WILL DEAL MULTIPLES FALL AS DEBT DOES A DEJA VU?

Remember the run-up to the global recession when lenders were tripping over themselves to get in on a mergers and acquisitions climate that was positively giddy?

When debt capacity, typically expressed as a multiple of a company's earnings before interest, taxes, depreciation, and amortization, reached milestone levels, eclipsing the "6X barrier" (as coined by PitchBook)?

When the term "covenant-lite," describing loan agreements with fewer protective covenants for the buyer and less restrictions for borrowers, became a thing?

When, flush with borrowing capacity, in order to secure the most attractive acquisition candidates, private equity pushed average purchase price multiples to almost ten times EBITDA?

And when, ultimately, faster than you could say collateralized debt obligation, it all came tumbling down?

Well, it's beginning to look a lot like 2008 again.

Let's examine the data, courtesy of the PitchBook Platform.

The chart below represents trends in the median purchase price multiples of private equity sponsored deals, broken down by the proportion of the multiple attributable to debt and equity.

So, if we look at the last year's data, the median purchase price multiple was 11.6x earnings before interest, taxes, depreciation, and amortization. Moreover, funding from debt and equity was 6.2x and 5.3x respectively.

While not quite a record, since purchase price multiples crashed in 2009, valuations have more or less been climbing steadily, approaching the pre-market crash peak. Although slightly less pronounced, the same can be said for debt capacity expressed as a multiple of EBITDA.

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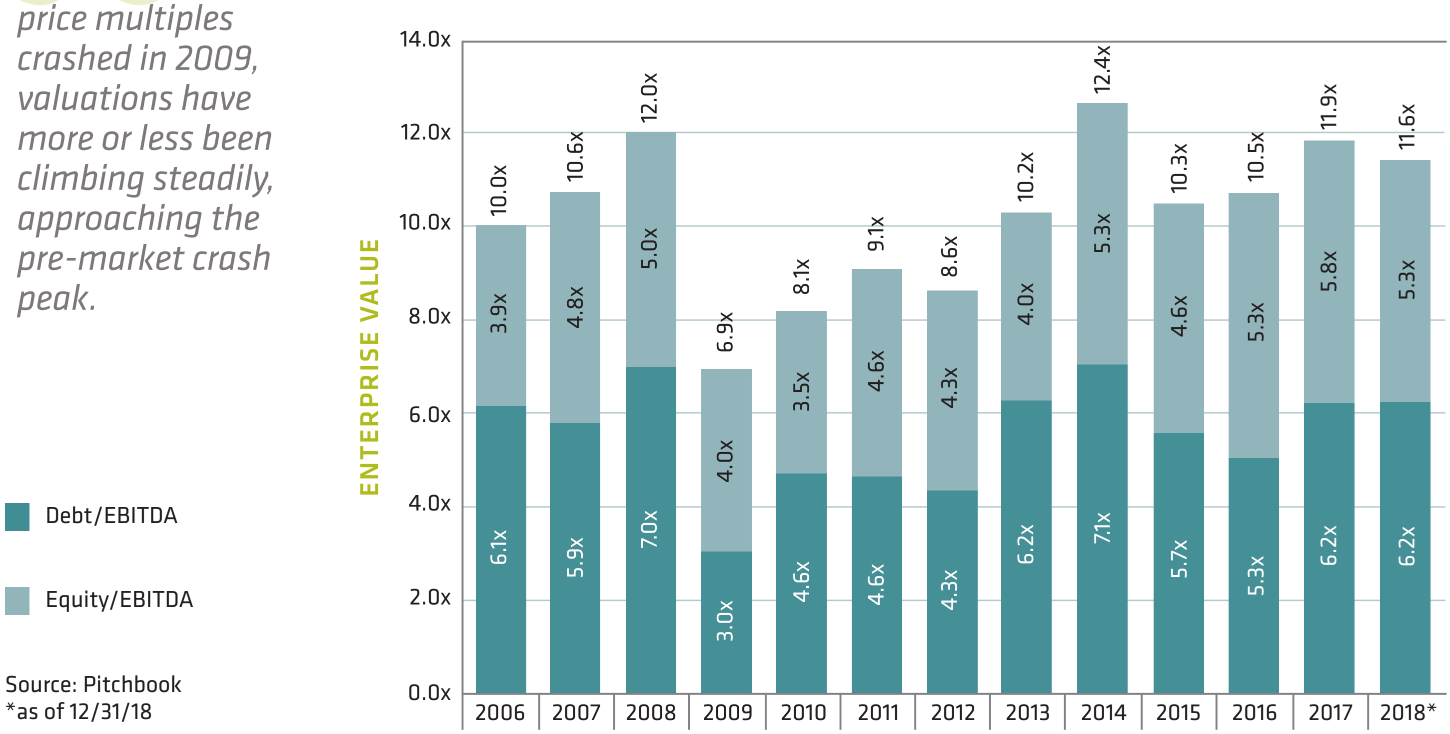
Private Equity Buyout Multiples by Debt and Equity: Median



Source: Pitchbook
*as of 12/31/18

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According to an article published by Weil, Gotshal & Manges, in a hyper-competitive deal climate that has once again goosed purchase price multiples,

> 2018 *"…saw a rise in leverage levels and the number of covenant-lite loans in the market. 73% of all buyout financings were leveraged at or above 6.0x and 41% were leveraged at or above 7.0x, which is the highest level seen since 2007. In addition, over 79% of institutional new issuance in 2018 was covenant-lite."*

But here's the kicker.

As much as lenders have pushed the upper limits of debt capacity, it's actually more than what these statistics suggest.

> *Overly aggressive proforma adjust-ments [to EBITDA] … are effectively adding 'a full turn or more in the total amount of leverage that supports a given transaction.'*

In an excellent piece published by valuation firm Murray Devine entitled *"Mathematical Sophistry: Aggressive EBITDA Adjust-ments Raise Concerns Among Creditors,"* they discuss how "inflated" EBITDA calculations based upon a mix of overly aggressive historical and proforma adjustments have crept into debt capacity assumptions, effectively adding "a full turn or more in the total amount of leverage that supports a given transaction."

In many cases, then, loans extended at 5-7x EBITDA are really leveraged at a whopping 6-8 times, substantially increasing the risk of default.

They go on to say, "Today, egregious behavior is taking on other, less obvious forms. Covenant-lite loans, for instance, seem to be trending ever 'lighter,' while moving higher in the capital structure as senior stretch financing blurs the lines of subordination."[1]

> *In many cases, then, loans extended at 5-7x EBITDA are really leveraged at a whopping 6-8 times, substantially increasing the risk of default.*

To some degree, such credit terms have been justified by a rising economy and growth expectations tied to the Trump corporate tax cuts.

Perhaps.

But get a lender alone in a room with two fingers of Johnny Walker Black, you may well hear some version of, "If we don't offer such generous terms, we'll lose the deal to someone else. And if management executes on its vision and the markets continue as they are, we should be OK."

And it will be (OK, that is).

If the assumptions and variables in the financial models play out just so.

Which, you know, in a health care environment that often relies on third party billing, are about as rock solid as Jell-O.

> *Will buyers, particularly private equity sponsors, be forced to reign in purchase price multiples?*

So, are we on the precipice of another market correction?

And, absent "cheap" debt (and the boost to returns that can be "manufactured" through leverage) will buyers, particularly private equity sponsors, be forced to reign in purchase price multiples?

Time will tell.

But you know what they say about history.

It has an uncanny way of repeating itself.

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[1]As *CrowdStreet* explains, each capital source has seniority over all capital sources located above it in what is often referred to as the "capital stack." Said another way, each capital source is **subordinate** to all capital sources located below it in the capital stack. So, the higher a lender is in the capital structure, the riskier the loan.