

# M & A Multiples: A Key to Value or a Distraction?

By Chas Chandler & Doug Marconnet

*Multiples* is a key word in the language of mergers and acquisitions. In its most common form, a multiple represents the price paid for a business divided by some measure of earnings, such as earnings before interest, taxes, depreciation, and amortization (EBITDA) or operating cash flow (EBITDA less maintenance capital expenditures). Less common forms are industry specific valuation benchmarks. For example, in the 1990s, high-growth but profitless companies such as software companies sold for a multiple of revenues, and dot-coms sold as a multiple of clicks or hits.

Reported multiples are based on actual prices paid in historical transactions from a particular industry or of a certain size. Many investment banks and other organizations regularly report multiples to establish benchmarks for evaluating other transactions.

During negotiations, relying too heavily on reported multiples can do a disservice to everyone. This article explores some of the subtleties with reported multiples and offers ideas on how to properly position multiples in negotiations. While multiples provide a negotiating perspective, they should not be the primary driver of value discussions.

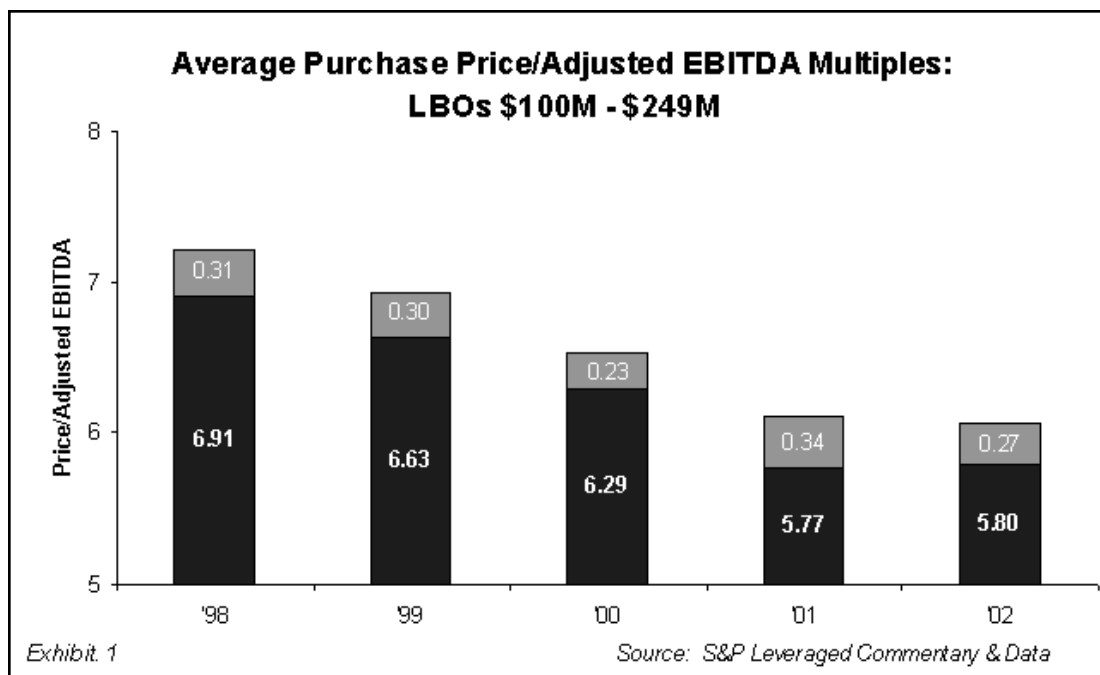
## The Makeup of a Multiple

Reported multiples aren't as definitive as they seem. One can calculate several different multiples for a single transaction depending on what it's being multiplied against. For example, when benchmarking EBITDA multiples, does the multiple reflect reported EBITDA or adjusted EBITDA—after removing nonrecurring, extraordinary expenses (see exhibit 1)? Is the multiple based on last year's earnings, trailing-12-month's earnings, or projected earnings? Does the price include assumed liabilities or consideration for future contingent payments?

As a result of all this, if two people calculate a multiple of EBITDA for the same transaction based on the same historical data, they will likely derive different numbers. When using a multiple from a completed transaction, it is important to learn the context and against what measure the multiple applies.

## Differing Perspectives

Another significant consideration is the perspective from which one calculates the multiple. For example, in a transaction recently closed for a buyer, the seller received a multiple of about six times the prior year's



EBITDA. From the buyer's perspective, however, the price reflected an effective multiple of three ( see exhibit 2).

How can there be such a difference between the seller's and the buyer's perspectives? When conducting a strategic acquisition search, there is usually a compelling reason for approaching each target. In this case, the buyer knew several strategies to improve operating efficiency and increase sales volume. In addition, it knew areas to reduce operating expenses. These were not highly theoretical synergies but very achievable ones. The result was that the buyer could realize higher cash flows than the seller. While paying a strong, fair price to convince the seller to sell, the buyer still bought at a relative bargain.

### Value Beyond the Multiple

Multiples are frequently used, directly or indirectly, during negotiations. Bear in mind, however, that the price of a business is not really based on a multiple at all. Rather, price is a reflection of the value enhancers and reducers for a particular business. Value enhancers are qualities such as sustainable competitive advantages; consistent profitability; strong cash flow; diversification of products, customers, and markets; demonstrated growth potential; and efficient use of capital. Value reducers might include customer concentrations, supplier dependencies, declining markets, and various other risks.

To develop a price, a buyer considers the future prospects of the business, the amount of equity to invest, the cost of capital, and an

acceptable, risk-adjusted rate of return. The absolute price the buyer is willing to pay determines the multiple based on the financial metrics. The resulting multiple can then be compared to the buyer's experience and examples of similar businesses.

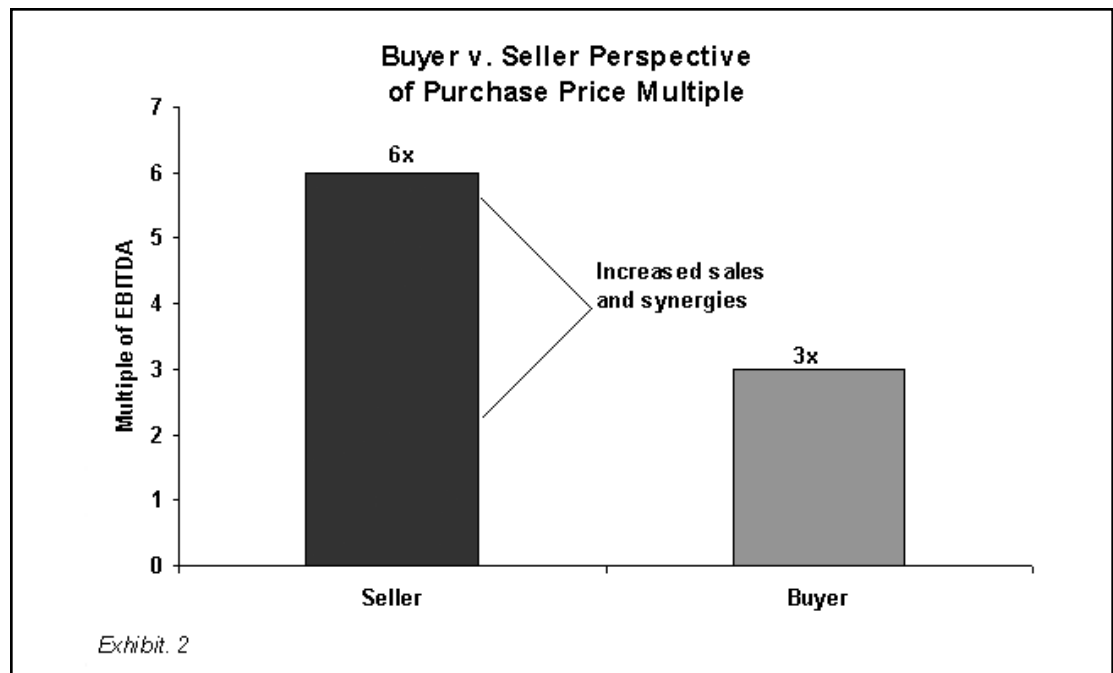
For a buyer who is familiar with the seller and industry, it may be possible early on to discuss a range of multiples based on the buyer's risk/return requirements. The range should not be based on reported multiples but on an early assessment of the many factors that make up value for a specific business. In addition, with recent awareness of the tendency to employ creative accounting, buyers should be careful to establish a reliable base value from which to derive a multiple.

### A Tale of Two Multiples

Putting aside the issue of the buyer's capital structure, consider this comparison: Company A served the metalworking industry, and Company B provided key components used in the food industry. Both businesses had similar sales volume and profitability. Company A had a stronger growth history and larger asset base, yet Company B commanded a multiple double that of Company A. In addition, Company B received all cash while Company A's terms included a *seller note*.

The difference in multiples paid lies in the underlying desirability of the businesses, considering value enhancers and detractors. Company B served a growing market with a strategically key component. Company A, while fundamentally strong,

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<b>Multiples Comparison of Companies with Similar Sales</b>		
	<b>Company A</b>	<b>Company B</b>
<b>Five-year compound annual growth rate</b>	36%	23%
<b>Adjusted EBITDA percent of sales</b>	20%	20%
<b>Adjusted book value percent of sales</b>	45%	25%
<b>Terms</b>	Seller note	All cash
<b>Sale multiple of EBITDA</b>	5	10

*Exhibit 3* *Fleet Capital*

was more of a job-shop, commodity business.

If the buyer in each case had offered an overall average EBITDA multiple of six, Company A's buyer would have overpaid and Company B's buyer would not have been successful. Bottom line: even though Company B sold for a 66 percent premium over the average multiple at the time, the business prospered and the new owner subsequently sold for an outstanding return on investment. Company B's buyer was seasoned and had clear strategic objectives for the company.

### **Conclusion**

Since multiples can be gathered from independent third parties, they can help the buyer and seller gain a comfort multiple range during early price discussions. As the transaction progresses, however, reported multiples or industry valuation benchmarks should become less prominent in negotiations. In the end, a business is sold at a value determined by thoughtful analysis of the business itself, its markets, the investment risk versus return, and the buyer's specific needs.



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