Saw Dust 01:

Maximizing enterprise value during a time of high uncertainty

January 2023

Saw Mill Capital

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ANALYSIS IN BRIEF

A recession seems to be getting ever closer. We hear management teams gossip about signs of a recession during business dinners. We have seen the ominous headlines in various business journals. Yet, in the last six months, an overwhelming number of private companies reported record profits in both dollar and percentage terms.

A set of extraordinary factors has driven unusual growth in price and volume, producing an overall record level of corporate earnings. In general, today is unlike any era that we have experienced in our professional lifetimes or in the life of our investment firm (Saw Mill Capital started in 1997). In fact, most people working today are unlikely to have experienced any combination of the following issues.

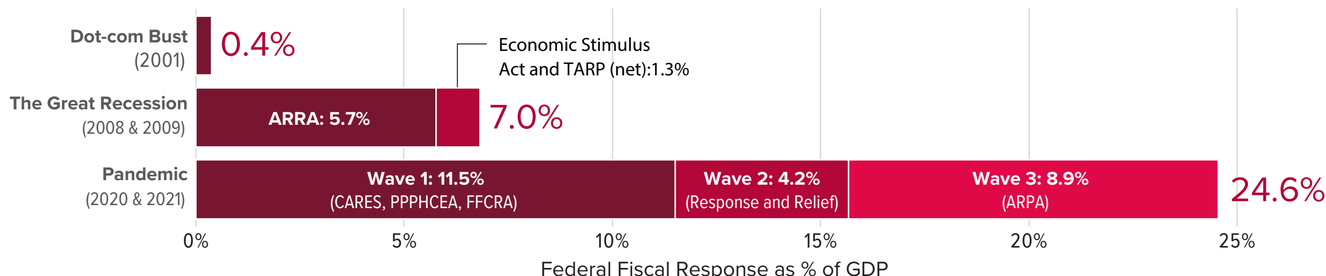
- A global pandemic that caused volatility in demand and severe disruptions in the supply chain
- Fiscal stimulus at the scale found typically during war times
- Monetary easing and tightening unprecedented in both its scale and pace
- Geopolitical conflicts caused by a land war in Europe and tensions in East Asia
- Inflation reaching levels not seen in over 40 years

How these forces will evolve is highly uncertain, making forecasting future cash flows incredibly difficult. This uncertainty challenges investors to assign fair enterprise values to businesses.

Over the course of this newsletter, we will explore what management teams can do to optimize the enterprise value of their companies in the face of an uncertain future. We will first review some of the latest macroeconomic data. We will then dive into specific examples of how these above forces are driving record earnings but also uncertainty about the sustainability of these elevated earnings. We will also explore how the elevated level of uncertainty is challenging how we as investors can determine enterprise value. Finally, we will discuss what managers can do to maximize enterprise value.

All data shared below are illustrative and not actual. They are based on real company data but scrubbed for confidentiality reasons.

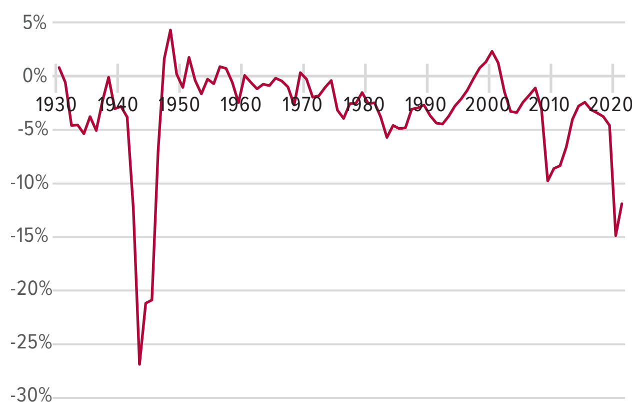
Massive fiscal & monetary response to COVID-19

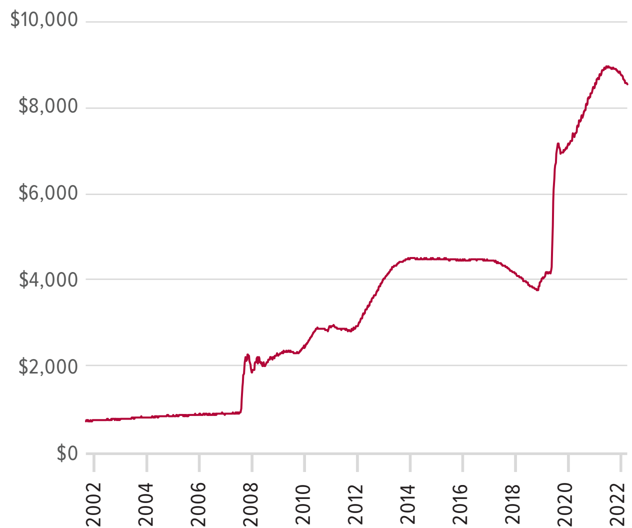


Source: University of Iowa, Congressional Budget Office and U.S. Bureau of Economic Analysis

Within 12 months of the pandemic starting in the US, the Federal government delivered an unprecedented amount of fiscal stimulus in three waves, totaling nearly five trillion dollars (~25% of GDP). This Federal fiscal response far exceeded those of the previous two recessions. In fact, the Federal deficit as a percentage of GDP reached levels not seen since World War II.

In addition to dropping its Fed Fund Rates to nearly zero, the Federal Reserve also expanded its quantitative easing program to volumes far exceeding those used to fight the Great Financial Crisis. The total assets held by the Fed increased by ~2.2x between September 2019 and September 2022. In other words, the Fed bought ~$4.9 trillion in debt securities. In comparison, the US debt securities market is roughly $46 trillion. Thus, the Fed bought ~10% of all outstanding US debt securities in roughly 24 months.





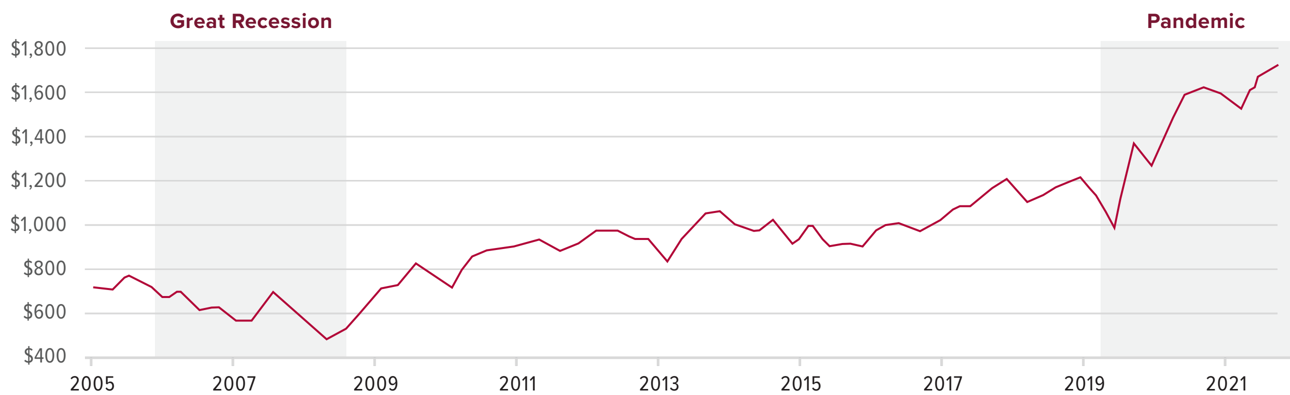
Inflation adjusted corporate profit is ~40% higher in 2022 than in 2019

The fiscal stimulus combined with low interest rates drove corporate profit to reach record levels. According to the Bureau of Labor Statistics, even after adjusting for inflation, non-financial corporate dollar profit was ~40% higher during first 3 quarters of 2022 than the same period in 2019.

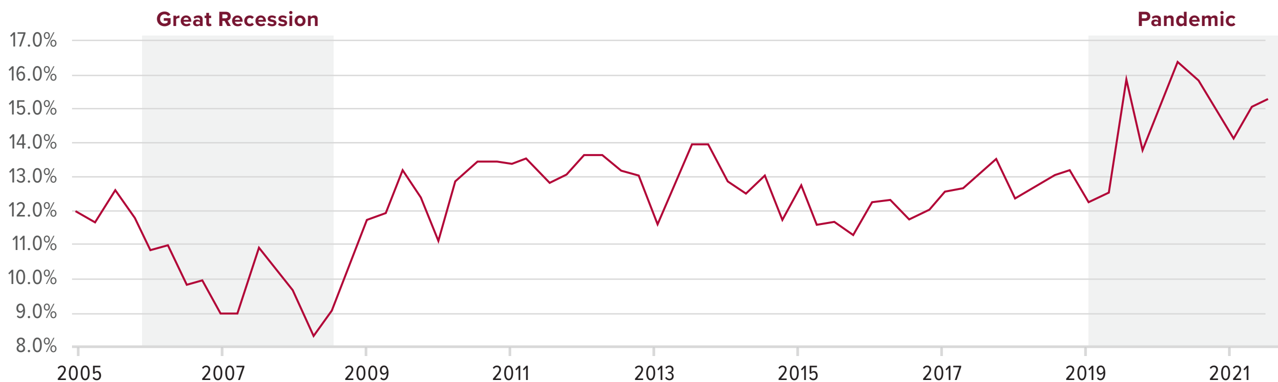
Moreover, corporate profit margin is also at a record level. Corporate profit as a percentage of net value added was 13.1% during Q3 of 2019 but increased to 15.4% during Q3 of 2022. A margin lift of two percentage points across all private non-financial businesses (i.e., excluding banks, insurance companies, etc.) in the largest economy on Earth is not a small number.

Non-financial corporate profits ($ billions)

After tax with inventory valuation & capital consumption adjustments

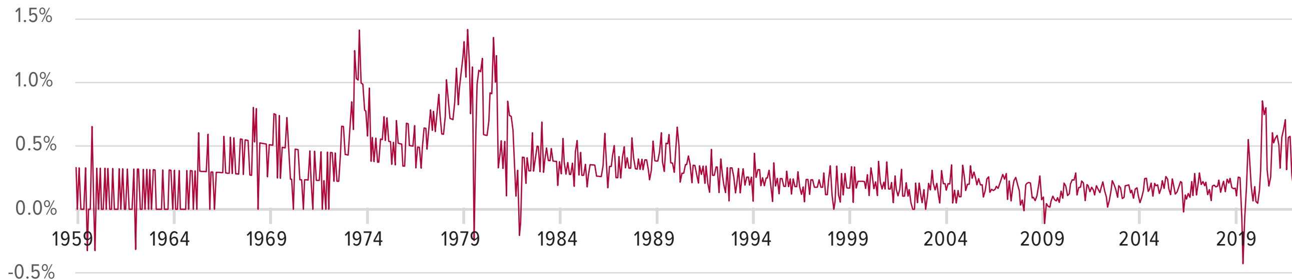


Non-financial corporate profits as % of net value added



Highest inflation & fastest pace in monetary tightening since the early 1980s

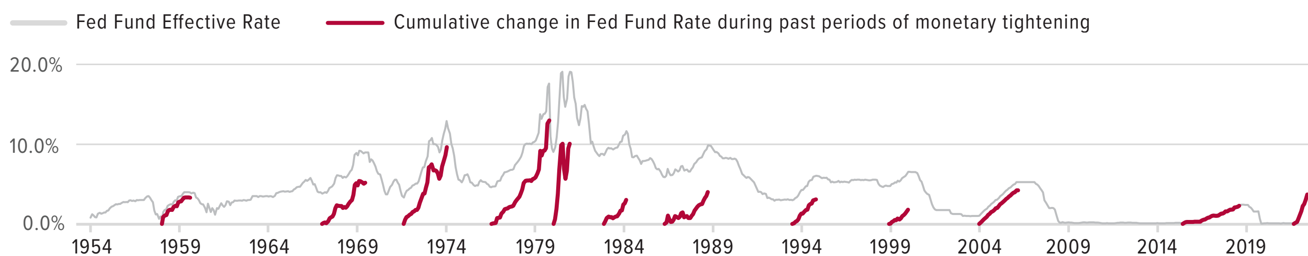
CPI excluding energy & food



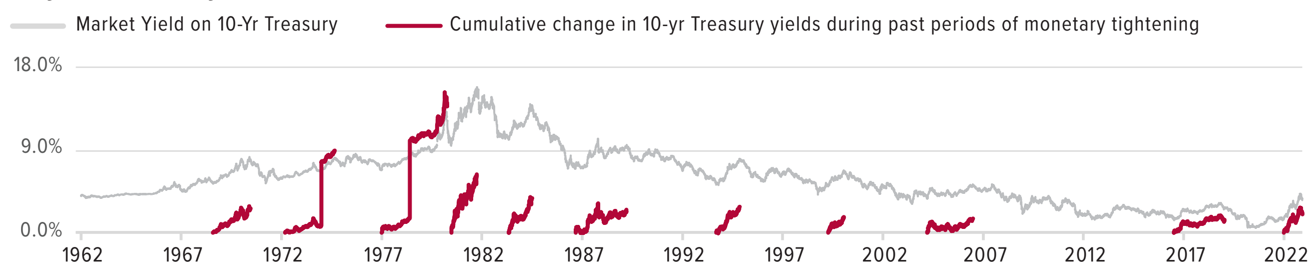
The dramatic pickup in demand across the entire economy lifted not only corporate profits but also prices. The consumer price index (excluding energy and food, prices of which tend to be more volatile) rose at its fastest rate since the early 1980s.

Since April 2022, the Fed has hiked interest rates at the fastest pace since the early 1980s while also rapidly unwinding its balance sheet after a decade of quantitative easing. The dramatic pace of monetary tightening calls into question the sustainability of recent earning growth. Combined with a return to pre-pandemic patterns of consumer and business behaviors, the Fed's aggressive monetary tightening has made forecasting future profit increasingly difficult over the last 12 months.

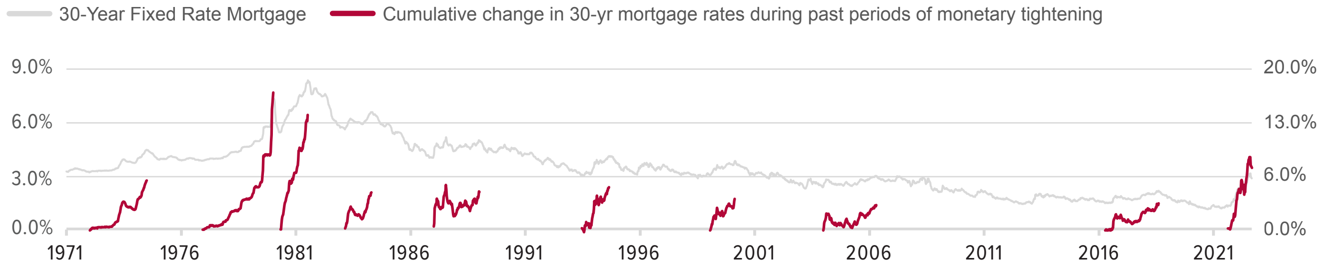
Fed Fund Effective Rate



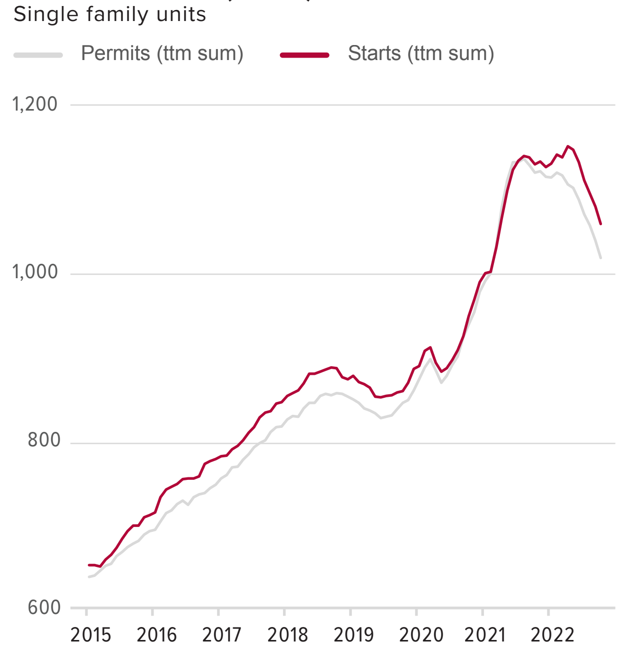
10-year Treasury



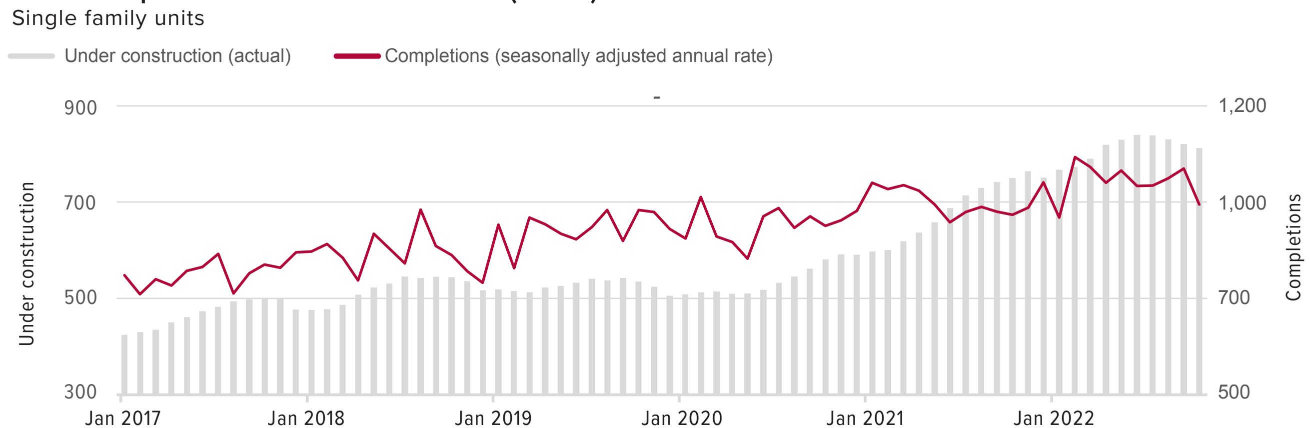
Monetary policy's intended effects can have a lag that is long and variable



To make matters even more complicated, we have not yet--a big yet--seen a significant decline in demand in sectors that should respond faster to changes in monetary policy. Many industries are still working through massive backlogs caused by supply chain disruptions and unusual demand and supply dynamics. In fact, large back logs are even masking the impact of tightening monetary policy on residential and commercial construction activities, which are historically affected the most and fastest by rising interest rates.



Although permits and starts for single family homes are declining, housing completions have



not declined as much as in past economic slowdowns. Builders are still working through a record backlog of homes under construction caused by supply chain and labor shortages. Thus, the companies serving production homebuilders have yet to see a meaningful decline in their current earnings. This is especially true for firms whose construction services are needed closer to the point of completion.

As the Nobel prize-winning economist Milton Friedman wrote in 1961, the timing of the Fed's intended effects may lag. Given this uncertainty, we have broadly seen M&A activity cool. Leverage availability by lenders is also declining. In general, the M&A market is recalibrating as the uncertainty is creating a disconnect in expected value between investors and sellers.

Despite the uncertainty, there are still ways that managers can increase enterprise value in the face of high volatility in volume and price. First, we will walk through a specific example of how these uncertainties are affecting the way we evaluate businesses. Second, we will walk through some strategies of how managers can reduce the uncertainty wrought by current macroeconomic forces.

Valuing companies when it is uncertain whether recent record profits will sustain

A good example of the current uncertainty in predicting future profit growth can be found in the janitorial services space. The pandemic drove janitorial services to hit record profit dollars and margins. As one industry insider put it, "COVID was like the Super Bowl for janitorial services."

When COVID first spread across the country, customers asked their janitorial services companies to run a high volume of disinfection work. Disinfection work is typically twice as profitable as normal janitorial services. Starting in early 2022, disinfection work disappeared as fears of COVID subsided.

Around Labor Day of 2022, many companies began calling back their workers into the office in a hybrid structure. Ostensibly, the hybrid work environment should have led to a downsizing in service levels (e.g., no more need for daily cleanings) and a comparable decline in revenue and profit. This did not happen. Janitorial service companies were able to reduce price less than the comparable reduction in service levels, thus dramatically expanding the margins on their core business.

For example, prior to COVID, a regional janitorial services provider (let's call it "Clean-Co") had a customer contract that required daily cleaning Monday through Friday. After moving to a hybrid work environment, the customer won a 15% price concession from

Table 1: the new normal

($ '000s)	Old Contract	New Contract	% chng vs old contract
Annual contract value	$1,000	$850	-15%
COGS	$800	$552	-31%
Gross profit	**$200**	**$298**	**49%**
# of days serviced	5	3	-40%
Annual COGS per service day	$160	$184	15%
Gross margin	**20%**	**35%**	

CleanCo for reducing the cleaning services by 40% to just 3 days per week (Mon, Wed, and Fri). In effect, the new contract reduced cost faster than price, significantly lifting margins.

Ending the analysis here, of course, would not be fair. We must consider the rapid rise in wages. Like the rest of the economy, wages in janitorial services have risen substantially since early 2020. Moreover, the dramatic decline in immigration added additional pressures on the labor supply as many janitorial services workers are recent immigrants. However, even after incorporating wage increases, the new contract was still significantly more profitable than the old one in both percentage and dollar terms.

But how sustainable is this new margin? When we asked this question to senior executives at various competitors of CleanCo, nearly everyone thought the new normal will hold. In fact, one person told us that the pandemic has "reset the customers' expectations on the margins earned by their janitorial service providers."

The bull case is clear--elevated percentage margins are here to stay. The bear case, on the other hand, is a bit messier.

If a recession were to materialize in the coming year, customers will likely ask for price concessions as they have in past economic downturns. Moreover, this pricing pressure will be compounded by a return to normal competitive dynamics put on hold during the pandemic.

COVID created an artificially depressed competitive environment. Janitorial services work on multi-year contracts with competitive bidding processes. The industry is very fragmented, thus placing a reasonable amount of pricing discipline on all competitors. From the start of COVID to early 2022, many customers held onto their existing janitorial services contracts. Some renewed contracts without competitive bids due to the uncertainty around return-to-work plans.

So the updated version of the above contract for CleanCo may look something like this: a significant decline in contract price with a modest increase in wages reflecting the fact that the recession has reduced inflation to the Fed's target rate of 2%. Under this scenario, the margin on this contract is lower than the current one but still elevated when compared to the pre-COVID one.

Of course, there is a chance that Fed may not able to easily tame inflation. Perhaps a new geopolitical supply shock may appear. Wage inflation for janitorial services could stay in the double digits while the recession forces CleanCo to give price concessions. In this scenario,

Table 2: uncertainty in forecasting downside scenarios

($ '000s)	New Contract	Bear Case #1 Recession	% change vs new contract	Bear Case #2 Stagflation	% change vs new contract
Annual contract value	$850	$765	-10%	$765	-10%
COGS	$552	$563	2%	$607	10%
Gross profit	**$298**	**$202**	**-32%**	**$158**	**-47%**
# of days serviced	3	3	0%	3	0%
Annual COGS per service day	$184	$188	2%	$202	10%
Gross margin	**35%**	**26%**		**21%**	

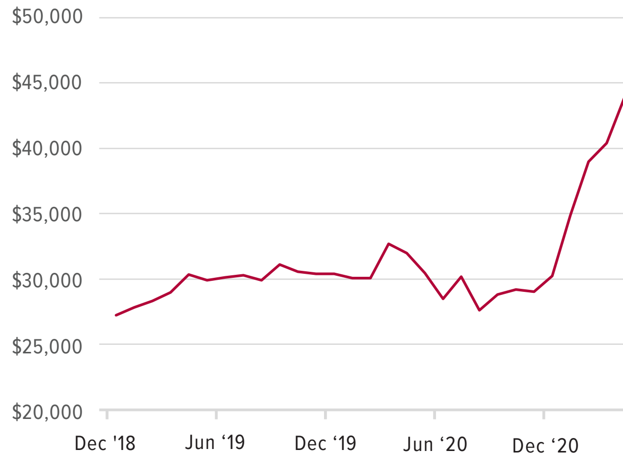
the gross margin on this particular contract has returned to pre-COVID levels. Thus, profit margins will likely contract in any bear case, but the degree of margin contraction is highly uncertain.

Let's talk macro (but let's actually talk about it)

Among the simplest but most powerful things that a management team can do amidst this uncertainty is talking about the uncertainty. We have seen many management teams that have pretended supercharged earnings growth of the last 12 months will continue despite the evidence suggesting otherwise.

One example is a national company that provides transaction services for commercial real estate. Lenders require developers to use services provided by this company and its competitors before a real estate deal closes. Its volume (and revenue holding pricing constant) should broadly follow the volume of commercial real estate transactions. In 2021, its revenue and EBITDA grew by nearly 50%.

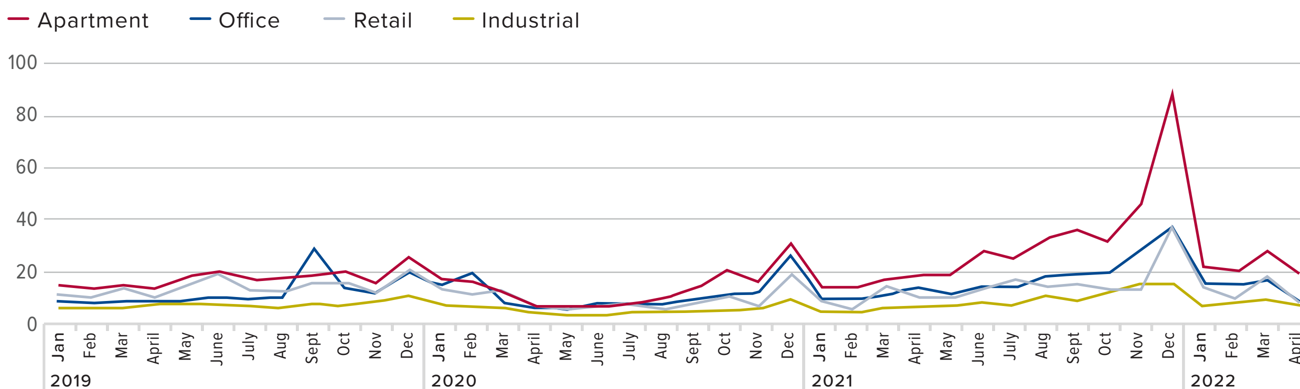
In 2021, commercial real estate transaction volume boomed, totaling ~$850 billion. That is double the trailing 17-year average of ~$430



billion. The elevated activity in commercial transactions did not subside until late summer of 2022. In fact, the company did not report a year-on-year decline in volume and revenue until August 2022.

When we met with the company, the management team attributed the recent growth to

US real estate transaction volume by property stype (SB)



Data Compiled May 24, 2022
Based on independent reports of properties and portfolios $2.5 million or greater.
Source: MBCI Real Assets

investments in the sales organization and market share gains, which do drive sustainable enterprise value creation. However, the evidence suggests that the preponderance of growth was cyclical and not sustainable.

We recognize that we will never know as much as the managers do about their own businesses. When we meet with management teams, we are looking for reasons why our doubts and concerns are wrong. In this situation, we were looking for a structural reason why this company would sustain volume and market share gains across cycles (e.g., once the economy recovers from a recession).

More specifically, we were looking for management to help us understand what future cash flows over the next 3-5 years would look like given the current market conditions. Only after we have agreed on the range of possible cash flow forecasts can we then confidently assess the value of the company.

In general, managers should take control of the market data and present well-defensible scenarios. By steering clear of market dynamics, managers throw away the opportunity to tell their story and overcome the doubts of potential investors.

In our business, it is always easier to say no to an investment opportunity than to say yes. Yet, we are paid to say yes, regardless of economic conditions. Our customers (e.g., pension funds, university endowments, insurance companies) expect us to invest their capital in attractive opportunities even in a tough macroeconomic environment. Thus, when managers overlook glaring issues, it gives investors another reason to say no or, at least, a reason to offer a lower price.

Managers can help prospective investors get to yes by showing how they are building a business that will thrive once the economy emerges from and continues to grow after a recession. Even if the next 12-18 months may look tough, managers do not need to be disheartened.

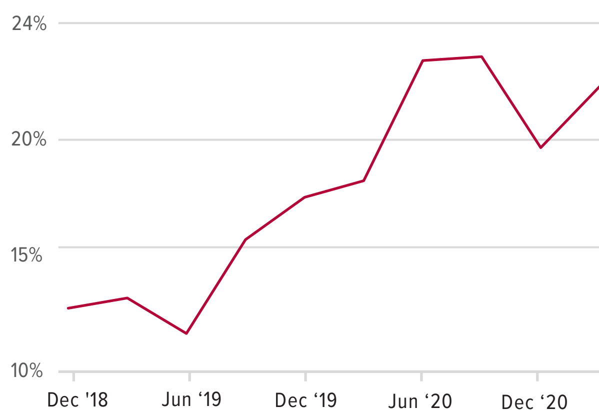
Finally, managers should consider focusing on telling prospective investors how they are optimizing what they can control and why their business will fare better than those of their competitors. In this current macroeconomic environment, we as investors oftentimes assume more factors are outside the management team's control than they actually are. By tackling the issues head-on, managers can help investors understand what is truly uncertain and what is under their control.

Focus on controlling cost controls in an uncertain pricing environment

One area that most companies can control is cost. This is especially important given the extraordinary price growth experienced by many companies across a wide variety of sectors. An unusual imbalance in supply and demand combined with inflation of input costs led many firms to raise prices.

The unusual price increases have led to extraordinary growth in profits because the price hikes have often outstripped the growth found in the companies' COGS and/or SG&A expenses. Even for some companies whose volumes have already started to decline on a year-on-year basis, profits are still at an all-time high due to the price increases instituted over the last 12-18 months.

A few months ago, we met one such company. Its EBITDA doubled from $10M in 2021 to $20M in TTM Sep 2022 even though (i) its volume declined and (ii) its product mix did not change meaningfully. The firm distributed metal components that went into various industrial uses cases. Due to metal-related commodity inflation and China-related supply chain disruptions, the firm grew its pricing



much faster than any inflation found in its SG&A expenses.

Like many companies we have described in this newsletter, this company also faces an uncertain future. As demand slows due to macroeconomic headwinds and supply chains normalize after years of pandemic-driven disruptions, the decline in its volume will likely accelerate while also experiencing minimal growth, if not outright reductions, in price.

However, the timing and severity of these negative effects are highly uncertain. The degree of price reductions may depend on the

pace and severity of the decline in volume demand. A rapidly falling market may force competitors to slash prices to levels that are perhaps avoidable in gentle (but still declining) market conditions.

Companies may not be able to avoid declines in dollar profit, but managers can minimize the decline in percentage profit margin by controlling their costs. As investors, we pay substantial attention to how percentage margins evolve over time. Percentage margin is one of the main components used to calculate return on invested capital (ROIC). ROIC is a measure of value creation. More specifically, it measures how efficient the company is at generating profit with every incremental dollar of investment.

Holding everything else the same, investors will usually assign a higher enterprise value to a company with a higher ROIC. Moreover, a company that can sustain its percentage margin and therefore its ROIC as revenue declines is much more attractive than one that does not.

Moreover, as Sam Walton once said, "control your expenses better than your competition. This is where you can always find the competitive advantage." By programmatically reducing costs, managers can preserve flexibility while investing "freed" cash to build new capabilities and improve existing ones. Moreover, optimizing costs now provides managers the cushion and resources to handle future uncertainty, creating opportunities from instability.

How we are responding to this period of high uncertainty

When uncertainty is high, so is the variance in investor behavior.

Some of our private equity peers have chosen to ignore the volatility in future earnings. In one janitorial services deal, one investor submitted a bid for a ~$50 million revenue business operating in a single city at a valuation that matched that of ABM, which is a publicly traded national janitorial services business with ~$7.5 billion revenue. On the other hand, we chose to discount our valuation considering the elevated uncertainty in predicting future earnings. Obviously, we did not win this auction process.

On the other hand, we have also seen an increasing number of processes break down or be paused due to volatility in forecasting future cash flows. Some market intermediaries have also indicated that they are not bringing companies to market due to the uncertainty caused by the current macroeconomic conditions.

We cannot control macroeconomic conditions. What we can control is how we evaluate investments in this environment. We will continue to be disciplined on valuation while focusing on finding companies with attractive industry positions that have multiple ways to

grow. Even in such an uncertain macroeconomic environment, we believe there are niches of the economy that will continue to enjoy strong growth.

Perhaps one silver lining is that as investor sentiment continues to deteriorate, there will be an increasing number of undervalued and misunderstood companies. It's in these instances that we typically excel—finding opportunities in places that our peers may have unfairly dismissed due to headline risks.

With the proliferation of private equity firms in the market, reputation is critical. We invest for the long run, beyond our ownership period.

We stand behind our companies and the management teams with whom we partner, providing each with a unique combination of capital, strategic guidance, tactical support, and entrepreneurial freedom.

Family has always been an important part of our culture and the reason why our office is near where we live: outside New York City, not in it. Beyond our immediate family, we take pride in the deep relationships we have developed with our management teams and board members.

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