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It's Not About The Multiple

As I travel around the country speaking at conferences, visiting clients, or just seeing friends at cocktail parties, I'm always being asked: "How much debt can my company get? What's the leverage multiple? My friend just got total debt of 4.5x for his company, so why shouldn't I?"

Borrowers often think knowing the "multiple," the ratio of total debt divided by a company's trailing twelve month earnings before interest, taxes, depreciation and amortization (EBITDA), is the magical answer to all their woes. If they just knew what multiples lenders were providing today, they could easily figure out how much money they could borrow for that next acquisition, capital expenditure, or even complete a dividend recap.

Unfortunately, it's not that easy.

In fact, in today's financing markets, we are seeing a wider standard deviation of leverage multiples than ever before. While we are arranging loans for our clients, and seeing others raise debt at 4.0–4.5x EBITDA, we are also placing, and seeing, just as many financings at 3.5x. So why the big difference and how can you tell what your company's borrowing capacity really is?

The answer: It's not about the leverage multiple but all about a company's enterprise value. Yes, it's the value of the company (debt plus equity value) that really determines a company's borrowing capacity, not the leverage multiple.

Lenders have always relied on having equity below them. Although they look to collateral and a company's cash flow to service their debt, they know that, in a crunch, if they need to sell the company, there is sufficient value above and beyond their debt, which will enable them to come out whole. This is particularly true in acquisitions where a sponsor is providing a substantial amount of cash equity below their debt.

In today's environment, lenders are looking for a minimum of 40% equity below them. In other words, lenders want to know that they have a 40% cushion in case

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all their analysis is wrong and they need to liquidate the company in order to get repaid. So, if your company has the profile that results in an 8.0x enterprise value, there is a good chance you'll get total debt of 4.0–4.5x EBITDA, still leaving the lender with a 3.5–4.0x EBITDA, or 40-50%, cushion. However, if your company is really worth only 5.0–6.0x, EBITDA, don't expect to get much more than 3.0-3.5x leverage.

Obviously, there are many more factors that go in to determining how much money a company can borrow, including its growth prospects, barriers to entry, sustainability of earnings, capital expenditures and working capital requirements, to name a few.

But next time you sit and ponder how much debt your company can get, first determine what its enterprise value is. After that, it's simple.

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