



Back for good?

Jon Moulton welcomes a degree of inflation – explaining how it can be a friend to dealmakers, not an enemy

Between 1981 and 1985, I worked for Citicorp Venture Capital in London. Our buy-out portfolio returned a more-than-reasonable internal rate of return (IRR) of 118%. We weren't geniuses and inflation was one of our greatest helpers. As usual, I might sound a little contrary here, but with a bit of luck, it's back again.

Back in 1982, the year started with UK inflation at 12%. Base rates at the banks, which of course were the only lenders then, rose to 14%. Today, we have 5% inflation and 0.25% base rates.

Now for something unusual: some quantitative corporate finance calculations. If we go back to 1982 and buy an imaginary business that's completely steady in real terms, its enterprise value (EV) would therefore be reasonably expected to rise at an inflationary rate. So, buy in 1982 and sell in 1987 – the EV would be expected to rise at 12% compound – and £10m would rise to £17.6m.

Getting 75% (£7.5m) of the purchase price in debt wouldn't have been unreasonable. If all you achieved was paying five years' interest, with no cash accumulated nor debt repaid, the £2.5m you put into equity will have grown in value to £10.1m on a sale in five years – a 4x return and an IRR of 32%.

Often, you could get more leverage, so returns were even better. In addition, vendors back then were far more naïve and less frequently advised by corporate finance professionals, so we could buy cheaply, with no auction processes. The opportunity to sell more cleverly was helped along by a roughly tripling stock market between 1982 and 1987, a recovering economy, very friendly tax regimes and falling interest rates – this all added up to a great time to be in LBOs.

Leverage limits

Back then, the customary limit on leverage was annual interest to be covered twice by annual earnings before interest, taxes, depreciation and amortisation (EBITDA). The huge difference today is that with very low interest rates, this would imply that huge amounts of debt could be used in capital structures. Currently, lenders are prepared to provide a high level of debt, but not as much as

the low interest rates might imply. It would simply be far too risky at very high levels.

If you believe that today you could buy a completely steady company with a debt equity ratio of 5:1, then interest might be taking a third of EBITDA. This would mean that there would usually be cash available for debt amortisation. Clearly, the extent varies with capital expenditure and working capital, but one turn of the debt should be easily repaid in five years.

So, buy for £6m, £5m debt and £1m equity, and inflation is 5%. The EV will start at £6m and in five years rise to £7.7m. In addition, the equity will benefit from debt amortisation of, say, £1m, so the equity rises in value from £1m to £3.7m – a 3.7x return and 30% IRR. Very respectable nowadays.

In a completely hypothetical scenario looking forward, where inflation is zero, the equity might just double in five years. But if inflation reaches 10%, the equity gets to a much juicier 5.7x and IRR of 41%. It's really easy – the obvious advice is to find steady targets and lever up.

Free and easy?

However, there really is no such thing as a free lunch. What could possibly go wrong? Interest rates could rise a lot, so fixing rates is very sensible in order to reduce default risk. Companies with large inventories or debtors – or both – that are not adequately matched by trade credit should be approached with caution. If margins are not fat enough, these businesses, known as 'doomsday companies' during the last period of inflation, simply mop up cash as inflation bites. But (some) inflation has been a great friend of LBOs. Welcome back.

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