SIMPLIFYING VALUATION MULTIPLES

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Simplifying Valuation Multiples – A Primer for Private Business Owners

This thought leadership piece focuses on interpreting different valuation multiples and their relevance under different applications. We further highlight differences where certain multiples are used to derive enterprise value (EV) vs multiples which lead to a direct calculation of equity.

Valuation multiples are commonly quoted in the media in connection with public equity prices as well merger and acquisition activity. These valuation metrics appeal to private business owners as they are readily understood and can easily be applied to derive an estimate of value for their own businesses. However, when making these comparisons, it is important to appreciate the theory behind the use of valuation multiples, the assumptions underlying the different types, and their relevance to the particular situation. Business owners should also be aware of certain limitations when applying the multiples of publicly-traded companies to value smaller privately-held businesses.

THE THEORY BEHIND VALUATION MULTIPLES

The application of valuation multiples across like businesses (commonly referred to as guideline public companies or market comps) is based on the premise that those businesses have similar underlying economics, which are apparent in their financial or operating metrics. In reality, there is never a perfectly comparable company; some differences are always prevalent including size, product and service offering, geographical outreach, cost structure, quality of management, amongst others. Accordingly, considerable caution needs to be exercised, and robust analysis undertaken, when adopting the multiple of another company that may seem somewhat similar.

Valuation multiples are in effect a simplified form of the discounted cash flow. Mathematically, the multiple is the reciprocal of the capitalization (or "cap") rate, defined as (r – g) - where "r" represents the required rate of return and "g" represents the long-term growth rate. Hence, a valuation multiple is essentially a derivation of the perpetuity equation, assuming a long-life, going concern with a constant growth rate. Consequently, multiples may be of limited use in instances where the business opportunity has a short life, or where significant growth (or contraction) of a business is expected over the next number of years.

TYPES OF MULTIPLES

Enterprise Value Multiples

Enterprise Value, or EV, is the total value of a business, comprising all forms of capital, including both its interest-bearing debt and equity. The most common multiples used in the derivation of Enterprise Value are those based on revenue and EBITDA.

Both revenue and EBITDA are approximations of cash flow available to all stakeholders (both debt and equity holders), which is consistent with the EV definition. EV multiples are widely used in valuations as they are capital structure neutral and can be applied regardless of a company's subjective choices regarding financing and capital structure.

1) Revenue Multiples

It is assumed that the revenue being capitalized is attained by deploying both debt and equity capital, in optimal proportions. In this respect, a multiple of revenue would always be representative of value to both debt and equity holders i.e., EV. The revenue multiple is reported as EV/Revenue.

Revenue multiples are less cogent measures of cash flow, since they do not consider the operating expenses or cost structure of the subject and comparable companies. They therefore tend to be more useful where operating metrics are consistent across the sector (e.g., regulated industries). Revenue multiples also tend to be used on a default basis, where profit or cash flow-related metrics are not available. For this reason, the EV/Revenue multiple is most widely used as the basis of valuation for technology and start-up companies that have yet to generate a positive earnings or EBITDA that can be used to support an earnings-based valuation.

The table below shows recent multiples for a number of randomly selected technology stocks on the TSX, all of which have negative EBITDA. It is not uncommon to see valuations in the technology space at more than 3 times revenue (and, at times, exceptionally higher than that), even in circumstances where a company has yet to achieve profitability. In some cases, the trading value of the company may reflect the value of a company's customers or intellectual property, which could be acquired by a competitor with potential cost synergies.

Technology & Software Company Multiples

Company	Revenue	EBITDA	EV	Multiples	
				EV/Rev	EV/EBITDA
Figures in CAD million	LTM	LTM	Current		
Medical technology company	68	-25	223	3.3	NA
Technology based learning platform Company	134	-15	1,444	10.7	NA
SaaS company	623	-164	2,616	4.2	NA

Source: S&P Capital IQ

2) EBITDA Multiples

EBITDA multiples, like revenue multiples, derive an Enterprise Value. This is because EBITDA reflects earnings before interest and principal payments to debt holders or dividends to equity holders. A multiple of EBITDA is again representative of value that is neutral with respect to capital structure. The EBITDA multiple is reported as EV/EBITDA.

The EV / EBITDA multiple is most commonly used as a valuation measure for mature and established companies with sustainable EBITDA levels that are reflective of future earnings at normalized growth rates. The following table summarizes the average EBITDA multiple for various S&P 500 sectors as at May 8, 2022:

EV/EBITDA Multiples by Industry

Industry	EV / EBITDA
Energy	6.1x
Utilities	10.8x
Materials	6.5x
Industrials	10.2x
Consumer Discretionary	11.4x
Consumer Staples	12.4x
Health Care	13.2x
Information Technology	14.7x
Communication Services	8.9x

***Source: CapitalIQ**

While not perfect, the above table indicates a correlation between EBITDA multiple and industry growth, or growth prospects, where the higher-growth sectors are afforded relatively higher multiples. In addition, there may be a negative correlation between the multiple and the quantum of required capital re-investment. This is because, all other things being equal, companies with identical EBITDA but greater capital expenditure requirements, would generate lower actual cash flow, which is not picked up in the EBITDA calculation.

Equity Value Multiples

Price to earnings (P/E) and Price to book (P/B) are the most common multiples used in determining market value of a company's equity. In the case of the P/E multiple, both the numerator and denominator pertain to the equity of the company, where the price represents the price of a common share, and the residual earnings to equity holders are calculated after servicing any interest associated with debtholders. In the case of the P/B multiple, the comparison is essentially between the market value of the company's equity and its accounting, or historical cost value.

3) Net Earnings Multiple

P/E multiples, though a popular benchmark of a stock's performance, are not widely used when valuing private companies or pricing a private company transaction. This is because the capital structure embedded in the multiples of the publicly traded companies would not always be comparable to that of the private company.

In addition, private company acquisitions are typically negotiated on an EV basis, which makes the use of an EV valuation methodology, such as EV/EBITDA, more relevant in the M&A context.

4) Book Value Multiples

The P/B multiple is also a useful valuation measure as it provides a direct comparison between the book value and market value of a company's equity. The multiple is most commonly used in industries with significant tangible asset backing and is calculated by dividing the total market capitalization by the book value of equity.

The application of P/B multiples is often used in the valuation of financial institutions where there are significant loans and investments on the balance sheet. Since the value of loan portfolio on the books is directly linked with market driven yields, Price-to-Book multiples of comparable listed financial institutions with portfolios that have similar credit ratings are viewed as appropriate metrics with which to value privately held financial institutions. In addition, the use of EBITDA multiples to value financial institutions would not be appropriate as it is often difficult to separate interest income and expenses that are of an operating nature, from those that are related to capital structure.

Conversely, P/B multiples are less useful where a company's underlying value is predicated on significant goodwill or intangible assets that are not always adequately reflected on its balance sheet.

Relevance of Public Company Multiples

The comparability of public and private companies must be carefully assessed when attempting to apply the public multiples to their private counterparts. In particular, the public comparator may merit a higher multiple for numerous reasons including, but not limited to:

- Larger size and greater economies of scale
- Reduced risk due to a broader range of product and service offerings, customer segments and geographic reach
- Easier access to capital
- Better growth prospects
- Greater liquidity associated with minority interests

In addition, public company pricing can fluctuate significantly, due to investor sentiment stemming from transitory economic, industry and political events. As a result, the value of a public company at a particular moment in time may not be reflective of its true intrinsic value. Also, certain companies are well "marketed", often in the public limelight and enjoy significant investor interest, with the "hype" often not justified based on recent financial results or reasonable forward looking financial projections.

Conclusion

Vendors and acquirers of private companies often price transactions based on multiples of EBITDA or revenue because of their ease of application, as well as the fact that these multiples are typically calculated on an unlevered basis and most transactions are structured on a cash-free debt-free basis. However, the use of a particular multiple methodology is not appropriate in every circumstance and selection of the multiplier based on similar public companies without adequate consideration of differences in size, operations and profitability can result in misleading conclusions.

Accordingly, valuation of privately held business using market multiples is an exercise that must be undertaken with caution and diligence. It requires an extensive analysis to determine the relevance and application of publicly traded company multiples to an open market transaction involving private companies.