Zachary Scott has published this newsletter since 1997 to bring you a thoughtful analysis of issues affecting middle-market businesses.

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PERSPECTIVES ON THE CAPITAL MARKETS SPRING 2019

INSIGHT

Managing Growth, Part I: What is Good Growth?

How to identify opportunities to achieve value-creating growth.

by Jay Schembs

Expected future growth is arguably the most critical element influencing business value. How much, at what rate, and for how long a business can grow can overwhelm other variables in assessing the future profitability of a company and therefore its current value. Growth is coveted, but sometimes without enough thought given to the incremental operating expenses and capital investments necessary to achieve a higher growth trajectory. In other words, how well can the company's support systems scale to support the forecasted growth?

In this two-part series, we'll take a closer look at 1) what constitutes "good" growth and how to identify opportunities; and 2) tactical steps to take to execute growth initiatives.

PART I: IDENTIFYING VALUE-CREATING GROWTH

The nearly unquestioned belief that "growth is good" permeates public and private markets, with rapidly-growing businesses being valued at higher multiples than slower-growing businesses. But growth is not inherently value-

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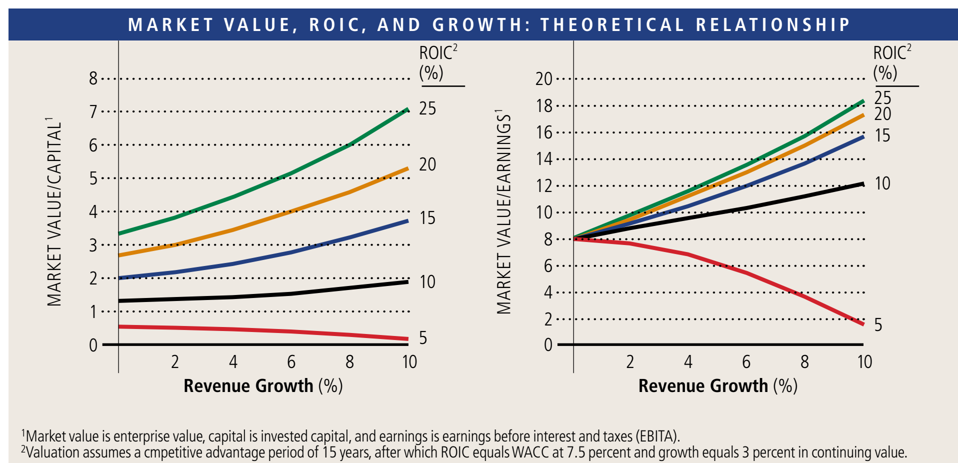
creating, as we've written about before ("Staying Smart About Growth," Winter 2015). How do we know if growth will create value for the business?

In academic terms, "good" growth generates a return on invested capital ("ROIC") in excess of the company's weighted-average cost of capital ("WACC"). The chart to the right illustrates this point, plotting five separate ROICs at varying levels of growth (assuming a 7.5% WACC). For high ROIC businesses, increasing growth rates lead to higher valuations. For the business with an ROIC below its WACC, a higher rate of growth actually yields a lower value. This is because the return on each dollar invested by the company generates a return below what its investors require to offset the riskiness of the investment. In other words, under these conditions, investors should prefer their company to eschew higher growth in favor of returning that capital back to shareholders to seek higher returns elsewhere.

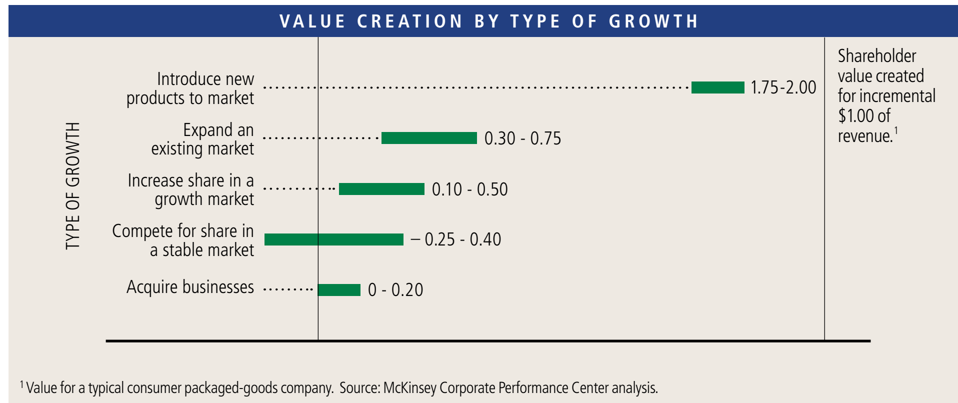
This phenomenon played out for one of our favorite clients, Mikron Industries, a manufacturer and supplier of vinyl window frames. In the 1990s, new laws required homebuilders to use more efficient building materials, including windows. Prior to that, window frames were made of expensive custom wood or more affordable aluminum frames. Vinyl frames made up a very small component of the market. Once vinyl became recognized as offering a higher heat value than other window materials, its market share skyrocketed. Mikron benefitted by adding new products through its existing relationships with window companies. For several years, Mikron's return on its growth

MARKET VALUE, ROIC, AND GROWTH: THEORETICAL RELATIONSHIP



[1]Market value is enterprise value, capital is invested capital, and earnings is earnings before interest and taxes (EBITA).
[2]Valuation assumes a cmpetitive advantage period of 15 years, after which ROIC equals WACC at 7.5 percent and growth equals 3 percent in continuing value.

VALUE CREATION BY TYPE OF GROWTH



[1]Value for a typical consumer packaged-goods company. Source: McKinsey Corporate Performance Center analysis.

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far exceeded its WACC, creating substantial value for the family ownership. However, as vinyl windows' market share reached their logical market position, Mikron's growth slowed to the industry average. Before that occurred, the family chose to exit—a number of strategic buyers had aggressively pursued the company, and the transaction timing resulted in an outcome far above how the company would be valued had the sellers waited for the business to reach its steady state.

The difficulty with applying conceptual tools, like many academic applications to real-world situations, is that no one can perfectly forecast growth rates or incremental ROIC. While useful frameworks help illustrate where pursuit of growth could create value, the only concrete measure of ROIC is historical. Owners and managers must rely on assumptions about the future and assessments of opportunities to come up with the best estimates of expected return.

The trick is to identify growth opportunities so compelling that minor forecast errors are overwhelmed by the magnitude of the value creation. For instance, in the chart on page one, the researchers conclude that introducing new products or expanding an existing market (organic growth) generally produces the most bang for the buck, and are logical places to consider growth strategies. Why is that?

A helpful way to think about ROIC is "incremental value created per incremental cost." In other words, the potential growth opportunity associated with a new product cannot be measured only as a revenue opportunity – instead, it must be measured relative to the costs necessary to fund the opportunity. It is important to note that ranking growth opportunities by value creation is unique to each situation and requires each company to consider its own situation. As an example, the graphic on page one shows the profile of a business where introducing a new product to a market is a relatively low-cost endeavor. The company likely has a history of introducing new products, meaning that the infrastructure to develop, market, and distribute a new product to existing customers is largely a sunk cost. The other growth opportunities featured would each require enough novel development of support infrastructure in order to support an equally-sized revenue opportunity that the ceiling on incremental ROIC for these ventures is lower. It then comes as no surprise that the other growth opportunities listed wouldn't create as much value for this company as would the introduction of new products.

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It can be difficult for an owner to recognize costly growth, because it rarely appears to be costly in the near-term and on the surface. A common example of this in our experience has been the growing consumer goods company that lands a major national or international distribution client (the Costcos, Walmarts, and the like of the world). On the surface, such opportunities appear to be a game-changing win for the company. However, after accounting for the investment to scale operations to satisfy demand and stock the channel, and with the pricing and volume terms that usually accompany the deal, it is not uncommon for the supplying company to find that its growth initiative exposed it to tremendous risk and much less value creation than was initially envisioned. This is not a broad categorization of growth opportunities with large customers, simply a cycle that we've seen play out enough times to establish a pattern.

Once a business owner has identified a robust strategy for productive growth, managing to execute on that opportunity creates its own set of challenges – how does one control the costs that turn "good" growth into "bad"? In part II of this series, we'll examine common pitfalls in high-growth environments, and suggest strategies and tactics that business owners can use to mitigate those challenges. ZS

The Anatomy of a Roll-Up

Common patterns for value creation through consolidation and scale.

by David Working

Whether as a business owner, investor, advisor, or customer, most of us have observed "industry roll-ups" in action. The mechanics are relatively simple: an investor or strategic platform enters a fragmented industry by buying a cornerstone business, then buys several similar businesses in quick succession. Soon, a marketplace of many small businesses is replaced by a larger chain or conglomerate, and the investor has "rolled up" the sector.

While the concept is simple, the rationale for embarking on such a strategy is more nuanced. The common refrain repeated in transaction announcements is a desire for additional "scale," or shorthand for "economies of scale." Scale is often incorrectly used as a synonym for "size," and the difference between the two is material: readers will remember from our discussion about "Staying Smart About Growth" (Winter, 2015) that with special exceptions, size itself is not a value creator – but economies of scale are.

Picture a manufacturing plant running below maximum capacity, or any other system with significant fixed cost and suboptimal utilization – if more volume is run through the system, revenue can grow without an equal climb in cost, increasing profit margin. The margin profile of the system becomes more attractive by growing, so the structure of the business is a "scalable model," and growing it "achieves scale."

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An industry roll-up is one way to achieve scale, one that requires a vision, some knowledge of industry dynamics, and familiarity and comfort with transaction execution. Although any multiple-acquisition model that allows significant cost reduction or revenue growth could be effective, a few patterns have emerged as common playbooks:

- **BUYING A BOOK OF BUSINESS.** In this scenario, a company has the infrastructure to support significantly more business volume, or can add the infrastructure at a low marginal cost. Acquiring customers, however, is slow or expensive. The acquirer buys the target essentially to buy customers, which the acquirer then bolts on and services through its own variable cost infrastructure. This is common in professional services businesses or other people-heavy enterprises, like insurance administration.
- **CONSOLIDATING EXCESS OR HIGHER VARIABLE COST BUSINESSES.** When there is excess capacity and a variable cost differential among industry participants, consolidation eliminates fixed costs and redirects volume to the lowest variable cost. This can occur when a growing market is addressed through new, more efficient capacity—like state-of-the-art manufacturing facilities—thereby creating an advantage for customer acquisition as well as for buying less efficient operations.
- **STREAMLINING VALUE CHAINS.** In this scenario, multiple businesses with similar supply chains or end customers overlap in their service

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of a market segment, and combining allows them to achieve better pricing power either forward or backward in their supply chain. Examples include grocery stores (to consolidate buying pipelines) or health insurance companies (to build power against growing hospital chains).

- **GEOGRAPHIC EFFICIENCY.** Services businesses that have significant geographic overlap – like home services businesses (plumbing, HVAC, contracting, etc.) can find efficiencies in customer coverage, marketing, and labor acquisition by increasing the geographic density of their customer base.
- **BACK-OFFICE CONSOLIDATION.** This is the classic healthcare provider scenario – a group of professionals without a business or administration background who nonetheless encounter significant business and administration problems are acquired by a platform that relieves that burden. IT, payroll, billing, and administrative functions are consolidated at the "parent," redundant systems are retired, and the professionals are freed to concentrate on their specialty – patient care. This is a common model for healthcare specialists, especially those where a primary care referral may not be needed – ophthalmology, dermatology, fertility, dentistry, and others.

In these cases, the value created is as a result of the economies of scale inherent to the business models. Interestingly, there are also industry rollups that have been successful and resulted in significant value creation for their ownership without such scale attributes. These are the exceptions to the rule that size in and of itself does not create value, and are the result of very specific industry or market conditions. While they are not the norm, they are nonetheless worth examination:

- **SERVICING A DIFFERENT CUSTOMER.** Some rollups have created value by adding locations in such a way that allows them to win different services contracts – if those contracts are larger, higher-margin, or longer, then the business has added value even if there is no other operational synergy to acquisitions. An example is in billboards – while the economics of operating thousands of billboards across multiple states are not much different than owning and operating a single billboard, a national presence can win national accounts – which through their relative length and low turnover lowers the maintenance cost and improves utilization of the space.
- **CAPITAL STRUCTURE AND DIVERSIFICATION.** Lenders have size thresholds, and a business with identical profitability attributes but more size, customers, or locations may be seen as less risky as a result of diversification. If a business can get better advance rates or financing terms, real value creation can accrue to equity holders.
- **ATTRACTING A DIFFERENT BUYER GROUP.** Investors, especially in private equity, have size thresholds for making investments that fit in their fund's portfolio. For example, if a firm is operationally-focused, has 2-3 partners, and is investing a $500mm fund, it would be difficult for it to hold more than 8-10 investments in its portfolio at any given time. That creates an effective "investment floor" where writing equity checks under about $30-35mm doesn't make sense for its strategy – even if a potential target is otherwise attractive. There are enough capital sources in the middle market with similar restrictions that growing a business to reach into their purview, and therefore accessing a competitive buyer market, is in and of itself valuable even if there's no additional scale economics realized.

Anyone who may participate in a roll-up —especially a business owner targeted by an acquirer—would be well-served to understand the market dynamics within its industry sector, the investment thesis driving the rationale for the rollup, and the economic contribution of the individual business. The primary driver of value in these strategies is scale, and while an investor should be rewarded both for the vision and execution of completing multiple acquisitions and integrating them, the management team, ownership, and advisors of a roll-up target will be better-positioned to capture value by understanding the value they're playing a part in creating. **zs**

Understanding the Forces in the Leveraged Lending Market

Business Development Companies' impact on middle market valuations.

by Brian Bergsagel

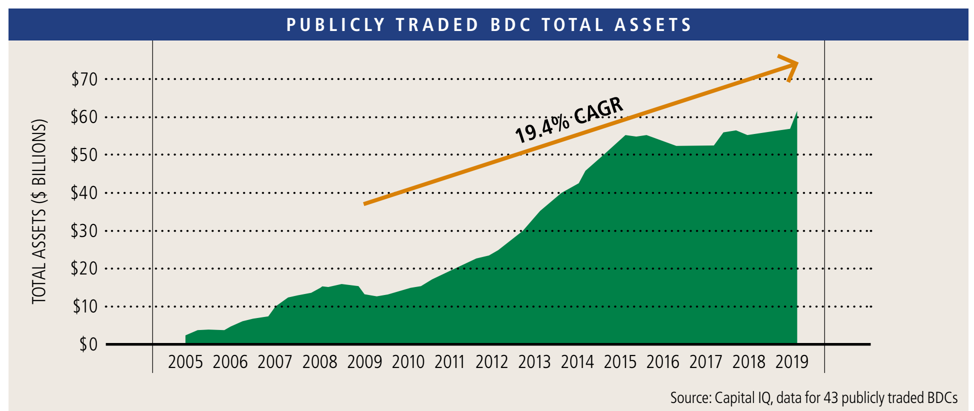
In the Summer 2018 IN$IGHT, "Debt Markets Remain Favorable to Borrowers – For Now", we discussed non-commercial bank sources of capital and, more specifically, Business Development Companies (BDCs). The purpose of focusing our attention on this relatively small capital market is that it represents the source offering the highest leverage to private company acquirers. As we have commented numerous times, higher leverage available to buyers, specifically private equity buyers, applies upward pressure on acquisition prices. The complement is also true. In this article, we dive deeper on BDCs, their influence on the leveraged lending market, and the resulting impact on middle market business valuations.

A common discussion among our clients and partners is centered around business valuations: Will multiples keep going up? Are we approaching the end of the current economic cycle? While no one can predict the future, there are certain market indicators that can give us a glimpse into likely market conditions in the near term. One of these indicators is the value of BDC equity relative to their assets deployed or invested. Analysis of publicly-traded BDCs can give us a view into middle market acquisitions, a market that is otherwise opaque.

BUSINESS DEVELOPMENT COMPANIES

The concept of BDCs was created by Congress in 1980 as an amendment to the Investment Company Act of 1940. In summary, BDCs are companies that invest in and finance small to medium-sized businesses in the United States. BDCs can be viewed as a transparent portfolio of loans giving retail investors access to private investment opportunities, similar in nature to a publicly-traded private equity or venture

PUBLICLY TRADED BDC TOTAL ASSETS



Source: Capital IQ, data for 43 publicly traded BDCs

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capital firm.

BDCs are governed by certain operating and financial restrictions, including requirements to:

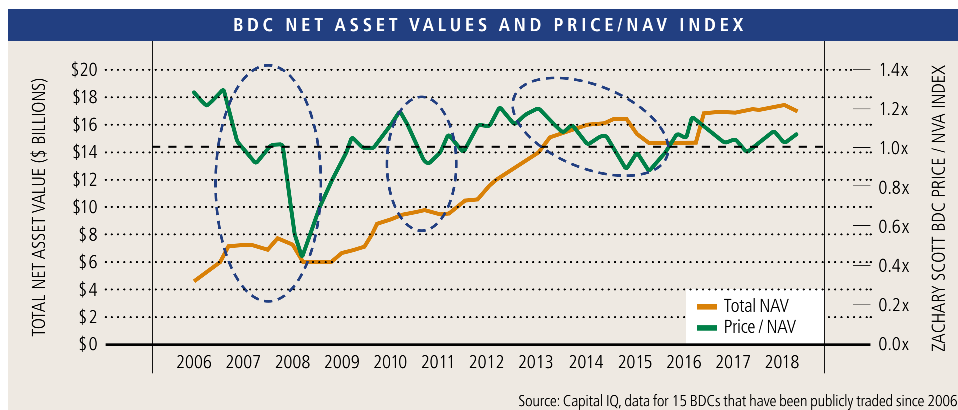
- Invest at least 70% of their assets in private U.S. companies or public U.S. companies with market values less than $250 million.
- Report to shareholders like traditional operating companies, including quarterly and annual reports filed with the SEC.
- Distribute at least 90% of taxable income to shareholders (if registered as a Regulated Investment Company (RIC) with the IRS).
- Maintain maximum leverage of 2:1 total debt to equity, with anything above 1:1 debt to equity requiring shareholder or board approval; phrased differently, BDCs must keep their ratio of total assets to total debt above 1.5:1.0.
- Mark loan portfolios to fair value on a regular basis.

Since 2009, BDCs have exploded as major players in the leveraged lending market, with total BDC assets growing at a compound annual growth rate (CAGR) of more than 19% over that time period. The primary users of BDC financing are buyout private equity funds, who utilize financial leverage to support their transactions and boost equity returns.

A common BDC offering to a private company is a unitranche non-amortizing loan allowing only a small line of credit (usually from a commercial bank) to have a priority claim on assets and cash flow. Currently, this unitranche loan will be issued in an amount of between 4x and 6x EBITDA (depending on size of business) and will carry a price in the range of 8.5-9.0% p.a. Because of the non-amortization feature, a company can often support higher debt than with other debt structures. The growth in the market is an indicator of demand – primarily by buyout firms seeking to push the leverage level on their transactions as far as possible. Private equity buyers are typically willing to pay more for a business when more leverage is available. As such, the rise in BDC assets since 2009 has corresponded with a strong rise in overall middle market private equity valuations. Although buyout multiples are a function of many factors, leverage is one and the absence of leverage dampens the prices private equity buyers will pay.

BDC VALUATIONS

Since many BDCs are publicly traded and by regulation have to continually update their investors with their performance, when BDC portfolios have problems, the market reduces the value of the loans it holds. The common metrics used to assess the health of a BDC are its Price to Net Asset Value (NAV) per share and its Debt to Equity. When a BDC's Price/NAV ratio dips below 1:1, it is an indicator that the market views its loans as not being worth what they have been booked at on the BDC balance sheet. When its Debt to Equity climbs above 2.0, it is restricted from borrowing more. Either metric is an indicator that the BDC is



Source: Capital IQ, data for 15 BDCs that have been publicly traded since 2006

having troubles with its ability to continue its current lending practices.

Several times over the past 10+ years, the market has anticipated declines in NAV before those declines are apparent on the financial statements on the BDCs – in the graph above, this manifests itself as a decline in Price/NAV just before a decline in Total NAV. Such events occurred in the year leading up to the start of the "Great Recession," and again in 2011 and 2013-2015. These were indications that investors had grown skeptical of the underlying credit quality of BDC portfolios, which then reflected in the trading price. Since 2011, the swings have not been as sharp, and BDCs have generally hovered around the 1:1 Price/NAV ratio we would expect in a stable or growing market. Today, in aggregate, public BDCs are borrowing at a rate of 0.8:1.0 Debt/Equity, leaving substantial room for additional borrowing and subsequent lending before reaching the 2:1 regulatory limit.

The market for private capital remains extremely competitive, with more and more capital chasing fewer and fewer opportunities. In our discussions with BDCs, they have indicated a pressing need to deploy available capital and an increasing willingness to take on additional risk. BDCs have been forced to become less selective on which opportunities they pursue, while also reducing pricing and relaxing covenant restrictions. Given the continued pressure to deploy capital, and the availability of additional capital through both debt and equity, we expect to see continued pricing pressure on this segment of the capital markets.

CONCLUSION

Business values have been high from an historical perspective for the last three years. As with any trend that cannot continue forever, we think it is important to understand the drivers of those valuations and, where possible, monitor those drivers for indications of what may lie ahead.

We have always maintained that one of the important drivers to business prices is the abundant availability of cheap credit to fund transactions. While not a sole predictor of things to come, BDC performance is an important indicator of where the market is headed as it relates to credit availability. Given the current market perception of BDC portfolio health, availability of additional leverage within BDCs and their continued appetite to deploy capital, it appears that private equity investors will continue to be armed with substantial cheap capital, which will play its part in maintaining high valuations. **ZS**

ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions through three service lines: sell-side M&A, acquisition and investment advice, and direct investing. For more information on Zachary Scott, go to **ZacharyScott.com.**

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