HOW PAYING DOWN DEBT IS GREAT FOR INNOVATION, GROWTH, EMPLOYEES – AND SHAREHOLDER VALUE

BY JAMES C. PAPPAS

If you look back over US financial history, back to even the mid-1800's, when the New York Stock Exchange really started most of its activity, you will find many financial disasters stemmed from having too much debt. (see the railroads in the 1800's and the utilities in the '29 bust)

Since then, many great companies, that had great innovations and employees who were doing great things, were destroyed by overleveraging themselves.

For most companies, big, and especially small, it makes sense to have little to no debt. Instead of making large interest payments to a bank and being worried about EBITDA falling, the company could use those interest payments for growth and innovation.

When smaller companies de-leverage, every dollar can create a lot of value.[1]

Also, the style of business can have quite an effect on leverage. For instance, as all know, real estate can support quite a bit of leverage.[2]

Paying down debt is a secret to creating a lot of equity value, but only if 1) the management team and board understand it, and 2) if they can execute on the plan.

Deleveraging to Create Value

If we analyze a typical situation – a company with $100 million of revenue, $10 million of EBITDA and $5 million of free cash flow.

	Today	Year 5	Growth
Revenue	100,000	110,408	2.0%
EBITDA	10,000	11,041	2.0%
Cash Flow	5,040	6,893	6.5%
Cash	10,000	10,000	
Debt	40,000	17,057	
Equity Value	35,000	65,749	13.4%
Enterprise Value	75,000	82,806	2.0%
Shares Outstanding	1,000	1,000	0.0%
Stock Price	$35.00	$65.75	13.4%
EV/EBITDA	7.5x	7.5x	
Debt/EBITDA	4.0x	1.5x	

Let's assume the stock is trading at $40.00 with 1 million shares, or $35 million valuation. And there is $40 million in debt.

Assume $10 million in cash.

Now, let's assume the market doesn't give credit for the $10 million because that is primarily swings with working capital.

With all the assumptions above, if we bought the shares today at $35.00 per share, we would be effectively buying the company for 7.5x EV/EBITDA.

If the company grows revenues at modest rates of 2% per year and margins staying flat at 10%,

[1] A $25 million EBITDA company is a company that's at the lower end of what banks like to finance (there are obvious exceptions like real estate). If you are below $25 million EBITDA, having debt is probably not a great idea unless you plan to rapidly amortize the loan.

[2] A predictable business that is less than $25 million in EBITDA can easily be more predictable than a business with $1 billion in EBITDA.

the company could pay down a significant amount of debt.

If we assume about 75% of the free cash flow is used to pay down debt and the multiple of EBITDA stays the same, the equity value expands at a little over 13% per year. A respectable rate.

However, the company is now 1.5x leveraged, instead of 4.0x. In addition, the company is now producing more cash flow on an absolute basis than before.

With all the above assumptions, the company would likely get a bump in multiple.

If we modify the above assumptions and assume the EBITDA multiple expands to 8.5x, the growth in stock price is an even more respectable at 17.0% per year.

If we assume that the multiple were to expand closer to the market average of 10x, the IRR expands to 21.0%.

Lastly, and most importantly, if the multiple falls to 5.0x EV/EBITDA, we would merely breakeven on our investment.[3]

Needless to say, if the company were allocating capital, it would seem few investments within the company could outweigh paying down debt. In fact, especially in this case, if there was a recession, it would not be a surprise to see the company in bankruptcy. By avoiding bankruptcy, the company can support its employees and innovate its products or services. Which brings us to the next point.

Growth, Innovation and Employee Retention

If a company is paying down debt, its reducing interest expense and removing the EBITDA covenants the company must abide by. Without the restrictions of EBITDA covenants, the company can be more flexible with pricing and volumes, among other things.

In addition, the cash used for interest payments could instead be allocated to hiring new employees and company innovation.

Trying to grow a business and create value for shareholders while under restrictions is a difficult path.

Shareholders would be better off, employees would more likely have a job and, all else equal, it's far easier to create value for everyone involved. And the least risky way and highest probability.

Finally, most companies give equity to employees. If the stock is stagnant or has potential for bankruptcy, why do employees want the stock? A company that increases value for shareholders, also increases value for employees.

Conclusion

A company simply paying off debt is not an incredibly exciting story. CEOs like exciting stories and Boards like to see companies grow.

Mostly, it's just inertia that a company keeps allocating capital to projects that have low or no return on capital.

Instead, by simply deleveraging the business, the company can create a tremendous amount of value and lower its risk.

The best action for a company to take is to run the numbers and see how much value the company can create by deleveraging. If the IRR that comes out of that analysis is in the double digits, it's a hard argument not to use at least a majority (if not all) of the free cash flow to pay down the debt.

[3] Investing is a *negative* outcome game – always looking for the risks and not worrying about the upside.

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