Jon Moulton's Diary

Many talk about the ills of high inflation. But for buyout firms, it may not be all bad news

Veteran financier Jon Moulton has been involved in buyouts, turnarounds and venture capital since 1979 with firms such as CVC, Permira, Apax, Alchemy and, most recently, Better Capital, where he has been the chair since 2009

I was reading the recently published and excellent Bain *Global Private Equity Report.*

They somewhat bemoaned the adverse effects of interest rate rises that followed on from higher inflation and now see the coming of lower interest rates as good news for leveraged buyouts.

Should they not be hoping for more inflation?

If you take a very over-simplified view of the effect of inflation; let's see what happens with a buyout in inflationary times.

Consider an LBO funded with 100 in debt and 50 in equity. Conveniently, the business goes neither up nor down other than because of inflation so its earnings before interest, taxes, depreciation, and amortisation (Ebitda) is indexed. It can pay the debt interest but after providing for inflation on positive net working capital, capital expenditure and taxation it neither pays off debt nor raises any more debt.

Now have inflation at 5% per annum. The enterprise value (EV) will likely also go up in 5 years by 5% compound, so 150 will go up to 191. The debt will remain at 100 so the equity will have risen to 91 – 13% equity compound growth, 8% real, without any need to grow the business or increase the rating.

The effect of an interest rise is less significant. If this happy little LBO has to pay 3% more interest every year the equity would still have risen by 91-15 to 76. Still a nominal equity annual return of 8.5% compound and 3.5% real so not bad for indolence.

A nice windfall

If you repeat the calculation with four parts debt to one part equity, you more than double the equity and generate an internal rate of return (IRR) near 20%.

Recent inflation – which peaked in the UK during the autumn of 2022 at 11% – should provide considerable baked in returns as interest rates lagged well below inflation. A nice windfall. In all likelihood some of the LBO firms will not major on this source of return when fundraising!

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A dose of higher inflation can help private equity funds obtain better returns on leveraged buyout deals

Those who found the traditional LBO targets of my youth (stable cashflows, strong asset backing, no need for operating genius) will have made out in style in the past couple of years as a higher debt component of their capital structures worked powerfully for them.

Exit returns

Inflation has been around before – I lived and operated through the heady days of the 1988-1992. Inflation roared to 9% but interest rates rose to 15%. We put together deals in 1998 with interest cover levels of Ebitda that are today unimaginable. Deals were being done with 90% debt and 10% equity. Some deals so embraced the "inflation and leverage deal" that a few deals were knowingly done with the last 12 months' Ebitda being below the future LBO interest bill – the financiers (including junk bonds) were betting that inflation would increase the Ebitda fast enough to make the whole deal work.

This led to the return on exits in 1988 being very high– 38% IRR in the UK – followed by the worst exit statistics ever as the exuberantly leveraged deals hit recession and sky high interest rates as the central banks really lent on monetary policy and jacked up interest rates in 1990/91. Bankruptcy became the most frequent mode of buyout exit.

Inflation is the LBO fund's friend – it's a shame to see it dropping so rapidly. The drop in interest rates is a lot less helpful.