Zachary Scott
INVESTMENT BANKERS

INSIGHT
PERSPECTIVES ON THE CAPITAL MARKETS

REPRINT
SUMMER 2014

What's in a Multiple?

It is necessary to look under the hood to find the factors driving value.

by Jay Schembs

EBITDA multiples provide good cocktail party gossip, but can be misleading in valuing a business. Too often, owners hear that a friend or competitor sold their business for "eight times EBITDA" and assume that metric can be applied to their businesses. This is not to say that there is no information in a multiple; rather, there is so much information imbedded in this one ratio that the shortcut calculation masks an intricate valuation thinking process that, once unwound, illustrates how difficult it is to apply a given multiple to another business.

While sophisticated investors often speak in terms of EBITDA multiples, implied in their discussion is a consideration of the complex drivers of business value. To them, a business is worth the sum of free cash flows they expect the business to generate over their holding period – discounted to the present by a rate appropriate for the business. This aggregate discounted value of future cash flows – enterprise value, in finance parlance – when divided by EBITDA, yields an EBITDA multiple.

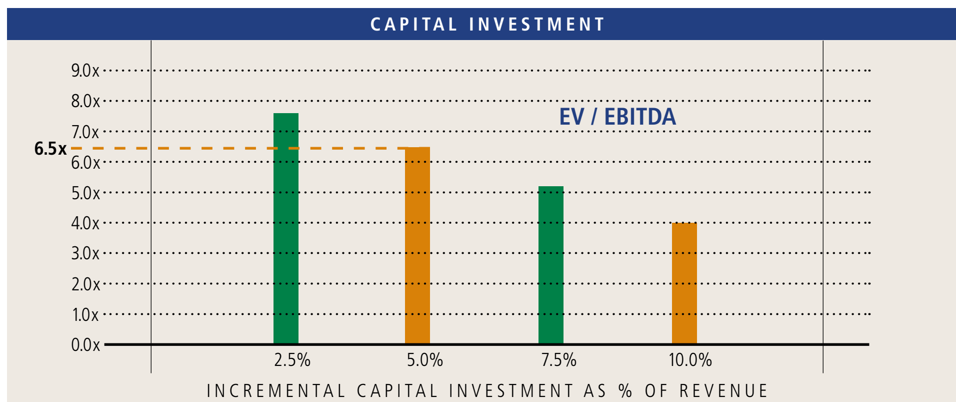
There are many forces that impact future cash flows, each with its own dynamics and influence on value. Understanding the relative impact of these factors helps business owners and their advisors form more intelligent discussions around value. Below we briefly examine four specific factors – capital intensity, growth, margins, and required returns – in greater detail to understand their impacts on EBITDA multiples. To illustrate the effects of these variables in isolation, we begin with an idealized company having the following attributes:

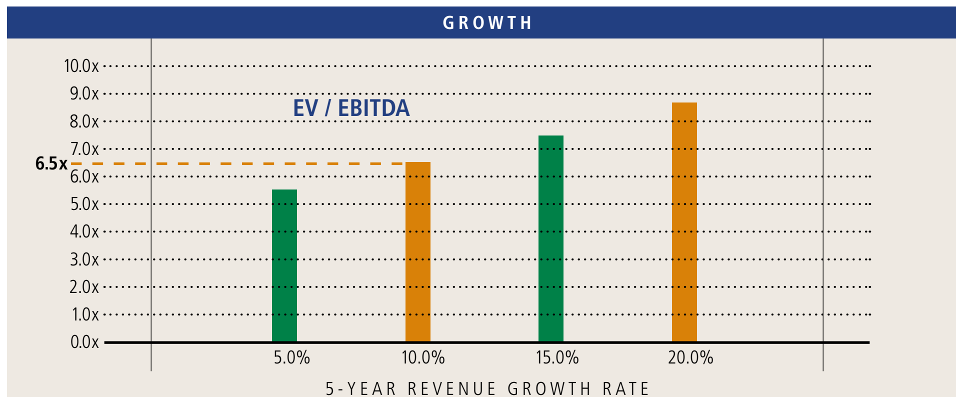
- $100 million annual revenue, growing at 10% over the next five years
- 20% EBITDA margins
- 5% of revenue required to invest in capital expenditures and working capital
- 35% tax rate
- 12% cost of capital

Discounting the projected cash flows generated by this business results in a value of roughly $130 million, representing a "multiple" of current EBITDA of 6.5x.

CAPITAL INVESTMENT

One of the more misunderstood aspects of valuation is the impact of future capital requirements. As illustrated in the following equation, EBITDA does not equal free cash flow. Real economic expenses, including investments in working capital and fixed assets, are not captured by EBITDA.





Two businesses with the same EBITDA margins may have vastly different free cash flow margins, resulting in different valuations and multiples of current EBITDA. For example, the free cash flow profile of a manufacturer requiring significant investments in equipment and inventory will greatly differ from that of a service business requiring minimal incremental capital investment. As seen in the exhibit, the "asset-heavy" manufacturer which requires 10% of revenue be reinvested in the business is valued dramatically lower than a services business requiring only 2.5% of revenue for capital

(continued p. 2)

investment. Both, however, could easily have very similar EBITDA margins. Investors consider all cash flows, and capital outflows are just as real as any income statement flow.

GROWTH

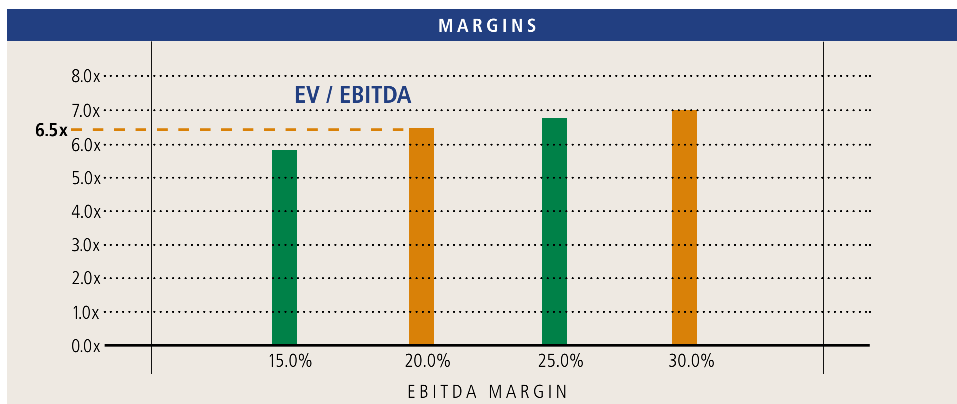
Higher growth rates translate into higher multiples to the extent that incremental cash flow rates exceed the cost of the capital necessary to support that growth. In our example, each five percent increase in absolute growth rate translates into an increase in EBITDA multiples of roughly 1x. Convincing buyers of realistic future growth certainly improves EBITDA multiples, particularly when the growth is at higher margins and requires less capital than historically necessary.

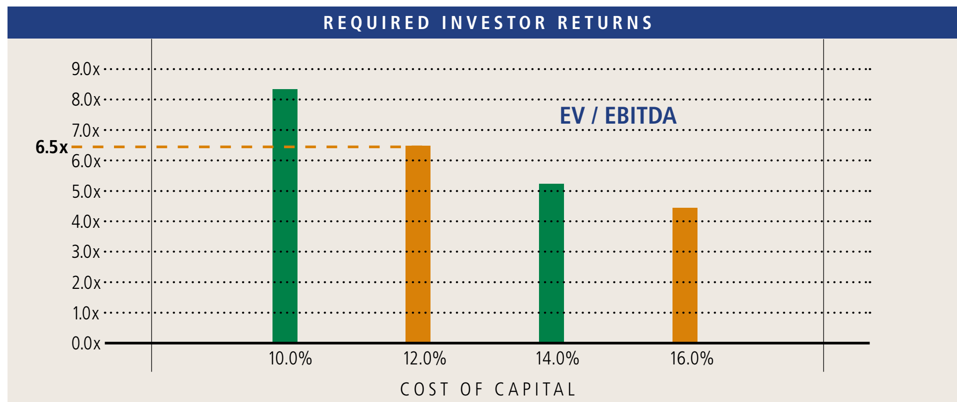
MARGINS

Margins do not have the impact on multiples one might expect, all else being equal. As illustrated for our idealized company, increasing EBITDA margins by 500 basis points (20% to 25%) yields a 0.5x increase in EBITDA multiple. In other words, a more profitable business has a higher value, but because this increased profitability yields a higher current EBITDA, the increase in multiple is relatively modest.

REQUIRED INVESTOR RETURNS

The rate at which future cash flows are discounted has the most meaningful impact on value. Unfortunately, this factor is largely independent from a business owner's decisions. In essence, the risk of the industry is the same for everyone. That is why comparing companies with similar financial metrics from different industries ignores each company's cost of capital. As seen below, increasing the cost of capital from 10% to 16% cuts the EBITDA multiple by more than half.





An investor's required return is more subjective than one might expect. Judgment supplants data and many buyers make adjustments to their return requirements based on the idiosyncratic risk of a given business. Each company has its own characteristics that add to, or reduce, the overall risk of the capital employed in the business. Examples include customer concentration, supplier diversification, management depth, and dependence on external forces, such as governmental regulations. Perceived mitigation of these risk factors can influence prospective buyers to accept a lower return in exchange for the lower perceived uncertainty of future free cash flows. A lower expected return translates to a higher value of the business.

SUMMARY

EBITDA multiples are the siren's song of M&A. The ease with which they are calculated helps explain their existence, but when applied to dissimilar businesses, especially in different industries, dangerous conclusions regarding business value can result. Understanding the underlying factors that affect future free cash flow (as opposed to EBITDA multiples), and therefore value, can help business owners interpret market data metrics as well as to help them focus on what matters – improving free cash flow and mitigating the factors that increase the perceived risk in their businesses. Managing the business from this perspective is likely to result in the greatest value realized by business owners. **ZS**

Zachary Scott
INVESTMENT BANKERS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

Mark D. Working
206.224.7382
mworking@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Ray D. Rezab
206.224.7386
rrezab@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Jeffrey Cleveland
206.838.5521
jcleveland@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Michael J. Black
206.838.5526
mblack@zacharyscott.com

David Working
206.838.5527
dworking@zacharyscott.com