Recession?...Someday – A Primer on Market Cycles

Part 2 – Where are we in 2018?

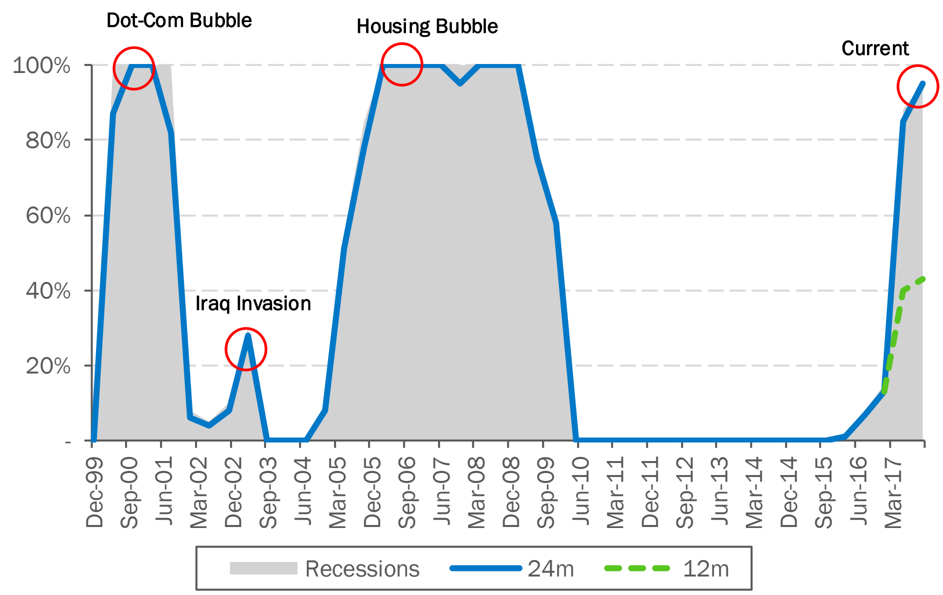
By Chris Tuszynski, Investment Banking Analyst

In Part 1 we looked at how the economic machine works. So far, in spite of some market turmoil it does not seem that 2018 will be like 2008.

Now that we have created a framework to understand the economy, it is important to apply the model to current economic indicators to access where we are in the cycle and where the economy is heading.

Global private equity firm KKR states that its base case projection is that there will be an economic slowdown in 2019. Previously, economists predicted decreased economic activity in 2018, but the effect of US tax cuts have reduced the probability of a near-term recession. Moreover, high interest coverage, tight yield spreads, low delinquencies and modest consumer obligation ratios should drive economic growth through 2018.

Figure 1: KKR Recession Model

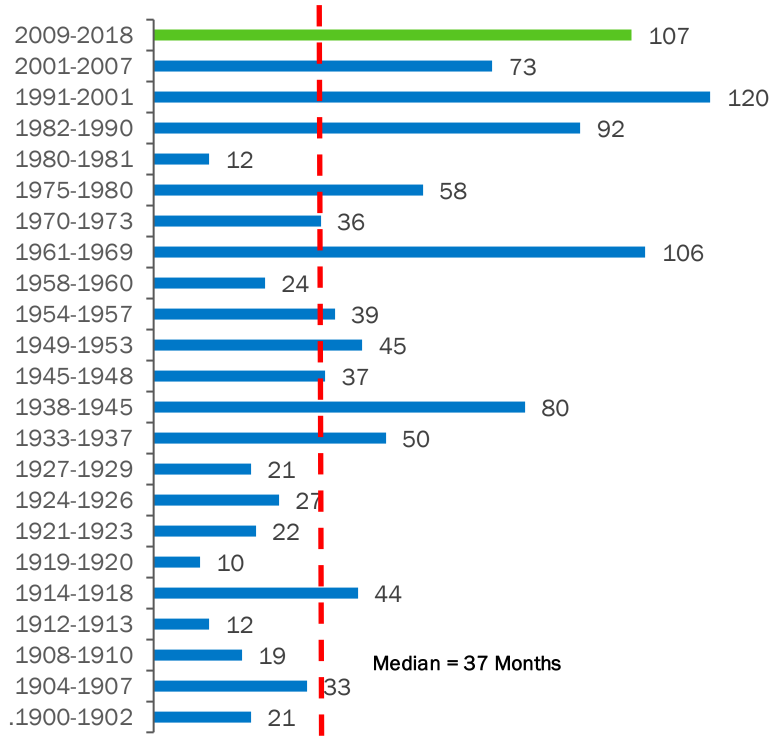


What is interesting is that when the model is pushed out from 12 months to 24, the probability of recession increases substantially. KKR cites the structurally peaking US dollar, flattening yield curve, higher labour costs and mean reversion in both consumer confidence and the housing market to be the key indicators of an economic downturn in 2019.

Irrespective of where we may be in the economic cycle, financial asset prices are currently inflated far above what is warranted by the current macroeconomic environment. This inflation in the prices of financial assets stems from the unconventional monetary policy stimulus that many central banks during the 2008 recession.

Figure 2 shows in very clear terms that we are overdue for a recession.

Figure 2: Consecutive Months of Economic Expansion



The US economy has been performing at an exceptional level and is entering the second-longest period of continuous expansion in history. Analyzing the equity market, we can see that if we can get through 2018 without a recession the S&P 500 will record the longest period of consecutive positive returns in history.

Figure 3: S&P 500 Returns Imply that Equity Valuations Are Inflated

Consecutive Years of Positive Returns	Summary Statistics			
	Start	End	Cumulative Return	CAGR
3	1904	1906	67%	19%
3	1954	1956	111%	28%
3	1963	1965	60%	17%
3	1970	1972	40%	12%
4	1942	1945	143%	25%
4	1958	1961	102%	19%
5	2003	2007	83%	13%
6	1947	1952	148%	16%
8	1921	1928	435%	23%
8	1982	1989	291%	19%
9	1991	1999	450%	21%
9	2009	2017	259%	24%
Average CAGR				**20%**

It is important to note that although the economic expansion is the second-longest in history, it has been quite slow. As discussed, economic expansion is at 107 months, but during this period GDP has grown only 2.2% annually and 19% in total. These numbers are far below the recovery averages of 64 months, 4.7% and 25%, respectively.

An alternative view of our current stage in the cycle is presented by Pierre Ouimet, CIO of UBS. Pierre sees monetary policy as the primary variable influencing the end of the economic cycle. Pierre's view, shared by a number of economists, is that while there are a few clear signs that we are in the late-cycle phase, a significant amount of time could pass before we near the end of this market cycle as monetary policy is unlikely to change in the near term.

Practical Implications For Business Owners

To gain insight on the effects of recessions, we sat down with Paris Aden, Partner, and Boris Novansky, Partner, at Valitas Capital Partners. Paris and Boris provided two key insights:

The first is that M&A market booms are liquidity driven. This means that business sales boom at the top of the market when prices are highest. This is caused by a frothy credit market with a lot of liquidity.

The second insight is that recessions can create challenges, but more importantly recessions create unique opportunities. Boris related a story of the challenges, and Paris related a story of opportunities.

Boris's story: Watching a train derail in slow motion

Boris's story comes from an experience he had acting on a business sale transaction for a large public company in 2008. On September 13th, 2008, a private equity (PE) firm signed a letter of intent at $10 per share.

Two days later Lehman Brothers set a new record with a $600 billion bankruptcy. This historic bankruptcy signalled the end of the "too big to fail" safety net, which big banks had always relied on to get bailed out. Boris described the strangeness of that time. For the first few days no one really seemed to notice the mushroom cloud looming over the market.

The pre-Lehman purchase price was based on a multiple of 8.0x EV / EBITDA. During the frothy liquidity days the PE firm arranged credit with a bank to finance 5.5x of the purchase price with debt.

Over the next few months the PE firm proceeded with the normal due diligence, checking all the legal documentation and other issues. But during these months the market was changing. The bank that was financing the deal – and all banks – slowly, and then quickly, became extremely risk averse. The bank was no longer prepared to offer such aggressive leverage on the business.

Because the bank would not offer the financing, the PE firm had to raise more equity to fill the gap – in the most difficult market since the Depression. The PE firm had to take on a lot more risk than it was comfortable with, so it started to walk away from the purchase price as their return threshold became much harder to meet.

However, walking away from legal obligations requires a valid reason. So the PE firm dug far more deeply into the due diligence nooks and crannies than it would have if it wanted to complete the deal. They found a number of flaws. Normally these flaws would not have been fatal but they were enough to provide a legal basis to renegotiate the deal.

This in turn required the board of directors of the public company to go into CYA mode. The easiest option was to blame the management team for understating the flaws. No one seemed to want to blame the real culprit – the market.

Boris described these unusual market circumstances: "It was like the tide had gone out and all of the garbage at the bottom of the ocean was exposed … I aged five years in five months watching the train derail in slow motion."

Ultimately, the PE firm walked away from the deal and some of the management team was fired. Six to seven months later, another purchaser acquired 80% of the business for $4.50/share. The deal was arranged by the board as part of a shotgun wedding, leaving the shareholders with 50% of the value the PE firm had been prepared to pay less than a year earlier, in the pre-Lehman days.

Paris's story: A successful merger of equals

Paris worked on the Petrocan/Suncor merger, the third-largest in Canadian history. The 2008 recession created the economic conditions necessary to complete the transaction.

These two Canadian oil and gas companies were big fish in a small pond. Compared with the $450 billion market capitalization of Exxon Mobil, the $20 billion Petrocan and $25 billion Suncor were just minnows. Oil and gas companies benefit from scale: the larger they are, the more money they have for exploration, bigger refineries, pipelines and other benefits.

Petrocan and Suncor were trying to find a way to create a global champion that would be competitive in the international market. A "merger of equals" was the best way to achieve scale.

In a bull market with frothy credit, a merger of equals is challenging for companies without significant market share because an interloper can come in and pick one or both of them off. However, during the 2008 recession, the large global players in the oil and gas industry were preoccupied managing internal financial issues, creating the environment where a once in a lifetime transaction could be completed. This is a great example of how strategically navigating the macroeconomic environment allowed both companies to come out of the recession in *far better* shape than they went into it.

Conclusion

Recessions create challenges, but they also create opportunities. Strategically navigating these periods can permanently alter the trajectory of a business – for better or for worse. It is therefore paramount to have quality strategic advice.

While there are several operational and strategic aspects to your company's resilience to a recession, liquidity is crucial. Liquidity in a recession can be the difference between being a predator or prey. Recessions often create opportunities for well-capitalized companies.

What can you do now to ensure adequate liquidity? Maximize undrawn credit capacity and negotiate significant covenant headroom while the money is flowing and the banks are lending.

About Valitas

Valitas Capital Partners is a Canadian boutique advisory firm that collaborates with passionate business owners to unleash value over time and realize that value through a well-timed exit. Our work is bespoke, tailored to the unique priorities and circumstances of each client, recognizing the legacy they have built through years of dedication and sacrifice.

Valitas delivers global firm capability from an agile, entrepreneurial platform. Our value creation excellence is rooted in best practices developed by leading global investment banks and private equity firms. Over our careers, we have completed almost 200 M&A and financing transactions with an aggregate value exceeding $180 billion, including some of the most notable and complex M&A transactions in Canadian history. Valitas' clients trust our thought leadership, experience, and privileged access to global networks to identify, evaluate and execute on their strategic opportunities.

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As an Investment Banking Analyst, Christopher conducts industry research, acquisition target identification, valuation analysis, and financial modeling. Prior to joining Valitas, he worked as a Private Equity Analyst at a boutique private equity fund, where he assisted in executing mid-market leveraged buyouts. Christopher previously worked as a Private Equity Summer Analyst at the Ontario Teachers Pension Plan in their private capital group, helping to evaluate new buyout opportunities for the fund.

Christopher holds a Bachelor of Arts in Applied Economics, with distinction, from Queen's University specializing in Econometrics.