Reaching and managing a higher level of leverage

At a recent ACT seminar in Birmingham, Trevor Harrison of Fortis Bank outlined funding trends, particularly among smaller manufacturing companies.

Anyone with even a passing interest in the quoted company sector will appreciate that manufacturing companies are not exactly the flavour of the month. Looking at some old economy industries (see *Figure 1*), we see some disappointing price earnings (P/E) multiples. For example, the steel and other metals sector is registering 'infinite', in that there are no earnings to multiply!

The lack of interest in manufacturing is a source of much frustration and many management teams feel that the stock market does not fully understand the intrinsic value of manufacturing companies.

FIGURE 1

Actuaries shares indices
FTSE as at 17 January 2001

Old economy	*P/E*	*New economy*	*P/E*
Engineering & machinery	9.30	**Information technology**	65.78
Steel & other metals	*	**Software/computer services**	80**
Packaging	10.65	**Telecommunication services**	78.03
Chemicals	13.79		
Construction	11.20		

* Value as negative ** P/E ratios greater than 80 are not shown

Does size matter?

Until recently, it has been felt that size matters, and in industries that are subject to globalisation you need to be big to compete. So in the past we have noticed a disparity between the P/E multiples of the larger and the smaller public companies in the manufacturing sector.

Worryingly this now no longer applies to many larger old economy public companies which are now also trading on dismal P/E multiples. The implication of this new feature is that the stock market is not expecting sufficient earnings growth even in these companies.

Many may feel that this is an incorrect assessment, but we should bear in mind that the past is not necessarily a good predictor of the future. It is interesting to refer the top 30 FTSE firms in 1935, which includes such well known names as the Bolsover Colliery, Finns, Spinners & Dublers and Pinchen Johnson & Associates!

Despite the recent stock market correction, for new economy companies, there remains an appetite for public equity. Now we find ourselves at the opposite end of the spectrum to the old economy industries, and the FT in some instances is unable to record P/E ratios greater than 80 (see *Figure 1*). We should bear in mind, though, that these astronomically high P/Es are but a function of the future earnings expectations of the companies concerned, and so being a treasurer of a new economy company is not necessarily any less stressful than being a corporate treasurer of an old economy company!

The choices facing 'old economy' companies may seem bleak. The markets in which they operate are globalising and logically they feel that in order to survive they need to grow, and to grow fast. They are faced with the dilemma of financing this growth in the absence of attractive public equity and the management team want to keep gearing low – the latter is considered by many companies to be a 'good thing', a low risk strategy and what the shareholders expect of them.

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However, is the result of the above strategy an inevitability of a corporate take-over either by a larger company, or by a company with a management team that is less risk-averse than yours with respect to gearing?

Going private

It is hardly surprising that many companies in the publicly-quoted sector have either gone private or are seriously considering the prospect. A public-to-private process will invariably involve a switch in the source of financing from public equity and traditional bank finance to private equity and highly leveraged acquisition debt.

The management teams of the companies concerned, of course, will often have no experience in managing the increased financial risks associated with high leverage.

The growth in the private equity market has been phenomenal, with enormous funds being raised primarily to fund public-to-private transactions and management buyouts (MBO) and management buy-ins (MBI). From 1 January to 30 September 2000, there were 132 MBOs of more than £10m, worth £15.47bn.

Case study

As an example of the pitfalls of excessively leveraging a company, we should consider a quality, profitable company, ACE Co Ltd, turning over £100m, which is seeking to raise £50m of debt to finance its MBO. The covenants that have been set are fairly typical for such a situation: interest cover of 3x, debt not to exceed 4x EBIT and what our acquisition financiers call, the 'golden covenant' debt service of at least 1:1.

ACE achieves a healthy 35% gross margin, paying interest at 7% on its £50m and is comfortably complying with its bank covenants. Interest cover being achieved is 4.3x, debt comprising 2.9x EBIT and looking at the cash flow statement we see debt service of 1.13:1 (Scenario 1 below).

Sensitivity analysis

The company has performed sensitivity analysis and thought about what will happen if, for instance, interest rates increase by 2%. So here we carry out a fairly straightforward sensitivity analysis increasing the interest rates on the debt payable from 7% to 9%. On the face of it the structure seems robust with interest cover reducing from 4.3x to 3.3x, debt to EBIT stays the same and cash flow is still satisfied, albeit less healthily than in the past at 1.07:1 (Scenario 2).

This is the type of analysis that frequently passes our desk! We should, of course, recognise that an increase in interest rates of 2% is not just going to affect the interest line. It is almost certainly going to have a profound effect on the top line, and it is this economic exposure which crude forms of sensitivity analysis often tend to overlook.

Scenario 3 below demonstrates the implications of a modest decline in turnover by 3% and a decline in gross margin from 35% to 32% – something that would surely not be considered to be unrealistic for many industries suffering from a 2% rise in interest rates. We can imagine the atmosphere in the boardroom as the implications filter through and it is recognised that a structure initially considered to be conservative, enjoying sufficient headroom, is in fact vulnerable to fairly small changes in some of the underlying variables. So in this example, we see that the company is breaching its interest cover covenant. It is just satisfying its debt-to-EBIT covenant and fails to achieve its debt service covenant by quite a margin.

Responses

We now need to consider the response of the various financial parties. Under these circumstances, a bank is at liberty to put all of its committed loans on demand. Whether it will actually do so is clearly down to its understanding of the finances of the company at the time and the faith it places in the management. In the early months post completion it is rarely in the bank's interest to put the company under : these deals are rarely asset backed and such a course of action would result in significant loss to the bank. There is, of course, another party that has a lot more to lose, namely the private equity house. If you choose your bank carefully, making sure it understands the business and is experienced in handling high leverage, it is not likely to be the bank in the first instance that causes draconian action to be taken. It is far more likely to be the private equity house that is most exposed and again it is important to make sure you choose your financial partner with care with the objective of ensuring that the private equity house will work with the management team in a variety of different market conditions to protect the value of everyone's investments. ■

FIGURE 2

Ace Co. Ltd

	Scenario 1 £m	Scenario 2 £m	Scenario 3 £m
Profit & Loss			
Gross profit	35	35	31
Fixed costs	20	20	20
EBIT	15	15	11
Interest payable	3.5	4.5	4.5
Profit before tax	**11.5**	**10.5**	**6.5**
Tax (30%) and dividends (£1.5m)	5.0	4.5	3.5
Retained earnings	**6.5**	**6.0**	**3.0**
Cashflow			
Net cash from operations	17.0	17.0	13.0
(EBIT: £15m + £2m depreciation)			
Taxation	3.5	3.0	2.0
	13.5	**14.0**	**11.0**
Financing costs			
Senior debt repayment	7.0	7.0	7.0
Interest payment	3.5	4.5	4.5
Dividend payment	1.5	1.5	1.5
	12.0	**13.0**	**13.0**
Debt service: Covenant	1:1	1:1	1:1
Out-turn	1.13:1	1.07:1	0.84
	(13.5/12.0)	*(14.0/13.0)*	*(11.0/13.0)*

Scenario 1 - *Turnover £100m, 35% gross margin, 7% interest rate*
Scenario 2 - *Turnover £100m, 35% gross margin, 9% interest rate*
Scenario 3 - *Turnover £97m, 32% gross margin, 9% interest rate*

Covenants	Required	Out-turn
Scenario 1		
Interest cover	3x min.	4.3 (15/3.5)
Debt:EBIT	4x max.	2.9 ((50-7)/15)
Scenario 2		
Interest cover	3x min.	3.3 (15/4.5)
Debt:EBIT	4x max.	2.9 ((50-7)/15)
Scenario 3		
Interest cover	3x min.	2.4 (11/4.5)
Debt:EBIT	4x max.	3.9 ((50-7)/11))

Invariably, the private equity house will want to take control of the company and will not be interested in, say, taking a minority stake in a mid-cap public company. In this respect, it must be frustrating to the management teams of long-established and profitable public firms that the management teams of their subsidiaries wishing to effect a management buyout are often more able to raise external finance than the parent!

Accommodating a higher level of leverage

The growing importance of the private equity houses in corporate ownership across all sectors has had a profound effect on the appetite for debt and leverage. It is generally the case that the private equity house will be far less risk-averse towards accepting high leverage than the previous owners. Moreover, the private equity houses have been increasing their own appetite towards higher levels of leverage in corporate structures. For example, while debt only funded 35% of the average consideration of MBOs in 1993, debt is currently funding on average 55% of the consideration.

High leverage has become the norm for MBOs and public-to-private transactions and many independent private and publicly-quoted companies are starting to follow suit. They have significantly leveraged up their balance sheets to finance the acquisitions and the capital expenditure that they believe are necessary to enable their companies to compete in the global market.

In most cases, the reaction of public company shareholders has been surprisingly sympathetic, and there are a number of publicly-quoted companies in traditional industries that have come to live with leverage which, a number of years ago, would have been considered by them to be excessive. However, the management teams have displayed an ability to live with and manage the increased risks, the return available to the shareholders has correspondingly increased, and consequently the stock market multiples have responded favourably.

So perhaps there are new financial avenues available for companies operating in the old economy. It is particularly comforting to note that some fund managers are prepared to take a serious interest in good management teams actively taking measures to deliver shareholder value despite being labelled 'old economy' stocks.

How much leverage can the business take?

The view strongly held by Fortis's acquisition finance teams is that businesses with a good track record of profitable and cash-generative trading are in a good position to borrow to finance these activities. It is essential, however, to recognise that historic cash generation needs to be demonstrated to be sustainable in the future. Growth plans which relate, for instance, to new activities for which there is no historic track record are more appropriately funded by the equity market.

The key requirement is **CASH**, with banks now recognising its importance in all of their lending activities. As a result, less emphasis is now being placed on 'net worth' and 'gearing' when evaluating borrowing opportunities, as bankers start to recognise that companies do not fail because their gearing is too high or their net worth inadequate – they fail because they run out of cash!

The structuring of a banking facility will invariably try to be sympathetic to a company's cash generation ability. For this reason, the three most important covenants that banks are now placing reliance upon are:

- **interest cover**, which has been around for many years, but is considered to have far more correlation to a company's cash generation ability than, say, gearing or net worth;
- **debt-to-EBIT**, which relates a company's debt quantum to its earnings before financing costs and is again considered to be an appropriate test of debt financing capacity; and importantly,
- **debt service**, which compares a company's total financing obligations, including principal repayments, with cash generated before external financing costs. Simply, a company should not borrow more than it can service.

At this stage you may be thinking 'let's tear up the history book of banking and leverage ourselves to the hilt'. But, as the example in the attached case study shows, there may be pitfalls in doing that.

Falling foul of the business plan

Having worked through the example, you may not be surprised to learn that a very high percentage – we estimate up to 50% – of highly leveraged structures fall foul of their business plan in one way or another in the early years post completion.

Having suggested the possibility of tearing up some of the traditional values towards high leverage, we now come full circle, back to page one of the chapter in the economics textbook on financial risk: highly leveraged companies really are far more vulnerable!

Taking a balanced view

So the message should be to take a balanced view. Banks are now looking at companies and their underlying cash streams differently. In some cases, it is appropriate for companies and their management teams to realise their ambitions by leveraging up.

In doing so, though, it is important to take a realistic view of the risks, incorporate these into the forecasts and ensure that the headroom is sufficient to accommodate modest underperformance and some of the things that life has a habit of throwing at us from unexpected quarters.

Make sure the maturity profile is not over-challenging and, as far as possible, consider mitigating some of the risks such as the interest burden by taking out the appropriate form of cover.

Finally, agree covenants at a realistic level and make sure that you enter into partnerships with institutions and banks which genuinely understand your business, are going to be attentive, sympathetic and reasonable in supporting your management of the company in the future. ■

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