Chapter 20

Market Information: Why Does Equity Matter?

What's in this chapter:

- valuation based on equity markets
- monitoring equities

EQUITY MARKETS CANNOT be ignored when analyzing leveraged finance credits. This is true whether or not the company has public stock. The equity markets are an easily accessible and fluid signal of what corporate valuations are for public companies and for valuation trends generally. Equity markets are significantly more liquid than leveraged finance investments so that when events break on a company or an industry, the price reactions in the markets can often show a quick response if the news is viewed as positive or negative. Stock market moves are not perfect. Prices of stocks can move rapidly, and sometimes the moves have nothing to do with an individual company but are a response to macroeconomic or technical events. A credit analyst has to be careful not to become overly dependent on an equity market valuation for a company or over-react to short-term price movements. Equity market valuations can fluctuate wildly, and any analysis using public equity market valuation should not be anchored on a point-in-time valuation. It is better to look at averages over time, as well as peaks and troughs. An equity price that has more volatility cannot be trusted as much as one with less. The stock prices of the companies that are being followed in the credit markets and their peers have to be monitored for any sudden or unusual activity as well as for long-term trends. The equity market is not always right, but it should not be ignored and can be a powerful early warning system to changes in a credit or investor sentiment.

Valuation Based on Equity Markets

Equity market valuations can be used to arrive at an estimated asset value for a company. To undertake the analysis, comparable companies need to be carefully chosen. A classic way of biasing results in any analysis is through the sample group that is chosen for comparative purposes, so careful thought should be involved in choosing the constituents for a peer group. It is unlikely that the perfect public comparable will be found, so differences in business lines, ownership, size, growth, and operating margins have to be considered. Stock valuations can also differ depending on whether a company is paying dividends or not, or whether a company is undertaking significant stock repurchases or not.

A key task is to make sure that the most up-to-date stock information for the company is being used. This can include making sure the right number of shares is being used in the analysis. This may seem simple, but various items such as multiple stock classes, options, and convertible securities can complicate the issue. Analysts must be consistent in how they choose to count in-the-money[17] options or converts and be sure to count preferred shares if any are outstanding.

One of the decisions that has to be made when looking at the equities is which valuation metric to use. Leveraged finance analysis usually assumes that the equity is being valued on a multiple of adjusted EBITDA. This may not always be the best metric to use. Sometimes stocks are valued using FCF, net earnings, or even revenue, for higher-growth, low-cash-flow companies. Even nonfinancial metrics have been cited as a valuation metric, such as a value per subscriber for an early-stage mobile phone company or proven reserves for an oil and gas company. If the equity market is believed to be using a metric other than an EBITDA multiple, forcing an analysis of equity-market EBITDA

17 This means a stock option or convert that has the right to convert to common stock on a per-share price that is below the stock's current trading price. If the conversion price were above the current stock price, it would be referred to as out of the money.

multiples may prove to be a misleading metric. Equity markets do seem to shift key valuation metrics depending on the life cycle of the business and the industry. This is prevalent in newer and rapidly developing industries. The example in Exhibit 20.1 employs the widely used metric, which in leveraged finance is total enterprise value (TEV) to adjusted EBITDA.

This example is based on a hypothetical provider of broadband service and analyzes what multiple of EBITDA the company is trading at and where some of its peers are valued. Note that the cash is subtracted from the valuation. This is done to get a sense of the value of the business, not the excess cash on the balance sheet, and makes comparisons cleaner. When developing a total value for the company, the cash could be added back, as could other non-cash-flow-producing assets.

Exhibit 20.1: Sample Enterprise Valuation (in $000,000s Unless Noted)

		My Broadband Company	Their Broadband Company	Another Broadband Company
1	Total number of shares	110	50	90
2	Recent share price (in $)	$35.00	$10.00	$12.00
3	Public market equity value (line 1 × line 2)	3,850	500	1,080
4	Total debt	2,000	1,500	2,300
5	Cash on hand	100	100	200
6	Total enterprise value (line 3 + line 4 – line 5)	5,750	1,900	3,180
7	Adjusted EBITDA	800	300	500
8	TEV/adjusted EBITDA (line 6/line 7)	7.2×	6.3×	6.4×
9	Net debt/adjusted EBITDA (line 4-5/line 7)	2.4×	4.7×	4.2×
10	TEV cushion (line 8/line 9)	303%	136%	151%

When there are variations in valuations, the analysis should try to discern what other factors might be the cause this variance. The following is a list of some examples of items that could cause a differentiation in valuation multiples:

- If a significant number of shares are not outstanding or free to trade, it can be said that there is not enough float.[18] If a stock does not have enough float, it may limit larger investors from looking to own shares in the company and may cause it to trade at a lower valuation.
- One company might be a more likely takeover target than the others because of ownership or other items. This may cause it to trade at a higher enterprise valuation.
- One company could be a significantly better operator or face more competition.
- A company could be paying dividends on its stock or doing stock buybacks. Both of these actions can help the valuation but are not necessarily good for the debt.
- The equity market does not ignore leverage. It often looks at leverage as a risk and may put a discount on the more leveraged companies in an industry sector. In Exhibit 20.1 the equity valuation is higher for the least leveraged of the comparable companies (i.e., My Broadband Company).

The easiest thing for an analyst to do is to compare this valuation to the debt leverage and see what kind of public enterprise valuation cushion there is for the debt. This cushion is shown on line 10 in Exhibit 20.1.

It is interesting to compare these average valuation metrics across industries. Too often, investors apply the same range of reasonable leverage to all industries. For example, an analyst may look at My Broadband Company and also at a chemical manufacturer (That Chemical Company) and see that both have 2.4× leverage. If the bonds of That Chemical Company were trading at a higher yield, the conclusion might seem to be that the chemical company bonds represent better value. However, after doing equity market valuation analysis, it is clear that broadband service company equities trade at over 6× EBITDA and chemical companies at about 4× EBITDA. Because broadband companies tend to trade at higher multiples, My Broadband Company actually has much better enterprise value protection even though the two companies have the same leverage. These differences should also lead to different yields and spreads in the valuation of these companies' debt instruments.

18 The float is generally the number of shares that actually trade. For example, if a company has fifty million shares outstanding, and the chairman owns fifteen million of them, the float would generally be considered to be thirty-five million.

The principal goal of the leverage ratio is to get a sense of how well protected the debt is relative to asset value. Different industries and different types of asset have different valuation ranges, for a multitude of reasons. The major point is that leverage ratios cannot be assessed in a vacuum; they have to be compared to the cost of funding and asset valuations.

A healthy stock multiple can often help give a company more financing options. Consider this when doing scenario analysis for a company. Stock can be used in lieu of cash to make acquisitions and can have certain tax advantages in mergers and acquisitions. Additionally, a healthy stock valuation may lead a company to issue stock and utilize proceeds to deleverage.

The stock price at which a company is valued is not the be-all and end-all of valuations. The stock market does not price everything to perfection; there will always be disputes over a company's value. If stocks were consistently valued perfectly, there would be much less trading volume and much lower price volatility in the equity markets. Sometimes the market is wrong and misvalues a company or industry. The public stock price is typically based on a few shares of stock trading in a company and does not give someone control over that company. Usually, someone pays a control premium to actually control a company. The stock market also does not often factor in synergies and cost savings that a strategic buyer could achieve. This is why, when doing asset value to debt analysis, a database on the valuation of mergers and acquisitions in various industries and a record of what multiples of EBITDA (or other metrics) are being paid in those transactions can be very valuable. All it takes is one person with lots of money who really wants to own a company to change that company's valuation and make the prior stock multiples look wrong.

Databases of Equity Valuations

Some databases can spit out equity multiples. However, they tend to use cookie-cutter rules and not make the typical adjustments an analyst may want to make to EBITDA or OIBDA. Additionally, these databases do not always adjust for share count accurately when factors such as convertible securities and options are significant and close to being in the money. If they are third-party systems, be sure to understand how they are defining their terms and gathering the data.

Monitoring Equities

Whatever market monitoring systems are available to analysts, it is *strongly* recommended that the stocks of all the companies they are responsible for should be followed. It is best to keep the peers grouped on the computer screen. Stocks tend to be more liquid than bonds, and stocks typically trade on listed markets where prices are updated rapidly. Monitoring these stocks for unusual changes in trading patterns in prices or volumes can sometimes be an early alert to news.

Analysts should also follow the stocks of leaders in an industry, whether they have leveraged debt outstanding or not. Although they are usually investment-grade companies and much larger than the leveraged companies, analysts want to know what trends the industry leaders are facing and try to understand how that will impact the credits they cover.

Monitoring stocks can be especially helpful during earnings season. If certain peers report early, an analyst can often develop a sense of how the industry may have performed for the reporting period and how the equity markets are reacting to these types of result.

It can also be helpful to monitor the volume of trading in a sector or an individual company's stock. Unusual spikes in volume can indicate that stories are beginning to circulate about a company or industry, or that some investors are either buying or selling large meaningful positions. There can of course be many false signals from stock price movements.

Closing Comment

Following equity market movements can be a valuable tool to understand valuation trends in different companies and industries. It can also be valuable to get a sense of how investors are reacting to news events about an industry or a company. It is important to not become too dependent on using equity valuation to make credit decisions. It is also important to not be too dependent on the most recent stock price. Rather than using just one spot in time, it might be useful to use the average stock price over a period of time. When using an average, an analyst may choose to use an exponentially weighted moving-average price to give more weight to recent prices. The value of public equity valuations can be fleeting and should not be the linchpin in coming to a conclusion about a credit.