WHAT TO EXPECT WHEN EXPECTING A RECESSION

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With economists predicting an economic slowdown in 2020 and a recession perhaps as soon as 2021, how will valuations and EBITDA (earnings before interest, taxes, depreciation, and amortization) multiples fare? While it is difficult to get meaningful data specifically on distressed sale transactions, turnaround professionals can review key measures from the past 20 years in core industries to determine how sale prices may be affected if, and when, the economy slows.

Reviewing data from the last two recessions demonstrates the difficulties presented in predicting the impact on values caused by a still nebulous future recession. After all, no two recessions are exactly the same and as investment bankers' disclaimers state: "Past performance is not necessarily an indicator of future performance."

The conditions that caused the tech bubble in 2001 and the financial crisis of 2007-2008 were quite different and won't be precisely replicated in 2020, but by examining the unique economic factors percolating in today's economy in conjunction with past EBITDA multiples, investment bankers and turnaround professionals can predict approximate value drops in various segments of the economy. Considering these figures in the context of the factors that drove recessionary action in 2001 and 2008 and then isolating key factors that will likely inform an upcoming slowdown reveal hints of what's to come.

A review of CapIQ and GF Data comparable sales data from public and private mergers and acquisition transactions from four core industries—automotive, metals, plastics, and distribution—does demonstrate price dips during the last two recessions but does not reveal the strict correlation between recession and multiples one might expect to find. The data included both public and private company transactions and only included transaction types listed as mergers and acquisitions, which excluded bankruptcies, private placements, and other situations.

But an EBITDA/EV (enterprise value) analysis using Pitchbook data on equity-sponsored M&A transactions with enterprise values ranging from $10 million to $250 million reveals a clearer story (**Figure 1**, page 26).

While values outside of the dot-coms weren't high in 2000, they still fell in 2001 and 2002, during the tech bubble recession. More telling is when multiples were high in 2008, as they are today, they fell sharply in 2009.

Before that Great Recession, low interest rates and the relative ease of raising capital elevated prices. As is visible in **Figure 2**, page 26, the thin spread between Moody's Seasoned Baa Corporate Bond Yields relative to low-risk 10-Year Treasury Yields, in addition to the low interest rates between 2004 and 2006, pushed multiples to a peak in 2008. As interest rates crept up and spreads widened, the recession hit and median private equity transaction multiples dropped from 12 to 6.9 times EBITDA, a 42.5% collapse.

With easy access to debt, low interest rates, and historic amounts of dry powder in private equity arsenals, the current economic cycle has seen valuations skyrocket, even in smaller deals. It won't continue, particularly for companies that are either below the radar of private equity sponsors or are too distressed to get sponsors' attention. The factors that will drive valuations lower in the next recession include the inevitable tightening of credit and corresponding rise of historically low interest rates; a population reaching retirement age in unprecedented numbers, which will result in more sellers and fewer buyers; and the current, historically high valuations that mirror the 2008 bubble.

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FIGURE 1: MEDIAN PE MULTIPLES EV/EBITDA VS EQUITY/EBITDA VS DEBT/EBITDA

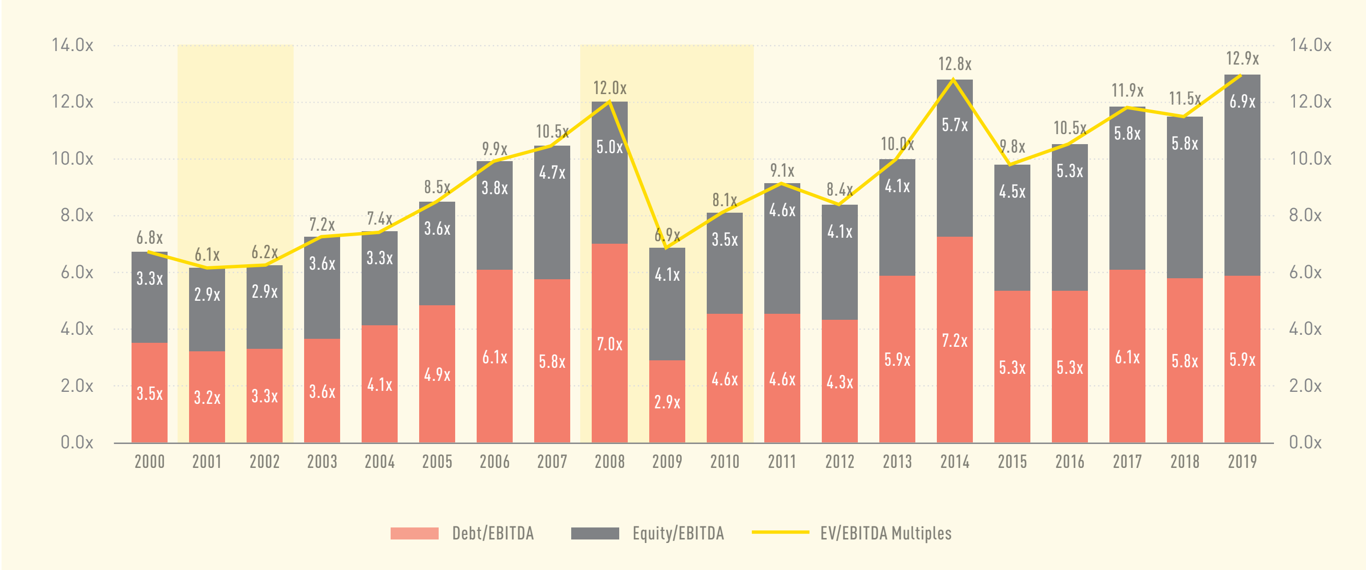
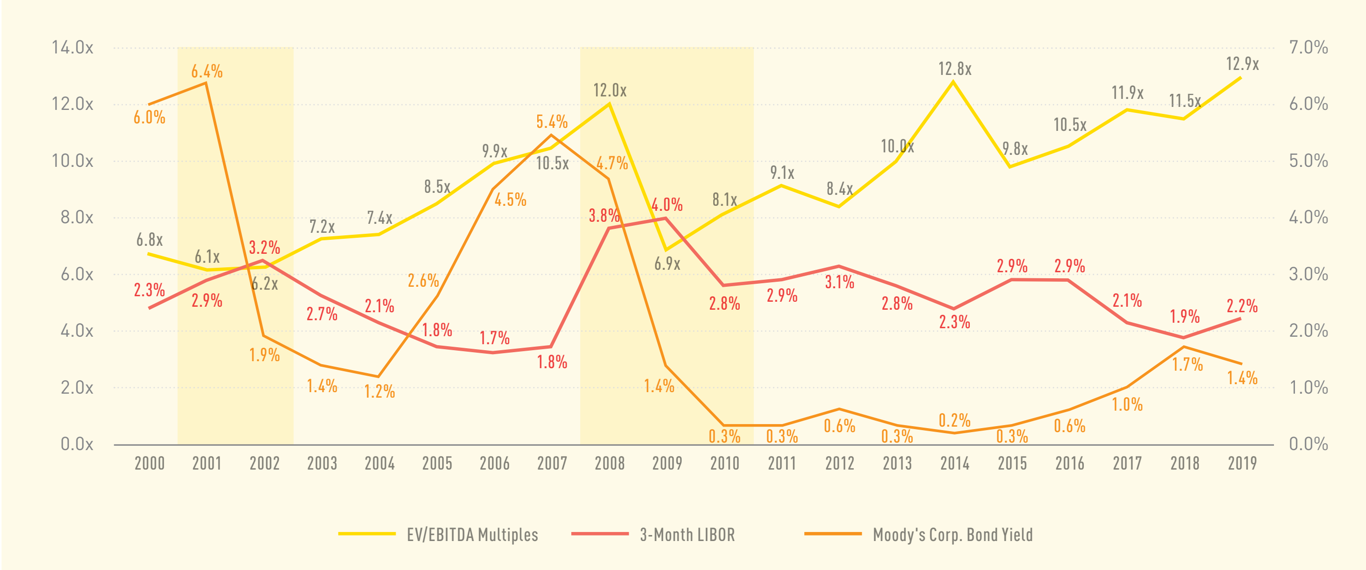


FIGURE 2: MEDIAN PE EV/EBITDA VS LIBOR VS MOODY'S CORPORATE BOND YIELD



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Companies too small to turn private equity groups' heads will have a harder time finding buyers, and even bigger companies will feel a value squeeze. As private equity buyers rely heavily on debt to enhance their internal rates of return, a reduction in the available debt-to-equity ratio will proportionately lower the price a sponsor can pay.

These factors will likely cause a pronounced percentage drop in valuations that will be more statistically significant than they were in the 2001 slowdown and more akin to the drops seen in 2009.

Price Drops and the Availability of Capital

One mitigating factor in the current paradigm is the availability of funding from the prodigious number of hedge funds and other non-bank lenders that have appeared since the Great Recession. The recession of 2007-2009 was unique in that it was characterized by a complete lack of liquidity in the market. Companies could not finance their way out of trouble, and buyers couldn't finance acquisitions. In fact, prices for troubled companies didn't drop as low as they could have in the last recession because banks were often forced to be patient with their workouts, knowing investors couldn't access capital to finance acquisitions.

While a lack of liquidity won't factor into this recession as significantly, valuations will likely still see drops on a similar scale. That's because the liquidity that will make it easier to find buyers this time around will be expensive; a non-bank lender is going to have a bigger yield spread and that is going to impact what buyers can pay, contributing to reduced prices.

Automotive

The Federal Reserve reported a 7.1% drop in auto production in 2019, but this was in part the result of the auto workers' strike, an issue independent of outside economic indicators. Despite a slump in the past two years due to labor and supply chain complications, the automotive industry's output has consistently topped 17 million vehicles per year since 2014.

Has the high production of automobiles in the last few years become the new normal, or will production plummet in the same way it did during the last recession? Between 2007 and 2009, vehicle production fell from 15.43 million to 8.76 million. If the latter happens, failing suppliers will flood the market, potentially leading to lower valuations and more difficulty selling.

The headwinds in the automotive industry are different this time, so this author doesn't believe it will play out quite that way. High oil prices ($160+ per barrel in 2008) preceded the last recession, which exacerbated problems for an automotive industry that had anchored its sales strategies on large SUVs. That is not the case in this cycle; even after oil prices surged to seven-month highs on January 3 on fears of supply disruptions after the U.S. killed Iran's top military commander in an airstrike, oil was trading at a relative bargain of $70 per barrel (and was back to below $60 within three days).

After the auto bankruptcies of the last recession, the original equipment manufacturing supply base thinned out in response. This reduced number of suppliers, plus a lack of capital investment into new equipment, means the industry has less capacity and is using older equipment. When equipment breaks down, it takes longer to repair, reducing productivity. When the OEMs are forced to re-source work on certain auto parts, it can be difficult to find the right presses with enough time available to run production parts.

Despite the certain speed bumps ahead for OEMs—ranging from a stumbling Chinese market and trade issues to the popularity of ride-hailing and the rise of electric vehicles—the aluminum mills and parts manufacturers that supply automakers do not have excess capacity. Therefore, when weaker suppliers do get into trouble in this recession, there should be buyers interested in acquiring their contracts and capacities. While there will be trouble in automotive, transaction values may not fall as far as one might expect.

Don't Wait it Out

According to a recent *Wall Street Journal* economic survey, 65.3% of private-sector forecasters said manufacturing was already in recession. Furthermore, in October 2019, the Institute of Supply Management's Purchasing Manager's Index sank to its lowest level since June 2009. Many believe manufacturing in metals and plastics is leading the slide into the next recession, and values are already beginning to slip.

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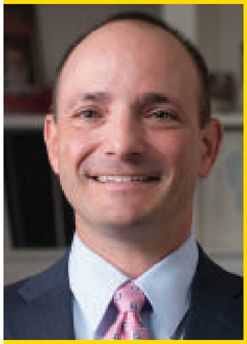
Data from previous recessions shows the pain for business owners is not likely to end when the recession officially ends. The available data provides no empirical evidence to support a strategy of waiting for a recession to end before selling. In most industries, prices remained relatively high at the start of a recession, then dropped mid-recession, and the end of the recession did not trigger an immediate pickup in prices. With the possible exception of non-distressed plastic industry transactions, prices fell further or stayed flat shortly after the last two recessions. Unless a business can survive three years without incurring further diminution of underlying value, waiting for a better day is a flawed strategy.

For all businesses, value is driven primarily by a calculus of cash flow and risk. For troubled companies, which by definition carry risk and lack cash flow, competition among suitors is a critical driver of value. While troubled companies often don't sell based on cash flow multiples—anything multiplied by zero is zero, after all—the up-and-down value trends that apply to healthy transactions apply proportionately to troubled companies. Turnaround professionals and M&A advisors for distressed companies should anticipate that prices will fall 20-40% from 2019 values during the coming recession, whenever that may be, just as they will in the healthy transactions that do trade on multiples.

While industry averages and medians can paint a general picture of what a business should sell for, business owners and their creditors want to be sure they land on the right side of the value bell curve for their industry, and that can be more difficult in choppier economic waters with strong demographic headwinds. To exit gracefully during this looming recession, management needs to head into 2020 aligned with experts who know how to improve cash flow and reduce risk as much as possible and who can quickly identify the right buyers and guide businesses through a competitive bidding process when a sale becomes the best solution. J



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