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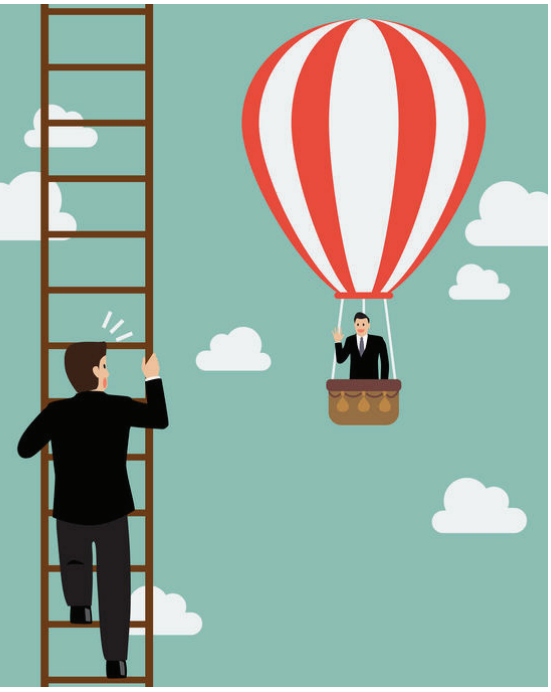
Will Multiples Go Higher? Maybe!



Five hundred years ago, Michel de Montaigne said: "My life has been filled with terrible misfortune; most of which never happened." In fact, studies suggest that 85% of what we worry about never happens. In most studies 79% of the subjects said that when the dreaded 15% event occurred, they found they could handle it. That means that 97% of what we worry about is just torturing ourselves for no good reason. The other 3% is the coronavirus or being caught on an island with a not so dormant volcano.

I worry a lot and it seems I'm not alone. However, I don't worry about the two things that I get asked about the most. These are the two magic questions for which I wish I had a dollar, as I would now be retired and residing on some island paradise. Manus Island looks nice and given my recent return from Hong Kong with a case of the flu perhaps a bullet dodged. In any event, and to quote Samuel Clemens, rumours of my death are greatly exaggerated.

And the two questions? What's the rate and what's the multiple? Usually asked without context and as such impossible to give a straight answer. $3M business loan, 3.65%.....$50K credit card limit, 20%. $90K net and $750K unit, maybe 3 times and maybe falling. $1M net and $750K unit……north of 6 times and rising.

Thing is, these two questions, usually asked as stand-alone enquiries, are inextricably linked. This is particularly the case as investors look for something better than a 2% term deposit rate or even the sometimes encouraging dividend yield on shares. I see Westpac's current gross dividend yield is being quoted, admittedly on a deflated share price, at 9.3%. Not bad for a blue chip even with an unpleasant fine pending. Westpac is currently trading on a price / earnings ratio of 12.9. That is effectively a multiple of nearly 13 times. Interestingly CBA is trading at a PE ratio of 18.2 times on a yield of 4.89%. Guess which company the market is pricing in risk for ? I'll come back to this later.

The bottom line is that low interest rates and subsequent cheap debt make a really substantial impact on demand, investment decisions, business risk and profitability. The lower the interest rate, the more you can pay for a debt funded asset while still maintaining a strong return on equity. The value of that asset will also be impacted by the availability of other investment options and the degree of risk involved. If we assume that my medium-term predictions for a benign interest rate environment are correct (yes, one hell of an assumption to be sure) then we might need to think about where multiples for larger management rights are going.

I would suggest that for big MLRs netting say, north of $750K, the answer may well be ….. they are going up. Assuming the business survives due diligence unscathed and doesn't present any unpleasant risks is it really worth less than half a Westpac share? How about a third of a CBA share. Yes, the comparison is a bit tongue in cheek, but you get my point. If you know of a safer going concern business model than management rights let me know. Until then there's a lot of money out there looking for a home and I expect that home will be management rights syndicates for many of our clients.

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fresh ideas...

Economic theory suggests that as this money seeks to find said home in the MLR space supply will dwindle and demand will rise. Rising demand and limited supply results in a thing called inflation. Prices rise. When the Saudis pump that last barrel of oil out of the ground or Penfolds bottle that last 2014 barrel of Grange we know the value will not be the same as it is today. Just as it is in management rights right now there will be more buyers than sellers.

Please understand that I not suggesting multiples will or should go higher and my suggested NP benchmark is just an example. I'm simply making observations in respect of some drivers that might impact multiples and cause uplift. Accor reportedly paid a 23.7 price earnings ratio for Mantra and a 39% premium over the average share price (inclusive of franking benefits). Yes, an integrated accommodation business of significant scale but underpinned by the value of management rights. That's a huge difference to the sort of values we are seeing for larger management rights. You've got to wonder if the value gap is really that big!

In closing , who the hell is Samuel Clemens I hear you ask……. you probably know him better as Mark Twain.

Oh, and by the way, about 50% of all studies are subsequently proved to be flawed. I worry about that.

Disclaimer: I'm not a financial advisor and I don't hold an AFSL. Seek appropriate independent advice and adopt some level of paranoia. It will stand you in good stead. Yes, I know there's more to PE ratios and direct comparisons with stand alone MLRs are fraught with danger, but I think the point is worth making anyway.

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