most recent fiscal year, trailing four quarters, or last 12 months on a rolling basis. Liquidity covenants are calculated from the business' balance sheet and reflect a single point in time. The lender's objective is to devise a set of financial tripwires that are triggered well before the borrower fails to generate the earnings to service its

obligations or runs out of cash.

While bankers are not renowned for creativity, they can get inventive in devising variations on somewhat standard tests. In soliciting financing proposals from a number of banks, the norm is for each proposal to have a different twist on the calculation of financial tests. The syndicated loan market has brought standardization to the definition of financial covenants. So, the focus here is on the most common financial tests.

PERFORMANCE MEASURES

The fixed charge coverage ratio is probably the most widely used financial test to measure a company's ability to generate enough after-tax "operating cash flow" (the numerator in the ratio) to cover debt service (interest and scheduled principal payments).

A ratio of 1.25:1, meaning a \$1.25 of "operating cash flow" must be produced for each dollar of debt service, is a fairly standard benchmark. The appropriate coverage varies depending on the nature of the business, but in today's aggressive lending environment, a coverage covenant of 1:1 is possible. A test of 1.5:1 provides a huge cushion that would, in most cases, be overly conservative. The one cash flow variable that is invariably left out of fixed charge coverage tests is changes in working capital. In a rapidly growing or

poorly managed company (where receivables and inventory are expanding) a coverage ratio of 1:1 may not produce enough cash to actually meet all obligations.

LEVERAGE MEASURES

There are two approaches to measuring financial leverage:

- The most common is the ratio of outstanding interest bearing senior (or total) debt to EBITDA, which serves to control the amount of debt relative to the most important yardstick of debt capacity, operating earnings prior to depreciation and amortization; or

- The old school approach, which compares total liabilities to tangible net worth (accumulated paid-in capital and retained earnings, less total intangible assets), as a measure of the proportion of capital provided by third parties relative to the capital provided by business owners.

Today, the norm is to measure interest-bearing debt relative to cash flow. And, the permissible level can vary pretty widely, from two to more than five times EBITDA, depending on the size of the business and the perceived stability of its earnings.

Because tangible net worth is not particularly well correlated to either a business' ability to generate cash flow or the fair market value of its equity, balance sheet leverage is a weak predictor of financial strength. In our view, this test rarely serves the borrower's or lender's interests well.

LIQUIDITY MEASURES

These covenants provide an early warning of a cash shortfall. The traditional tests have been minimum working capital (total current assets—total current liabilities) or current ratio (current assets divided by current liabilities). Both work fine, but they are clouded with a little extra noise as the result of the inclusion of the current portion of long-term debt. A trading ratio, which is calculated in the next column, can provide a little clearer view of liquidity.

The objective is ample equity in the business' trading assets as evidenced by a trading ratio in excess of 1.0. Erosion of the trading ratio is a sign that trading assets are being liquidated to fund losses, acquire long-term assets, or distribute funds to shareholders. Trading ratio is always viewed in the context of undrawn credit line availability, particularly at the peak of the firm's operating cycle. Excess credit availability and a strong cushion of trading ratio (> 1.5:1) are the hallmarks of adequate liquidity. A lower trading ratio may be warranted if receivables and inventory turn over quickly.

ADVICE TO BORROWERS

There are several considerations that borrowers should weigh when negotiating new credit arrangements.

1. Financial strength can be well protected with just two or three financial covenants (i.e. fixed charge coverage, financial leverage, and

FIXED CHARGE COVERAGE RATIO

$$\frac{\text{EBITDA} - \text{Capex} - \text{Cash Taxes} - \text{Distributions}}{\text{Interest} + \text{Current Portion Long-Term Debt}} = \text{Fixed Charge Coverage}$$

FINANCIAL LEVERAGE RATIO

$$\frac{\text{Total Senior Debt}}{\text{Annual EBITDA}} = \text{Financial Leverage}$$

BALANCED SHEET LEVERAGE RATIO

$$\frac{\text{Total Liabilities}}{\text{Tangible Net Worth}} = \text{Balance Sheet Leverage}$$

TRADING RATIO

$$\frac{\text{Trade Receivables} + \text{Inventory}}{\text{Accounts Payable} + \text{Accrued Liabilities} + \text{Revolving Credit Line}} = \text{Trading Ratio}$$

trading capital). Proposals that are larded with an extensive list of tests beyond these basics are likely an expression of the lender's lack of confidence or knowledge of the business.

2. Lenders tend to peg covenants 10 to 20 percent below either recent or projected performance. If business performance is strong, these levels may be well above what is required to assure adequate financial strength. Standards should be set relative to the firm's obligations, rather than its peak performance.

3. Proposed covenants should be sensitivity tested against a full economic or business cycle. They should trip when serious financial problems are encountered, but not by the normal ups and downs of an industry or operating cycle.

4. There should be little disparity between the levels of performance required to trip individual covenants. If the leverage covenant is breached at EBITDA of \$3 million and fixed charge coverage is tripped at \$4.5 million, cov-

enants are misaligned.

5. Treat covenants and pricing as separate considerations. A lender may argue that attractive loan pricing warrants tighter financial covenants. While it's fair to tie credit spreads and fees to a performance measure, such as financial leverage, the performance benchmark that grants the lender the authority to declare an event of default and potentially accelerate the loan should be completely separate from pricing benchmarks.

The implications of financial covenants are easy to overlook when everything is going well and lenders are hungry to put money to work. But that is the very time when borrowers can negotiate the greatest flexibility with lenders. Markets, economies and risk appetites all change in time. Close attention to these details now may provide essential flexibility down the road when the business outlook may not be quite as rosy. ♦

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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