The PCT Top 100 Has Lost $2.5 Billion in Enterprise Value in 2020… Thus Far

I expect the S&P 500 Index to decline over 60% from its February 2020 high through the end of this cycle; Pest control M&A impacted, but there is still hope.

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PREPARING FOR THE END GAME

On September 12, 2019, I published the following in our exclusive publication for Potomac clients, *Notes from the Front Line*:

"Last week I returned home from Stockholm after the closing of the $200 million sale of Nomor AB to ServiceMaster in what is likely the most expensive pest control deal in history. The head of M&A for ServiceMaster wrote to me: 'Paul, you absolutely run circles around every other advisor in this industry and you should be proud of what you were able to do for your client. Over the last decade, you've been the architect of the highest priced deals for every acquirer out there. Which is why we hate you ☺'

I absolutely loved working with the Nomor crew and I was thrilled with what we were able to do for them…. but I am not happy.

In my mind, this was the melt up transaction. This, to me, marks the beginning of the end of the pest control consolidation bubble. Once you've been running sell-side auctions for as long as I have, you develop a sense, or a gut feel that "this one is different." I had this feeling in the early 2000s out in Silicon Valley and again in 2008. The market is changing.

By now you must be tired of me talking about valautions at offensive levels and you might even feel like this is the new normal… valuations will never revert back to the historical mean. In the words of The Byrds (or King Solomon in Ecclesiastes), there is a time to plant, a time to reap. Right now is the time to reap.

We Are Entering the Late Stages of this Bubble

I am convinced that we are in the final stage of not only the pest control consolidation boom, but the central-bank induced speculative casino that is the stock market. Selectivity of buyers has increased to a level not seen in years. A tremendous amount of capital has already been committed this year. The stock market is so overpriced that one small hiccup and this all comes crashing down. You, as an owner, have been given a gift by the central planners in DC, Tokyo, London and Frankfurt.

In the words of The Byrds (or King Solomon in Ecclesiastes), there is a time to plant, a time to reap. Right now is the time to reap.

As much as I am happy for the business owners in this industry, and happy for myself, we should never forget that we are the direct beneficiaries of wealth stolen from the working class. People like your parents and people like my parents. My father was an airline mechanic and my mother worked at McDonalds to support us kids. It is an undeniable truth that what goverments are doing right now is dramatically increasing wealth inequality, setting the table for a massive pension crisis and saddling every young person around the world with a mountain of debt.

You have employees that work tremendously hard and struggle to live on $25,000 per year while the central banks around the world continue to flood the market with trillions of dollars in excess liquidity to create a wealth effect. Their lives get more difficult as you and I increase our wealth (or at least you increase yours on paper until you exit, if you exit in time). This is not the free market and this is not capitalism, this is central planning at its worst. Governments are stealing money from workers (through the inflation tax) and using that money to buy financial assets, which benefits those of us that own financial assets at the expense of people like your technicians, your managers, the teacher at your daughter's school, and the woman who cleans and presses your clothing. If there is any doubt why the young people in the West are feeling the Bern, just look at what governments are doing.

As interest rates have been forced to a 5,000-year low, the stock market has reached valuation multiples seen only immediately prior to the 1929 and 2000 crashes, and the level of greed among market participants has reached a level of absurdity. If you're reading this, you're a client and you know me. You know that I, more than anyone in this industry, believe in extracting every cent possible out of a sell-side process and I have proven that, given that I have done the highest priced deals in the industry. However, as this boom grows long in the tooth, I have begun to see the dark side. I have watched as sellers have become absurd in their demands to acquirers, setting up deals that are lopsided and are almost certain to be a bust. I have seen sellers lose sight of the bigger picture. Your $20 million pest control business is not worth $65 million dollars. You might get $65 million dollars for it, but make no mistake, that's not what it's worth, and that's not what it's going to sell for for much longer. You and I are blessed, but don't lose sight of the fact that by the virture of you getting $65 million for that business, something is tremendously wrong in the world that we live in.

An unimaginable amount of debt is underpinning your valuation and subsidizing firms like Uber, Tesla, Blue Apron and on and on, businesses that would otherwise not exist in a free market. The government-sponsored central banking cartel has fixed the most important price in an economy – the price of money – and turned future generations into debt-slaves.

When your pest control business is worth 6.0x trailing EBITDA and you get to the final runoff in a process and someone is willing to hand you 17.0x EBITDA, you take it. You take the money and run.

Take the Money and Run

Thus far in 2019, I have run extremely competitive processes and handed sellers term sheets for 3.1x, 3.2x, 3.3x, etc, deals, and heard in return, "I heard you got 4.0x for so and so, where's my 4.0x revenue deal?"

When your pest control business is worth 6.0x trailing EBITDA and you get to the final runoff in a process and someone is willing to hand you 17.0x EBITDA, you take it. You take the money and run. You don't ask the acquirer to put you on COBRA for 18 months. Or pay you a $300 a month car allowance. You take that money. Because if you don't, a year or two from now, when your business is worth 1/3 of what it is today, you're going to say, "Godamnit, how is it that I was looking at putting $30 million in the bank and now I can barely get $10 million for it. What the hell was I thinking when I drew the line in the sand at $32 million and kept the business when I had $30 million in hand?"

Mark my words. There are a few of your colleagues reading this who will be saying that in the next few years. I know this because I advised sellers during the Dotcom boom and then again in the great runup to the crisis of 2008. And one thing I've learned is that it is always more painful for those who waited too long and missed the boat than those who sold a little too early.

Almost every one of our clients is able to sell his business for a public market multiple – 13.0x+ EBITDA. For 15 of the last 20 years, Rollins traded somewhere, on average, between 10.0x and 13.0x EBITDA. That's Rollins, the darling of the industry with almost 15,000 employees and a president that has all of his teeth. But that is where the market is.

So if you want to sell at the highest multiple in almost a century, you had better get out the door by the end of the year. If you miss it, don’t come crying to me.

A few years ago I did an interview with Ann Nagro at PCT Magazine. I said, ‘Just like the equity markets, the M&A markets never "crash up," there is a crescendo, but when the window closes, it typically slams shut.’ When this market unwinds, and it will, it will be shocking and it will be violent. By the end of this cycle, I have no doubt in my mind that the S&P 500 Index will be, at minimum, cut in half and when that happens, pest control companies will once again sell for 1.0x to 1.25x revenue – essentially 1/3 of what they are selling for today. I am not telling you this to scare you. I am not telling you this so that I can do more deals. I am telling you this because you are a Potomac client, and above all else, it is my job to make certain that you are informed more than anyone else out there. This market is on it’s last legs and I don’t believe that we’ll see it again in our lifetime.

There is no way to time this market. It could blow up by the end of this week. You don’t know and I certainly don’t know. But there is no historical basis for a ‘soft landing,’ when this market blows up, it will happen with no warning, and no time to get out in the market.

So if you want to sell at the highest multiple in almost a century, you had better get out the door by the end of the year. If you miss it, don’t come crying to me.

For those of you who are in it for the longer term, it’s time to slow down investment in your business. At the end of this month, I am going to be doing a webinar on the Cantillon Effect (i.e., the change in relative prices resulting from a change in money supply) in the pest control industry and how what is going on in the capital markets right now is creating a tremendous amount of malinvestment, particularly in the door-to-door side of the business.”

- Paul Giannamore, *Notes from the Front Line*
  September 17, 2019

The March 2020 Update

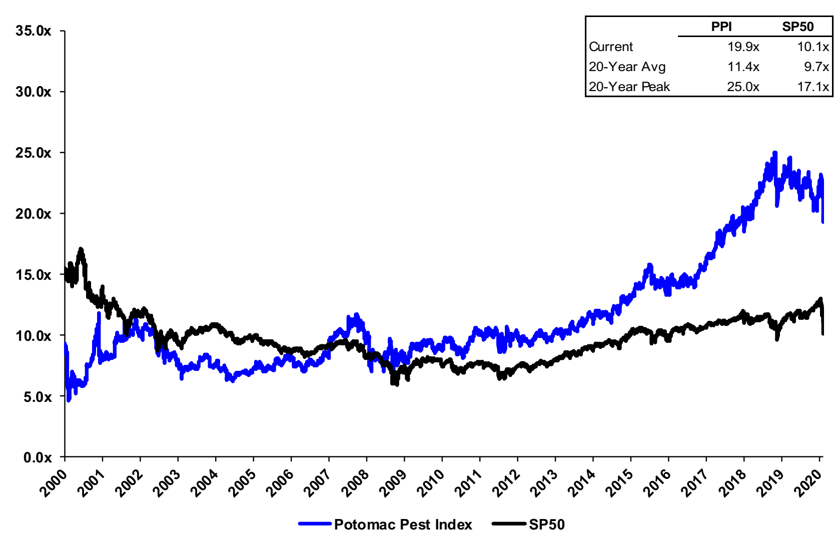
Obviously, when I wrote the above, Coronavirus didn't exist. Further, this was over a month before ServiceMaster shit the bed in public.

Although the markets are in free-fall, with the S&P 500 having fallen 20%+ since my last Commentary, you might be surprised to find out that my thoughts on 2020 are not as dire as you might have guessed by reading the above.

When we value businesses, we rely heavily on the Potomac Pest Index ("PPI"), Potomac's proprietary index of publicly-traded pest control companies.

In my most recent Commentary, I discussed that we were now able to see that the market peaked 2018 through the end of 2019. Given that this is one of the only times in my life that I've been right about anything, I am making sure that you hear about it again. In the chart below,you'll see the PPI ratchet up in 2018 and by March of 2020, it's trading at its late 2017 levels.

The PPI vs S&P 500 Index



Keep in mind, the PPI is a public market index and doesn't correlate 1:1 with private market transactions. Exit multiples in DCF models are based on future expectations, rather than precisely where the market is trading today.

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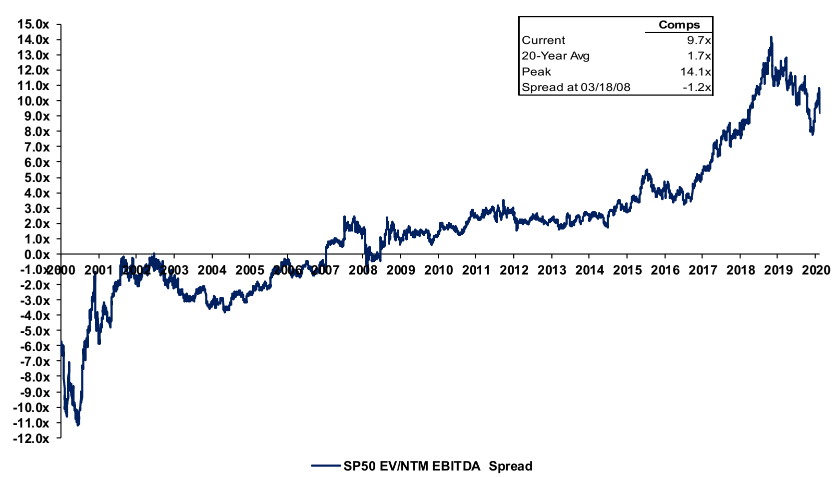
At present, the PPI trades at an average EV/NTM EBITDA of 19.9x, or a 97% premium to the S&P 500. After the recent “Coronavirus correction,” the S&P 500 is trading near its 20-year average of ~10.0x forward EBITDA.

While the PPI has also taken a hit, trading at ~20.0x forward EBITDA compared to its 20-year peak of 25.0x, it’s still trading 75% higher than its 20-year average. The question is for how long? I’ll have more to say about that below.

The pest control industry magazines love to quote “industry experts” that come up with all kinds of cockamamie reasons why asset prices have increased dramatically in the industry (and yes, the editors have heard my comments about quoting retards). But the reality is a simple one: (1) financial assets are absurdly over-valued due to government intervention in the markets, and (2) the pest control industry is valued at a premium over an absurdly overvalued equity market. The chart below illustrates the spread premium of the PPI over the S&P 500. At present, the PPI trades at an average EV/NTM EBITDA spread premium of 9.7x (vs 1.7x historically).

Historical EV/NTM EBITDA Spread Premium



The chart above indicates something that I think is important to keep in mind. During the financial crisis of 2008/2009, we began to see a re-rating of pest control businesses in the public equity markets. You can clearly see that in the chart above as the premium moves into positive territory with the onset of the subprime crisis circa 2007.

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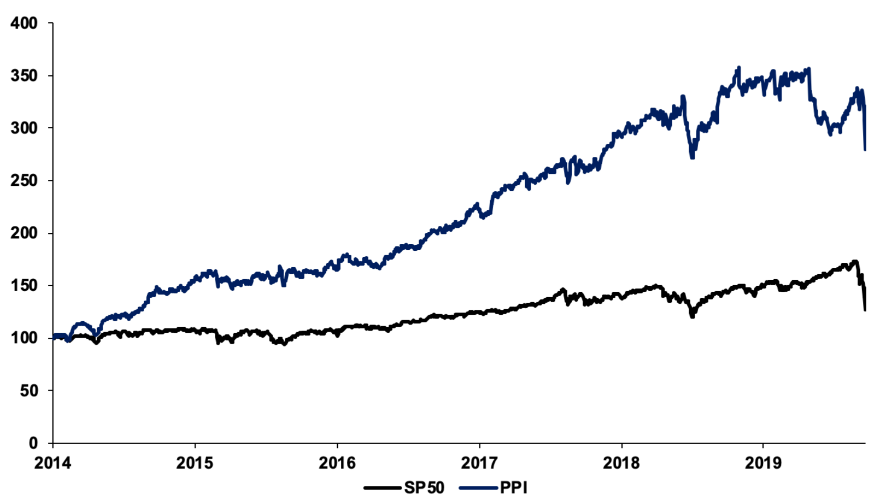
Businesses such as Rollins began to be viewed as "safe bets" and "recession resilient" plays. As quantitative easing kicked-in full force, pest control assets, namely Rollins, began to be thought of as a high-yield bond and Rollins EV/EBITDA skyrocketed.

In the beginning of this Commentary I said that that the S&P 500 Index will fall 60% from its February 2020 high by the end of this market cycle. As we've seen since late last year with the Fed's repo market intervention and this week's promise of $1.5 trillion in support, these governments will continue to kick the can down the road and compound our problems. They will certainly unleash the monetary and fiscal bazookas to prop up the equity markets. Even if the market continues to roll over, if the PPI spread premium remains, transaction multiples in the pest control industry will remain elevated (though off their 2019 highs.

The final chart below shows the performance of the PPI versus the S&P 500 from 2014 through today. Although I believe that ServiceMaster will be a drag on the PPI index in the near term, Rentokil and Rollins should provide support as I expect them to perform well relative to the broader market. (For you nerds out there, a long RTO/ROL and short SPX / Crude might start to look like an interesting trade this spring).

Relative Stock Price Performance – 2014 to Present



The Virus Threat

Even though I only call myself Dr. Giannamore when I go to the Middle East (if you're a doctor in the Middle East, you don't have to wait in line anywhere), I feel like COVID-19 is going to be a very serious problem. In fact, I think that it has the potential of being worse for the economy than the 2008/2009 financial crisis.

My uncle is the mayor of rubbish little town in Italy, and I have been getting the constant update from him on the situation – and it's horrible. With overflowing hospitals, medical professionals are now deciding who lives and who dies. Pay attention to what goes on in Italy, because in a matter of weeks, that is what the rest of Europe and the United States is going to look like.

If this thing ratchets up and stops global commerce, no amount of QE and fiscal stimulus is going to prop up this market.

I've heard this statement from just about every acquirer out there, "Paul, we're going to honor every deal in exclusivity and the LOIs that we have outstanding. However, those valuations would likely be changing if they weren't already on paper.

What Should You Do Right Now?

After sending our *Notes from the Front Line* out to our clients last September, we had quite a few of them pull the trigger and hit the market without delay.

They were ready. We had already done a full audit and a full-blown valuation on their businesses. We had stay bonuses in place with key management. Numbers were cleaned up and ready to go.

Because the largest deals are always the riskiest, yesterday I was able to make calls to our PCT Top 100 clients in the market right now and give them the good news.

I've heard this statement from just about every acquirer out there, "Paul, we're going to honor every deal in exclusivity and the LOIs that we have outstanding. However, those valuations would likely be changing if they weren't already on paper.

One client called me yesterday and said, "even after your note in September, we were going to wait. But when you told us about ServiceMaster in October, we knew we couldn't wait any longer. You always know things that others don't, so we're really fortunate to have you running the show."

If you're out in the market right now, you're probably safe.

If 2020 was supposed to be "the year," then get moving.

Reach out to us at team@potomaccompany.com today to get a valuation of your company.