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.

Zachary Scott
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PERSPECTIVES ON THE CAPITAL MARKETS WINTER 2017

INSIGHT

Beyond the Forecast Period

Long term planning creates positive returns for the business.

by Michael Dannenberg

"I rob banks because that's where the money is."
Slick Willie Sutton, famous bank robber

Privately held companies have the advantage of being able to have a long-term focus on value creation. However, our experience is that most businesses focus on the near-term and, for budgeting and planning, the forecast period is short. What might not be appreciated is that most of the value of a business is based on what occurs beyond the forecast period. The purpose of this article is to suggest that business value can be enhanced by taking actions today that will increase the probability of a stronger market position and more competitive business model down the road – that's where the money is.

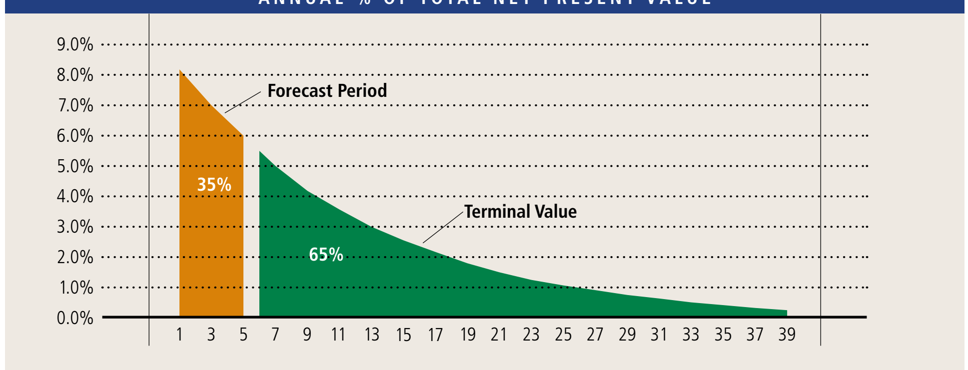
VALUATION THEORY REVISITED

The value of any business is the present value of its future cash flows, discounted using an appropriate rate of return for the risk employed. To calculate this value, business analysts must forecast the cash flows of the business over time. As one moves further from the current period, predictability decreases and accuracy becomes difficult. Because of the near impossible task of forecasting for an extended period, most valuation models calculate the cash flows for a set period (generally five years) and then perform a terminal value calculation to approximate the longer-term cash flows.

We find that the majority of analysis tends to be concentrated on the forecast period, with businesses (and analysts) supporting their work with robust models and detailed assumptions that have been evaluated from a number of angles. These forecasts represent the time period for which we have the most reliable information, but in actuality, the majority of the value of the business actually lies outside this forecast period in the terminal value.

Take for example, a business growing at 3% annually with a 10% cost of capital where the actual cash flows have been mapped over a 40-year period (a decent approximation of perpetuity).

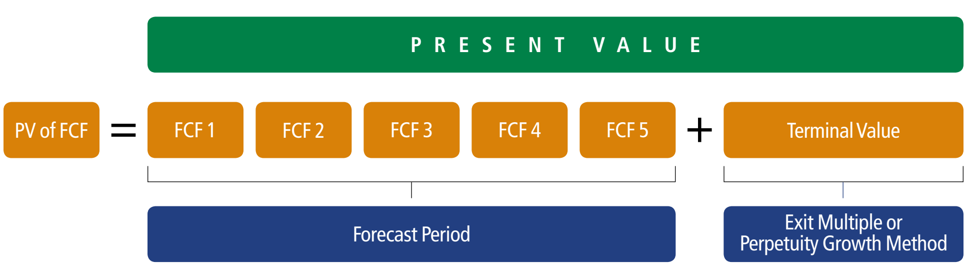
ANNUAL % OF TOTAL NET PRESENT VALUE



Clearly, due to the time value of money, near-term cash flows in the forecast period are more valuable than later ones, but the forecast period only accounts for 35% of the total present value, while the perpetuity value, accounts for 65%. Extend the forecast period to ten years, and the perpetuity value still accounts for 55% of the total value.

CALCULATING THE TERMINAL VALUE

Terminal value is calculated using one of two methods: the perpetuity growth method or the exit multiple method. In the perpetuity growth method, which is used most commonly, cash flow in the year immediately following the forecast period is effectively capitalized by the difference between the cost of capital and the long term growth rate. In the exit multiple method, which is used less commonly, terminal value is calculated by applying an LTM multiple in the final period of the forecast to the relevant Company metric, usually EBITDA or free cash flow.



Both of these methods are widely used and accepted in the finance community but the nature of simplifying the difficult task of forecasting leads to limitations that need to be considered in any investment or operating decision. The growth method inherently implies that the business thereafter will be steady and will indefinitely earn its cost of capital, a condition that in a dynamic business world will rarely occur. Naturally, this model is very sensitive to the growth rate employed. The standard practice is to choose a rate that is somewhere between inflation and GDP growth, but depending on the stage of the company and when

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it may actually reach steady state, this may not be appropriate.

The exit multiple method, on the other hand, is a relative valuation, heavily dependent on multiples derived from comparable firms or transactions. While these are acceptable valuation techniques, when applied to a DCF, there is no longer an intrinsic measurement of value. This type of shortcut might make sense when modeling a leveraged buyout, which will likely be sold based on a multiple in the future, but it defeats the purpose of performing a DCF, which by nature is intrinsic.

Given the importance of the terminal value, we wonder why so little attention seems devoted to it in valuation exercises. While we have no issues with the formulas themselves, and certainly understand the need to simplify the estimation of cash flows in the out years, we find that in most valuation exercises, the calculation is merely reflexive, and in some cases, assumes the answer. If the growth method is being used, than an analyst will use GDP, and if the exit multiple method is used, than the exit multiple will be set to the entry multiple.

Investments in technology, equipment, people resources, and business systems may look like expenses that bring down current profitability, but could result in a much stronger long-term competitor in its industry.

WHY IS THIS IMPORTANT?

As advisors to closely held businesses, we do not advocate our clients lose sleep over how terminal values are calculated, but we do encourage business owners to consider the drivers of long-term growth that will directly impact value today and to take the necessary steps to drive value in the future. One way to think about this is to consider how their business will be evaluated at the end of the forecast period, when the current terminal period becomes the new forecast. Will the factors that drive the current terminal values (opportunities to expand, ability to sustain margins, competitive environment) still warrant the assumed exit multiple? This can only be the case if the next forecast period has the same opportunity for growth as the first, a scenario that is in no way guaranteed given the dynamic nature of markets and businesses.

Likewise, the long-term growth rate is not a fixed variable impervious to today's actions. Rather, it is directly influenced by decisions made today. Investments in technology, equipment, people resources, and business systems may look like expenses that bring down current profitability, but could result in a much stronger long-term competitor in its industry. In valuation terms, those investments can enhance the growth rate in the terminal value.

While it is always difficult to take a long-term view (in the long term we are all dead), the majority of the intrinsic value is in the terminal value. When the terminal value accounts for the majority of intrinsic value, the ability to increase the long-term growth rate will have a definitive positive return to the business owner. **ZS**

Building a Middle Market Leveraged Capital Structure

Private sources allow middle market companies to build a capital structure that fits their situation.

by Mark Working

The high-yield bond market is a source of capital to maximize financial leverage. For those who can access it, allowable leverage has varied between 4x and 5x EBITDA, cresting the top of that range since 2015. Over the past twenty years, spreads on high-yield bonds have averaged 5.5% over treasury bonds of the same maturity, varying from as high as 10% to as low as 2.6% (outside the credit crisis of 2009). Spreads in the current market are around 4%, yielding rates of approximately 6.25% with today's low treasury rates.

Middle market private companies can't access the high-yield market, but there are private sources that allow companies to attain similar leverage at comparable costs. Bank loans. Asset-based loans. Second-lien loans. Mezzanine loans. Unitranche loans. These are the tools used to structure the debt of private companies. Each targets a different segment of the risk spectrum. By layering different sources, a private company can build the type of capital structure that fits its unique situation.

BACKGROUND ON LENDER SOURCES

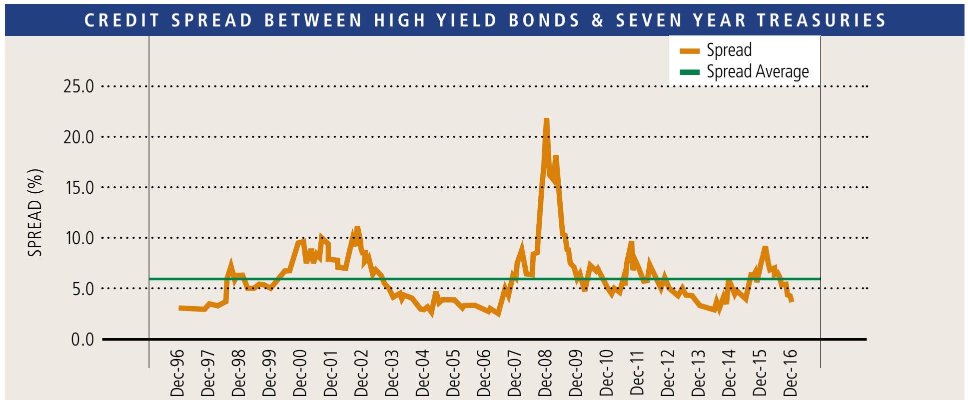
Credit providers view credit risk from several perspectives: primary dependency on asset values vs. cash flows and priority in the capital structure are the most important.

Both senior and junior cash flow lenders typically provide loans based on a certain multiple of profitability (usually EBITDA) of the borrower with priority rights over all other capital providers to that cash flow. These lenders are concerned with cash flow stability and the overall enterprise value of the business. Senior lenders, both bank and non-bank, manage their risk position through covenants that are designed to catch a knife before it falls. Mezzanine lenders (See "Middle Market Mezzanine: The Evolving Product", Summer 2013 IN$IGHT) are similarly focused on cash flow and enterprise value but are willing to take a junior (or subordinated) position with regard to rights to that cash flow, meaning that senior lenders are allowed to restrict payments should the borrower fall out of covenant. In addition, mezzanine lenders require little or no amortization, allowing senior lenders to get their loans repaid. For that, they extract a higher price.

Asset based lenders (see "Working Capital Finance with Asset Based Loans", Fall 2013 IN$IGHT) represent another form of senior debt. Although interested in cash flow, these lenders focus more so on the value of the underlying assets (e.g., receivables, inventory, and equipment) and obtain first priority liens on those assets to protect their rights to obtain value from their sale, if need be. Asset based lenders require regular detailed reporting and inspections of collateral to assure quality and to measure their exposure relative to these assets.

Second lien loans are the junior form of asset based lending. Like mezzanine loans, sec-

CREDIT SPREAD BETWEEN HIGH YIELD BONDS & SEVEN YEAR TREASURIES



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ond lien loans have little or no amortization. Unlike mezzanine, second lien lenders require a lien on the company's assets (although subordinated to the senior lender) and generally do not accept payment subordination to a senior lender. Because of the differences in type of subordination and rights to tangible collateral, second lien loans are considered slightly less risky than mezzanine with consequent lower pricing. As a result, the emergence of this product in the last ten years has eroded a portion of the traditional mezzanine market.

Unitranche lenders are the newest form of capital for the middle market. Unitranche capital providers are one-stop sources of capital willing to take the whole right side of the balance sheet, most commonly replacing senior, second lien, and mezzanine providers in a single loan that blends the attributes of all of these sources. Unitranche lenders often take security interests in assets. As with their junior debt brethren, unitranche lenders are quite flexible on amortization, sometimes agreeing to no amortization, instead allowing the borrower to use cash flow normally directed towards debt reduction to fund growth of the business. The unitranche structure results in the lowest amortization of any funding source combination and, for that, additional compensation is required. Besides the amortization flexibility, stated benefits over a layered structure are reduced closing and administrative costs, speedier closings, less syndication risk, and easier compliance and administration. Many private equity investors like unitranche structures because the after-tax cost of debt is still low and the minimal amortization allows the business to fund its growth even under a leveraged balance sheet. Unitranche lenders are particularly suited for asset-lite businesses that have low senior credit borrowing capacity.

Choosing the appropriate structure for a company requires knowledge of both the business and the unique characteristics of each source. Not all sources or combinations are appropriate in every situation. Exceptions are made all the time, but generally asset intensive businesses align with senior cash flow or asset based lenders and second lien junior loans, while asset-lite or higher growth businesses match up with cash flow senior debt and mezzanine, or with unitranche lenders. In fact, because senior credit capital is sometimes limited for lower middle market asset-lite businesses, unitranche offers a compelling alternative to the senior/mezzanine structure.

Alternative Leverage Structures

	BLENDED COST		
Source Mix Choices	<$10MM Ebitda	<$20MM Ebitda	>$20MM Ebitda
Senior Bank / Mezzanine	9.0%	7.4%	7.2%
ABL / Second Lien	9.0%	8.6%	7.8%
Unitranche	10.8%	9.8%	9.1%
Public High Yield			6.3%

The above chart shows a current representation of the weighted cost of debt in several combinations over different business size categories. The costs presented represent average mixes with floating rates adjusted to fixed rates for a seven-year period.

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Not all of these apples are equal. Allowable leverage is lower for companies under $20MM in EBITDA. Approximate limits are 3.75x EBITDA for companies with less than $10MM EBITDA and 4.75X EBITDA for larger companies approaching $20MM of EBITDA. When companies move above $20MM in EBITDA, leverage can expand to 5.75X.

The public markets remain the cheapest source of leverage if the borrower is large enough and has sufficient borrowing needs,

Ultimately, achievement of the business plan creates the most value. Having access to the required amount of capital structured flexibly to allow room for error trumps cost.

but a combination of senior and junior debt comes close. Unitranche debt appears the most expensive for companies under $20MM in EBITDA but the characteristics are different. Completing the capital structure puzzle is dependent on the unique situation of the borrower and the answer may not fit neatly into the cubbyholes defined herein. When a leveraged capital structure is desired, there are many tools to consider.

Leverage serves to fund growth, fund buyouts, and enhance equity returns. Cost is an important factor, but it is extremely important to match the capital structure and terms to the requirements of the business plan. Ultimately, achievement of the business plan creates the most value. Having access to the required amount of capital structured flexibly to allow room for error trumps cost. **zs**

Private Equity: Part III—Changes in a Maturing Industry

The future of private equity is changing, which is good news for middle market companies.

by Jay Schembs

We conclude our three-part investigation into the private equity industry with a discussion of the future. Part I examined the structure of a typical fund, concluding that short-term horizons often result in a number of incentives and constraints to investments. Part II introduced unintended consequences often encountered in traditional private equity fund structures, including asymmetric payoff structures and excessive costs. Part III of this discussion examines the current and future competitive environment and the evolution of the industry as it matures.

SUPPLY IN EXCESS OF DEMAND

Since the early 2000s, financial liquidity has increased, and is projected to continue increasing for the foreseeable future. For better or worse, capital abundance is here to stay.

Commensurate with this liquidity growth is an unprecedented amount of investor dry powder – amounting to nearly $500 billion of undrawn equity committed to private buyout funds. Further, the number of funds in North America trying to deploy this capital has grown to nearly 2,000 today from less than 1,000 in the year 2000. During the same time, the number and dollar value of investments have remained relatively steady. The differential, accommodated by a lenient credit market, has driven up prices. As current private equity portfolios were liquidated into an attractive market for sellers, investor returns were buoyed, further encouraging the supply side.

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The very forces that rescued recent private equity investments – record low interest rates and plentiful capital – now magnify the two issues that make it more challenging for private equity funds to profit from investments made today. Tepid GDP growth and limited further downside in interest rates suggest that longer holding periods and lower investment returns will be the norm.

THE EMERGENCE OF SHADOW CAPITAL

Institutional investors have spread their wings in recent years, investigating new ways to participate in private equity with the objectives of deploying more capital and enhancing returns. Their methods:

- *Co-investments alongside funds to which they have committed capital.* An example of this practice is when an institutional investor makes an equity commitment to a fund and gains an opportunity (but not requirement) to invest side-by-side for a certain percentage of each deal. Two objectives of this movement are to reduce the fees associated with investment management, by paying fees only on funds employed (rather than commitments), and to gain more direct control into which investments their money is deployed. A variant on this theme has fueled the growth of the fundless sponsor and pledge fund organizations. These entities are similar to traditional private equity funds except they do not have committed capital from limited partners. Fundless sponsors (or pledge funds, as they're also known) maintain handshake agreements with potential equity investors that are formalized for each investment.

The very forces that rescued recent private equity investments—record low interest rates and plentiful capital—now magnify the two issues that make it more challenging for private equity funds to profit from investments made today.

- *Co-sponsorships with private equity funds.* In this case, a specific "partnership" is created for an individual deal in which the institutional investor and the private equity fund are partners in the investment. The objective behind this is to allow the institutional investor to have input on the management of the investment, thereby evolving the traditional relative roles of general partner (GP) and limited partner (LP).
- *Separate accounts exclusive to the investor.* In this arrangement, the fund manager takes on a role more similar to a wealth manager or asset manager, with discounts on prices for services, reducing fees and carry from the traditional "two and twenty" formula. The fund manager accepts these lower prices in exchange for a larger, steadier volume of assets.
- *Direct investing.* In a growing number of cases, investors are recreating the capabilities and processes private equity firms possess by building their own experienced teams, thereby creating direct competition to traditional private equity fund managers.

THE COMPETITIVE RESPONSE

Private equity funds have responded in several ways to address current trends. With the objective of slowing fund turnover ratios, thereby allowing more time allocated to investing rather than fund raising activities, private equity fund managers have undertaken the following changes:

- Strategic relationships with certain investors to secure longer-term commitments outside of the normal fund raising cycle, in exchange for lower fees and carry.
- Extended fund term to 15-25 years, thereby allowing investment in cyclical industries and avoiding liquidation of an investment in a growing company simply because of fund structure.
- Smaller funds with rollover features that allow returns from investments to be reinvested rather than returned to investors.

It is reasonable to expect that further industry responses will emerge to address the unexpected consequences of the traditional fund structure.

A BETTER WAY FORWARD?

Private equity as a general model is a wonderful source of liquidity for business owners, and an important source of capital to support middle market business growth. However, every mature industry morphs as competition drives down prices and returns, and private equity is not immune. The changes and competitive dynamics, in our view, are mostly positive, especially for middle market business owners pursuing a sale or a capital partner.

Higher purchase multiples are a general result of increased competition (more money chasing fewer deals). In addition, sellers have gained sophistication and realized that in most cases a one-off transaction, negotiated directly between a private equity buyer and seller, is not in their best interest. Instead, most private equity groups, whether willingly or not, end up spending more time in competitive auctions that tend to drive higher prices. This condition is unlikely to be reversed.

Every mature industry morphs as competition drives down prices and returns, and private equity in not immune. The changes and competitive dynamics, in our view, are mostly positive, especially for the middle market business pursuing a sale or a capital partner.

A movement towards longer holding periods could have enormous positive benefits.

- Long-term ownership aligns with many selling families / business owners.
- Investors with a long-term orientation can focus more on acquiring and building great businesses, and less on preparing the business for a near-term exit.
- Investors are able to think more like strategic buyers, with less reliance on transaction leverage to generate returns and greater focus on investments anticipated to produce significant long-term payoffs.

A refocus on long-term ownership should help businesses and investors make decisions in the company's long-term best interest, which ultimately is in their best interest as well. **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.**

Frank Buhler
206.224.7383
fbuhler@zacharyscott.com

William Hanneman
206.224.7381
bhanneman@zacharyscott.com

Ray Rezab
206.224.7386
rrezab@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Derrik Larsen
206.838.5527
dlarsen@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Mike Dannenberg
206.838.5531
mdannenberg@zacharyscott.com

David Petrisor
206.838.5529
dpetrisor@zacharyscott.com

Mark Working
206.224.7382
mworking@zacharyscott.com

Zachary Scott
TRUSTED ADVISORS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101