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Multiples

Are they valid for valuations?

According to valuation textbooks, any asset is worth the present value of its future cash flows discounted at an appropriate risk-adjusted rate of return. Whew - that's a mouthful! The way we usually put that into practice is with a discounted cash flow analysis that spreads out forecast data and converts it into a value for the company. But valuation reports frequently include a market approach where a multiple is applied to some historical financial result; and we treat the resulting value as a useful indicator of what a company is worth. So, how can we use a multiple of historical earnings to estimate value when the textbooks clearly say it is future earnings and a risk-adjusted rate of return that we care about?

Multiples Defined

Most of us have seen valuation methods that use some sort of multiple applied to historical earnings – a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization) is common. Sales, gross profit, EBIT, earnings and book value multiples are also widely used. Some people will apply the multiple to a weighted average of past results while others will use most recent historical results. Others (but not many) will use an expectation of next year's results.

"If dolphins are just as smart as humans, why aren't we investing in underwater shopping malls and teaching them how to use credit cards?"

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Corporate Value Partners, Inc.

Corporate Value Partners is a corporate finance consulting firm. Services include:

- Assisting with the acquisition or sale of a business, business unit or product line;
- Assisting with the placement of debt financing;
- Preparing business valuations;
- Assisting creditors in corporate bankruptcies;
- Assisting attorneys with the financial aspects of lawsuits.

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If you have ever seen a discounted cash flow analysis (I mean a really detailed one!) there are a number of assumptions made to estimate future earnings, cash flow and the risk-adjusted rate of return. Imagine taking all those assumptions and squishing them together into one number – and what you'll get is the multiple. All sorts of future-oriented ideas about growth, relative profitability, volatility, working capital usage and other details are supposed to be captured in a multiple. So if we estimate the multiple correctly, we should get a result that is similar to the more detailed discounted cash flow analysis.

Importantly, the multiple is not a set number. It is specific to the company, economic environment and other factors on the date you're doing the valuation. The multiple will be different for different companies, and it will vary over time for the same company depending on what is happening with the business and economy at that time. If you've ever tracked valuation multiples for publicly-traded companies, you can see that the multiples do vary by day (even if it's only slight changes).

Gives and Takes

The benefit to multiples is that they're easy to talk about with other people. It's much easier to say, "It's a 5 EBITDA multiple," than to say, "We estimated light sales growth for 2 years then ramped up growth to double the historical trend to capture the effect of a planned capital expenditure that should really broaden our capabilities, which in turn should improve our profit margins so we projected that the operating profit margin would improve from 4% to 6.5% over a three year period and then level off, and working capital usage is expected to…" You get the picture.

But it's really hard to easily see what drives a multiple without a detailed explanation. For many executives multiples can be vague and very difficult to explain. The nice thing about those detailed discounted cash flow analyses is that they spell everything out and you can easily spot differences. That's why we prepare the detailed discounted cash flow models – they let us show exactly how and why we come up with the value we calculated. Then we can compare and contrast our answers in detail.

Despite their drawbacks though, valuation multiples are a useful method to value a company. Like anything else you just have to be careful how you use them.

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