

VALUE STRATEGIES

A Newsletter for Business Owners and Executives

Multiple Madness: What Does It All Really Mean?

When establishing the value or price of a company, reference is often made to valuation multiples. This includes multiples of revenues, multiples of EBITDA (earnings before interest, taxes, depreciation and amortization), multiples of free cash flow and other terms. But where do these multiples come from, and what exactly do they mean?

First, A Technical Explanation

From a technical perspective, a valuation multiple is the inverse of a capitalization rate. A capitalization rate represents the rate of return that investors need in order to place capital at risk, given the risk profile and growth prospects of an investment opportunity. A capitalization rate is expressed in “real” terms, that is, net of long term inflationary expectations and, in some cases, an allowance for real growth. Accordingly, dividing a given level of cash flow (or alternatively, multiplying a given level of cash flow by a valuation multiple) assumes that such cash flow level will continue growing annually at the embedded growth rate over the long term.

By way of example, a multiple of 5x EBITDA translates into an EBITDA capitalization rate of 20%. However, it is important to recognize that EBITDA multiples (and hence EBITDA capitalization rates) are expressed before income taxes and before capital spending requirements. Therefore, an EBITDA capitalization rate does not imply an after-tax return on equity.

Internal Consistency is Key

Fundamental to establishing a meaningful valuation multiple is to ensure internal consistency between:

- (1) the basis by which the valuation multiple is established; and
- (2) the cash flow base against which the valuation multiple is applied.

For example, where cash flow is determined on a pretax basis, the valuation multiple adopted also should be determined on a pretax basis. While after-tax cash flows and after-tax valuation multiples generally are preferable (because they force explicit consideration of all factors that ultimately influence shareholder value), a similar valuation result can be obtained using a multiple of EBITDA (or some other basis) assuming that internal consistency is maintained. This concept is illustrated in Exhibit 1:

Exhibit 1**Relationship Between Cash Flow and Valuation Multiples**

		Multiplied by: Valuation Multiple	or	Divided by: Capitalization Rate	Equals: Company Value
Revenues	\$20,000,000	1x		100%	\$20 million
Less: cash operating costs	\$16,000,000				
Equals: EBITDA	\$4,000,000	5x		20%	\$20 million
Less: sustaining capital expenditure requirements	\$1,000,000				
Equals: pretax cash flow	\$3,000,000	6.7x		15%	\$20 million
Less: income taxes	\$1,000,000				
Equals: after-tax cash flow	\$2,000,000	10x		10%	\$20 million

Factors Influencing Valuation Multiples

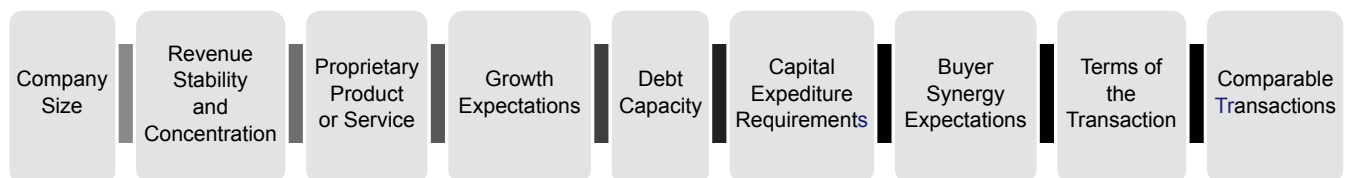
Valuation multiples (and capitalization rates) inherently are subjective. In business transactions, they are affected as much by negotiations and deal structuring as they are by economic analysis. That said, valuation multiples tend to be influenced by the following factors:

- company size. Larger companies tend to fetch higher valuation multiples within a given industry. This is because larger companies tend to enjoy a greater market presence and are less reliant on a handful of customers or the business owner. In addition, larger companies usually generate more interest from a broader group of larger, better financed buyers (both strategic buyers and financial investors), thereby creating a stronger auction for the company;
- revenue stability and concentration. A company's customer base has a significant impact on value. Valuation multiples tend to be higher for companies that have a diverse base of repeat customers. In particular, buyers tend to prefer companies that have a 'sticky' customer base, meaning that the likelihood that customers will remain loyal to the company is high (sometimes referred to as 'barriers to exit'). In addition, higher multiples are paid for companies that are not dependent on a handful of customers for a significant portion of their revenues;
- proprietary product or service. Companies that have developed some uniqueness or competitive advantage in their product or service offerings enjoy higher valuation multiples. This may come in the form of proprietary technology, an established brand name, a unique method of distribution, or other advantages, which are difficult for competitors to easily replicate (i.e. barriers to entry);
- growth expectations. Companies with a demonstrated history of growth (in terms of revenues and cash flow) and the prospect that such growth will continue tend to fetch higher valuation multiples. This is because business valuation is forward-looking, and buyers are paying for future cash flows. By way of example, if a company's EBITDA is expected to grow by 20% in the coming year, then a multiple of 6x historical EBITDA translates into a multiple of 5x forward EBITDA;

- debt capacity. The greater the ability of a buyer to use debt rather than equity to finance a transaction, the higher the valuation multiple. This is because the cost of debt financing is lower than the cost of equity financing, and the use of debt serves to reduce the buyer's overall cost of capital. A company's debt capacity is influenced by its cash-flow generating ability and the amount and quality of its underlying assets. Financial buyers tend to employ greater amounts of debt than strategic buyers;
- capital expenditure requirements. Companies with low capital expenditure requirements tend to fetch higher valuation multiples (of EBITDA). This is because a greater proportion (of EBITDA) will be available to the buyer as a return on investment, rather than having to be re-invested into the company;
- buyer synergy expectations. Buyer synergies can come in many forms, including cost reductions, incremental revenue opportunities, the ability to leverage the acquired company's technology, and so on. Where a buyer anticipates significant synergies from an acquisition, it usually is willing to pay a higher purchase price. However, whether or not a premium price actually is paid on account of synergies also depends on the relative negotiating position of the buyer and seller and the terms of the deal;
- terms of the transaction. The terms of a deal are just as important as the stated purchase price. Valuation multiples tend to be lower where the terms of sale are cash on closing, as contrasted with deals where some of the purchase price is paid over time, or is contingent upon the company's prospective operating results; and
- comparable transactions. The valuation multiples paid in a particular transaction are influenced by the multiples implied by transactions that have taken place within the industry or similar industries in the past few years. However, comparable transaction data must be interpreted with caution, given that no two companies are exactly alike. Important differences may exist in product and service offerings, markets serviced, business strategy and so on. In addition, without being directly involved with a particular transaction, it is not possible to know the relative negotiating position of the buyer and seller, the perceived synergies or other important factors, all of which may have affected the stated purchase price and implied valuation multiple. Further, there may be limited or incomplete disclosure of important elements of the deal, such as the terms and conditions of payment, which may also have a significant impact on the observed valuation multiple.

Exhibit 2

Factors Influencing Valuation Multiples



In the current economic environment, EBITDA multiples in the range of 4x to 7x for established mid-sized privately held businesses are not unusual. This translates into an equivalent EBITDA capitalization rate in the range of 12.5% to 25%. Higher valuation multiples (and lower capitalization rates) sometimes are observed for businesses where buyers anticipate significant synergies or where a company's growth prospects are believed to be substantial. On the other hand, EBITDA multiples for smaller companies, or those that rely on a handful of customers or the business owner, tend to be lower.

Lessons for Enhancing Business Value

While valuation multiples are subjective and fluctuate over time, business owners and executives should consider the factors that influence valuation multiples when assessing their own company's competitive position in the market and in strategic planning. By implementing business strategies that positively influence valuation multiples, business owners and executives will reap the rewards associated with lower business risk and higher growth potential, regardless of whether a sale of the business is being contemplated.

Value Strategies is a quarterly newsletter dedicated to helping business owners and executives in measuring, enhancing and realizing Shareholder Value.

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Topics Include

- Preparing for Ownership Succession
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- Selling to Management and Financial Investors
- Family Succession
- Avoiding the Pitfalls

Veracap Corporate Finance Limited is pleased to announce the release of its newest publication entitled

Exit Strategies *for* Business Owners

Realizing Maximum Value for Your Company

This book is intended to provide owners of privately held Canadian companies with an understanding of the most common exit strategy alternatives available to them, and practical guidance on how to successfully navigate the path that they choose. It is also meant to be thought-provoking and to help business owners reflect on the things that are important to them in ownership succession. This will help ensure that decisions are well planned and that shareholder value is maximized, whether ownership succession involves the sale to a strategic buyer, a management buyout or the transfer of ownership to family members.

A complimentary copy of **Exit Strategies for Business Owners** is available for order online at www.veracap.com