Zachary Scott

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Zachary Scott—an investment banking and financial advisory firm—has published this newsletter since 1997 to bring you a thoughtful analysis of issues affecting middle-market businesses.

PERSPECTIVES ON THE CAPITAL MARKETS FALL 2015

INSIGHT

Preparing a Business for Sale—Part III: Plotting the Course

Specific actions need to be taken to achieve a competitive process.

by Mark Working

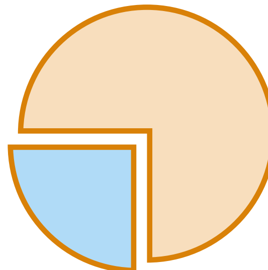
Investment bankers provide a variety of services, but a banker's primary mission is to create a competitive market for an illiquid asset – the privately held business. Competition invariably brings out the best, and a competitive market is created when each relevant and capable buyer simultaneously has a complete understanding of the opportunity. But for a decision on price, there are no unknowns. This article is the third in a series of three essays, each delving into a critical area in which advance preparation can make a meaningful impact on the ability to create a market for a business.

The banker's ideal outcome is conversion of a complex business entity into a virtual commodity. While this is rarely achieved, one can come close. It requires specific actions on the part of owners and managers to prepare the business for a competitive process. Three areas that stick out in our minds are the subjects of our series:

- **Data matters; its absence leaves only a story.** The existence of and accessibility of data on the detailed operational and financial mechanics of the business are necessary to quantify the company's business model and how it employs its capital and earns its return.
- **Understand the problem your company solves.** The size and growth curves for the market, the number and nature of the competitors, and how customers make buying decisions need to be understood and quantified in a manner that defines the environment in which the company competes; understanding precisely which problem the company solves thereby creates the framework for defining each of these items.
- **The future course must be plotted.** There is a specific value proposition that underlies every business and customer buying decision. What is it? The roadmap for future success has to be specific such that the equation for return on capital employed is clear to the potential next owner.

Part I: Data Matters

Part II: Understand the Problem



Part III: Plot the Course

PART 3: PLOT THE COURSE

Part I of this series outlined the necessity of developing robust data systems inside the business being brought to market. Part II addressed the need to define the position of the business within its ecosystem by asking, "what problem does it solve?" Part II also pointed to the need to quantify the expected future growth in the market, thereby defining the size of the pie for all competitors to pursue.

Plotting the course for the future requires several steps:

1. What strategy or strategies will be most successful in the future to solve the market's problems? Features, price, service?
2. What changes can be made by the business, and by when, to best position it to compete to solve future problems?
3. What are the financial implications of those actions over time?

Every market is dynamic, so it is not enough to suggest that overall market demand will grow by X% per year, therefore your business will follow suit. Competitors will adjust their offerings to try to garner a larger share. Some will compete on price; others will emphasize utility, ease of use, assistance, or some other service tied to the product. Fully understanding the nature of the problem to be solved and the possible approaches to offering a solution provide a basis for determining the best future course. Not all businesses will choose the same strategy, or are able to do so, because of differences in capabilities, resources, or market position. For example, the largest company in the market might be

> **The course for each business should be the one that is optimal for its specific situation and is achievable within the constraints placed on it.**

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able to invest in infrastructure that will decrease its unit costs, thereby enhancing its price competitiveness. This would be harder for a small company as it would be much more difficult to realize the same scale. The course for each business should be the one that is optimal for its specific situation and is achievable within the constraints placed on it. The critical thing is to demonstrate an understanding of the issues and tradeoffs, and to articulate the rationale for the choice of direction.

The future profile and characteristics of the business might be quite different than they are now. A path of activities needs to be defined that show all steps in the transition of the business from its current to desired state. Will the "go-to-market" approach be different? If so, does that mean changes in the sales and marketing effort, the number and attributes of the employees, or the use of external parties in different aspects of the strategy? Will products be produced differently from how they are today? Will there be expansion in physical capacity, outsourcing of services or production, different production processes, or integration of supplier or immediate customer functions? What actions will occur and when? They will need to be mapped out.

Numbers follow activities. A financial plan is the final step in the process. In essence, the financial plan is simply the future story of the business translated into another language – numbers. The backbone of the plan is the activity that is planned to occur – labor and infrastructure configuration, supplier arrangements, and revenue streams. Thinking about revenue as the product of units and price tells a lot about the specific positioning in the market and the expectations for results. If the activity is not projected and revenues and costs are not connected to that activity, expect to have to answer these questions from a buyer. If the logic doesn't tie together, it can change the negotiating dynamics.

The theme of this three part series is that planning is complicated and complex; it takes time and can result in conclusions that imply the need for change. The best strategic plan has as its core, good judgment and insight into the dynamics of the market, and is based on a solid foundation of data. This all takes work, but it pays off. Even if there is no transaction in the future, this effort will result in a better business. If a transaction is contemplated, besides being a more attractive business, due diligence efforts will be much smoother. Once an organization commits to regularly collecting and analyzing data along its value chain and translates those insights into tangible well-conceived plans, it will find benefits in management decisions, as well as being prepared when a sale process begins. **ZS**

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ZS Launches New Website

Fresh Look, User-Friendly Database, & Accessible On Any Mobile Device

We are pleased to announce our new website's launch **www.zacharyscott.com**. It is designed with a fresh look and user-friendly database enabling users to more quickly access Zachary Scott's transaction experience and proprietary IN$IGHT research articles. Further, the new website is accessible via tablets, laptops, and other mobile devices so users can visit it while traveling or on-the-go.

Co-founding partner Bill Hanneman commented, "We have strengthened our team and expanded our industry coverage over the past 5 years. We believe our updated website illuminates our growth and refined industry focus." Co-founding partner Mark Working added, "We needed to make our decades of transaction experience more accessible to our clients and their advisors. We look forward to hearing feedback from our friends, colleagues and clients."

Growth, Leverage and Multiples

Balancing competing objectives of winning deals and earning high returns.

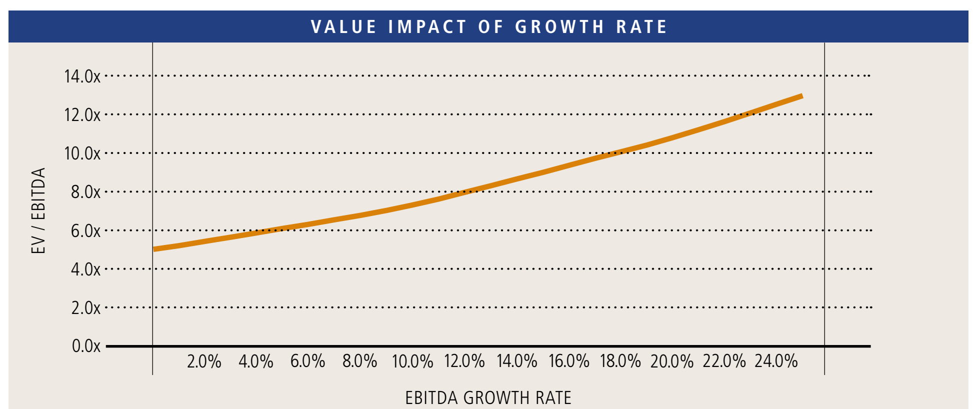
by Mark Working and Shaun Withers

Prices paid for privately-held businesses in today's market can surprise anyone who has been in the deal business for a long time. The confluence of a number of factors has driven up prices, most commonly for "growth" businesses, to levels not seen historically. As discussed in the nearby article, "Thoughts from the Combat Zone", private equity investors, in particular, are trying to balance the competing objectives of winning deals to allow them to put capital to work, while earning high returns for their investors. The purpose of this article is to create a framework to explain how investors are expecting to achieve both objectives by investing in growing companies and applying maximum leverage to the capital structure.

THE VALUE IMPACT OF GROWTH

Value is a function of future performance. Therefore, companies believed to have good growth prospects deserve and receive premium sales prices, evidenced by higher multiples of current EBITDA, as compared to prices paid for steady businesses with limited growth. The amount of the premium depends upon the perception by the buyer of the likely rate and duration of the growth curve, how the buyer thinks the business will be valued in the future, and how capable the management team will be in executing the growth strategy.

The summation of all future cash flows to investors is what determines value, therefore it stands to reason that as the future cash flow



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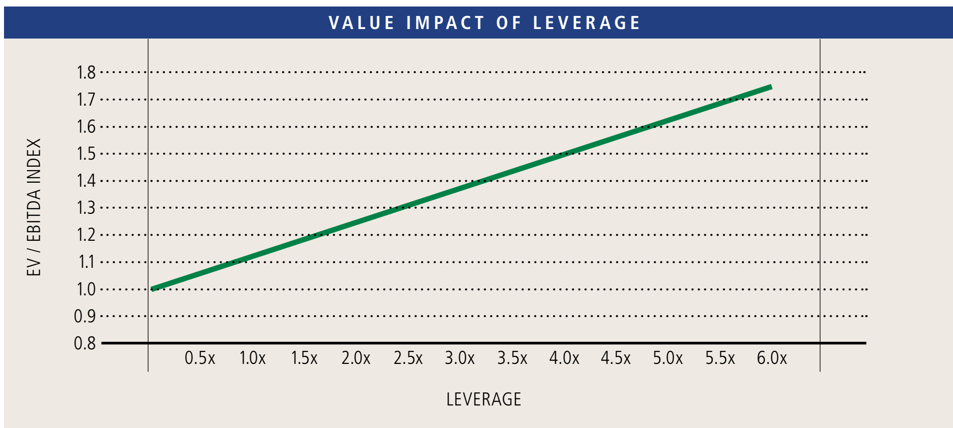
VALUE IMPACT OF LEVERAGE



stream grows, it is more valuable than one that remains constant or grows at a lesser rate. To illustrate the relationship between future rates of growth and current EBITDA multiples, we analyzed the impact on both value and multiples for identical businesses but with different expected future growth rates.

The basis of this analysis is a hypothetical service business that does not require significant investment in fixed or working capital to grow (rendering EBITDA a close surrogate for free cash flow). We looked at different futures

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for the company expressed in terms of growth of EBITDA from zero to 20% per year. We then valued each cash flow stream and translated that to a multiple of current EBITDA. The nearby graph shows the impact of growth on multiples, implying that expected growth in the range of 20% per annum translates into a business worth twice that of a similar business with no expectations for growth.

The value ascribed to the business with stable consistently profitable performance and no growth would yield a multiple of EBITDA in the range of 5x. As higher expectations of growth are factored into the equation, value, and the resulting multiple of current year EBITDA, rises at an increasing rate, reaching nearly 11x when annual compounded growth rate expectations reach 20%.

LEVERAGE ADDS "JUICE"

Most private equity investors evaluate their investments based on the expected return earned on their invested capital. Leverage is a tool employed by many private equity firms to increase the return on their invested equity. When the expected return on total capital is in excess of the borrowing rate, greater leverage yields a higher return for the equity.

The effect on returns and, therefore, prices is illustrated in the above graph. This analysis demonstrates the relationship between leverage (as expressed in debt/EBITDA) and value (as expressed by enterprise value/EBITDA) when expected returns on equity are held constant.

The intent of this graph is to show that a multiple can vary substantially depending on the amount of leverage employed in the acquisition target capital structure. When equity returns are held constant (we chose 20% for our example), multiples of current year EBITDA increase linearly as more leverage is added. The difference between a conservatively leveraged acquisition structure (say, 2x ebitda) and a highly leveraged capitalization (say, 5x EBITDA) results in an ability to pay almost a third more in purchase price.

THE TASTY COCKTAIL OF PERCEIVED GROWTH AND LEVERAGE

Some of the eye-popping valuations that have been announced in today's robust M&A market have been the result of combining high growth expectations with ample amounts of borrowed money. The following table illustrates the combined effect on potential value of a business under different growth and leverage combinations.

SENSITIVITY OF GROWTH AND LEVERAGE TO EV / EBITDA

	Leverage				
Growth Rate	2.0x	3.0x	4.0x	5.0x	6.0x
0%	5.8x	6.3x	6.9x	7.4x	8.0x
5%	6.9x	7.4x	8.0x	8.6x	9.1x
10%	8.3x	8.8x	9.4x	9.9x	10.5x
15%	9.9x	10.4x	11.0x	11.5x	12.1x
20%	11.8x	12.3x	12.9x	13.4x	14.0x

This table explains why we've seen businesses with attractive growth prospects realize such high prices. A business with a great management team that has a good understanding of the company's market and a well-conceived plan to take advantage of future opportunities attracts investors in the bunches. If lenders also view the business deserving of an aggressive credit structure, the ingredients are present to achieve a lofty price. This is why when acquisitions by private equity funds are announced at double digit multiple prices, it is safe to bet that the business has very well defined growth prospects, a stable underlying business model (to

Considerable pressure exists to put capital to work during a period when valuations leave no room for pessimists.

attract credit), and a great management team to lead the way. When competition among buyers is fierce, a scenario can be visualized that will allow the two conflicting forces – high prices and attractive returns to investors – to merge in the eyes of the buyer.

RISK, THE FORGOTTEN ELEMENT?

Anyone who thinks that private equity investing is easy hasn't done it, at least not successfully for any length of time. Today's managers of private equity capital are in a tough predicament. Considerable pressure exists to put capital to work during a period when valuations leave no room for pessimists.

All of the arithmetic in the graphs and tables presented in this article are valid, so long as assumptions about the future are "reasonable."

Rarely over the past thirty years has there been a time like today, where the combination of optimism over future growth and abundant, low cost capital has been present.

Optimism wins in this environment. The future is not knowable at the time of a transaction so, whether execution of the growth plan can be achieved as imagined or whether stalls in the development of the business conflicts with obligations under the capital structure, time will tell.

Rarely over the past thirty years has there been a time like today, where the combination of optimism over future growth and abundant, low cost capital has been present. These conditions have driven private company business values to unprecedented levels. It is the best of times for sellers and borrowers. Waiting for better conditions is a bad bet. **zs**

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Thoughts From the Combat Zone

Observations from the annual Growth Financing Conference.

by Mark Working

In July, the Association for Corporate Growth held its annual Growth Financing Conference in Seattle. The Conference is attended mostly by investment and mergers and acquisitions deal professionals, including private equity investors, mezzanine providers, senior lenders of various stripes, lawyers, accountants, and investment bankers. We took the opportunity to test our own observations of the current middle market private equity and credit markets with those of other deal professionals from around the country. Although not a consensus on all fronts, there were common themes among the participants.

Deal volume is average in quantity and above average in quality. As reinforced by most published deal data, deal volume is robust, but not frantic. That being said, good companies are coming to market. Equity firms are pleased with the quality of the businesses. Private equity firms expressed varying degrees of "busyness", but none indicated they were flooded or unable to respond to new opportunities. A common theme was that larger equity firms were "coming down market", primarily because there aren't enough deals of size to absorb their time and attention. This added focus on high quality middle market opportunities has created even more competition for each, leading to equity firms doing more front-end work in a sale process in order to compete and win deals. In some cases, due diligence, including quality of earnings studies, are being completed prior to final bids.

Prices are high, maybe reaching a peak? Competition leads to best efforts pricing and that is definitely showing up in sales processes. Every private equity investor had stories to tell of the deals they lost even though they broke all of their valuation limit rules. As discussed in the nearby article, "Growth, Leverage and Multiples", there is considerable pressure to put capital to work and plenty of evidence that valuation standards are being revised in order to win deals.

Several friends in the industry expressed concern over how this environment is changing the nature of private equity – from investors to asset allocators. Most private equity funds are structured such that limited partners are guaranteed a priority return, usually around 8% per annum. This return comes after recovering all management fees, usually 2% per annum on committed capital, which increases the hurdle for return on actual invested capital before managers of the fund begin to share in the gains. With prices on quality companies receiving prices equal to 10x, or more, of EBITDA, earning a carried interest becomes more challenging.

Not all companies are created equal. Everyone wants to talk about the high-multiple transactions, but there is actually a wide multiple range in which private transactions occur. The "averages" are being heavily skewed upwards by companies operating in markets where there is observable growth. It is investments in those companies where an opportunity to earn a higher return exists. Companies that have a perceived growth trajectory, especially those who operate in a market segment that exhibits natural growth characteristics, offer opportunities for investors to build bigger more valuable businesses. Achieving growth, and all the economic benefits that flow from it, is not without risk. Organizations will become more complex, new people, equipment, and facilities will need to be absorbed thereby altering the culture, and systems will need to expand and become more sophisticated. But, if everything goes well, great rewards in profitability and value can be achieved. Growth prospects and leverage each contribute to buyers being able to pay higher prices. When mixed with a competitive environment, very high (historically, speaking) multiples of EBITDA are possible.

> **Lenders funding private equity acquisitions are pushing the envelope in terms of historical debt-to-cash flow multiples.**

> **Competition is what is driving these conditions. Too much money is chasing too few opportunities. History will tell if this was a wise use of capital.**

Debt is plentiful and cheap. Lenders funding private equity acquisitions are pushing the envelope in terms of historical debt-to-cash flow multiples. Previously reserved for much larger companies with stronger and more diversified market positions, some middle market companies are able to borrow between 4x and 6x cash flow. Banks are generally not, as a result of regulatory limitations, the parties leading the parade, although banks accompanied by mezzanine investors jointly are able to compete in the stratosphere. Non-bank unitranche lenders (often referred to as the shadow banking system) seem to be leading the way in this market. Ultra-high leverage with little or no amortization, even with higher interest rates, offers equity fund investors the ability to boost their returns.

Capital risk is increasing. Lenders are advancing more than they historically would at lower rates, and equity investors are paying higher prices to participate in growth businesses. Competition is what is driving these conditions. Too much money is chasing too few opportunities. History will tell if this was a wise use of capital. Nevertheless, this tells us that the market for capital, whether to finance a company's growth, recapitalize the ownership structure, or outright sell the business, is strong and cheap. It is a borrowers' and sellers' market. **zs**

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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