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Myths about Middle Market Valuation Multiples

By Ron Stacey

Sometimes it seems as if the only requirements to be an investment banker are the ability to multiply two, usually single-digit numbers together and write your name. Hence, upon finishing the second grade, everyone is qualified. For example, take an EBITDA (earnings before interest, taxes, depreciation, and amortization) of \$10MM and the median lower middle market valuation multiple of five, which incidentally has nothing to do with the number of fingers on your hand. Continuing, 10 times five is 50 and *voilà!*—the value is \$50MM. So what's with post-graduate education from top schools, for top prices, and years of toiling long hours in the concrete canyons of Wall Street? Perhaps, there is more to it.

A multiple of EBITDA is a means to reflect the economic value of an operating business and is a primary driver in M&A price negotiations where a skillful investment banker engages in price discovery among several bidders, each with unique synergies, capital structures and tax attributes. This article addresses the origins of EBITDA multiples for valuing an operating business as an economic asset by using EBITDA as the earnings stream produced by the business, without consideration to capital structure (before interest) or taxes (before taxes.) The distinction is similar to valuing financial assets, stocks and bonds, as a function of cash flow prior to investor taxes.

Multiple Terminologies

Multiples are rooted in the conceptual notion of return on investment. The return an investor, or buyer, requires for a specific investment is termed the cost of capital. The mathematical manifestations for cost of capital are capitalization rates and discount rates. Applying the cost of capital to the expected benefit stream determines the value of the asset.

Benefit streams come in a number of varieties referred to as EBITDA, earnings before and after tax, cash flow and free cash flow. In keeping with our approach to value an operating business as an economic asset, we are employing EBITDA, as defined above, and net EBITDA as the benefit stream after additional investment required to support growth. Net EBITDA then is the benefit stream remaining for distribution to the investor.

What is a multiple?

A multiple is a means of expressing a desired rate of return or the opportunity cost of capital relative to other similar assets based on the economic principal of substitution. The reciprocal of a multiple is a capitalization rate, or alternatively a desired return on investment expressed as a percentage. Going back to our example, a 20percent capitalization rate on an EBITDA of \$10 million annually into perpetuity (theoretically at least), yields a value for the investment of \$50 million; \$10 million divided by .20. The reciprocal of a 20 percent capitalization rate is one divided by .2 or 5. The same \$50 million value can be found by multiplying \$10 million in annual EBITDA by 5; \$50 million. Perhaps the allure of multiples is the relative ease of multiplying 10 times five as opposed to dividing 10 by .2. Most of us, it appears, prefer to multiply.

Since multiples move inversely to the required return or capitalization rate, a higher multiple is a lower capitalization rate and a higher value since the return is the reciprocal of the multiple. These mechanics are illustrated in the following table:

Risk Impact on Multiples

Risk is the perceived probability of loss, default, or not achieving the cash flows necessary to produce the required return for the risk; the latter circumstance most often associated with

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the lower the perceived risk is in value for the asset. Risk adverse Note accepting a 3.5 percent return of return and multiples reflect risk

Risk appetite is not a constant but changes with economic conditions, liquidity in the markets, availability of credit, and herd instincts. For example, when the wizards of Wall Street convinced the capital markets that housing prices would never go down, and that risk was spread widely enough not to pose a systemic risk (which actually worked in the telecom bust), if you could fog a mirror you could get mortgage. Try that today. Most mortgage lenders today require a colonoscopy as part of the documentation.

One final caveat about risk and cost of capital for middle market companies: smaller companies convey greater risk and receive lower multiples. Very small companies typically referred to as mom-and-pops, trade in the aggregate at two to three times a metric known as seller's discretionary earnings, adding back a salary and incorporating the "job" that comes with the business. Moving up market by reported transaction size, deals from \$5 to \$50 million (75 percent of all reported transactions) will command our five times multiple; \$50 to \$150 million, seven to eight times, \$150 to \$400 million, eight to nine times, over \$400 million, 10 times and up.

Derivative Multiples, Rule of Thumb Metrics

Derivative multiples, reported in the press, are multiples derived after the fact and do not drive deals. For example, if a deal is reported in the financial press at a price of \$50 million and the revenue for the acquired company is \$25 million, then the deal can be expressed as two times revenue. Derivative multiples express the value of an outcome (done deal) driven fundamentally by EBITDA and a desired rate of return, influenced, of course, by the competition for the asset, and the disparities among buyers. Moreover, unless terms are disclosed via press release by the parties, the reporting services are not likely to report the price and terms accurately; particularly if the information is collected in an interview from people "familiar with the matter." Application of derivative multiples obtained from the financial press to a specific situation is a dangerous exercise, especially for buyers.

For example, if a company is in the market with maybe substandard earnings or perhaps no earnings, the seller points to two times revenue and the buyers, at least the smart ones, hold a different point of view. Once again, it is the buyer's perceived risk adjusted return to the benefit stream that drives the price and terms. One caveat, in the hands of a skilled sell side negotiator, derivative multiples can be useful in situations where the seller's earnings are "challenged."

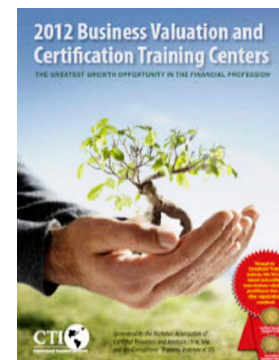
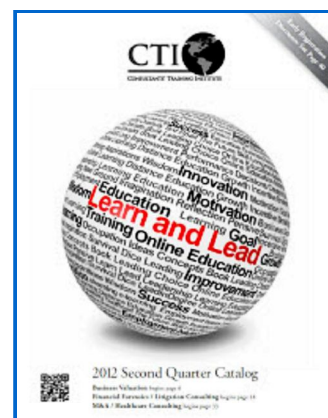
Public Company Multiples Sie does matter

Large publicly traded companies are distinctly different from middle market companies in three respects: risk, standard valuation methodology, and liquidity. A large multinational company with a diversified portfolio of assets (think GE), poses significantly less risk to an investor than does a middle market business; hence, the average cost of capital for large public companies is around 9percent, implying a multiple of better than 11 as compared to five. Reported multiples, particularly price earnings ratios (the P/E multiple), are calculated on after tax historical earnings for the specific entity and represent a return to the equity, not the entire enterprise, which includes debt and equity. Moreover, an investor in such a company traded on an active exchange has the option of selling the investment on a moment's notice for the then bid price; in other words, the investment is highly liquid.

Middle market companies entail higher risk, are typically valued from an economic perspective at the EBITDA level, and are highly illiquid. Any application of public company multiples to metrics for middle market companies produces inaccurate results and is especially dangerous in the hands of the uninformed, bliss aside. Take, for example, a \$100 million revenue business with an EBITDA of \$10 million and after tax net income of \$5 million. Looking to the average 15 P/E multiple for the S&P 500 suggests a value of \$75 million for the entity, 50 percent higher than the same value with a five multiple at the EBITDA level for the economic asset, which is a better approximation of value for an illiquid, closely held middle market business.

Summary

This article addresses the concept of a business as an economic asset separate and apart of a particular entity that might own it, best valued as a multiple of EBITDA. Multiples are defined as the inverse of capitalization rates or discount rates; a five multiple being a 20percent capitalization rate. Higher multiples denote lesser risk and value. Derivative multiples or rules of thumb are generally driven by economic fundamentals as a function of the acquired EBITDA and are simply a different form of expressing a result. Public company multiples represent liquid minority interests in large companies and rarely relate properly to middle market businesses.





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