Multipliers

In our previous article we described how there are broadly two distinct categories of share valuation and explained the market based methodologies. Under the capitalised earnings basis, the valuation of the target company is derived from multiplying its maintainable (or recurring) earnings by an appropriate multiplier, such as a Price/Earnings ("P/E") ratio which would be applied to post-tax earnings, or a lower multiplier applied to some measure of pre-tax earnings (such as earnings before interest, tax, depreciation and amortization ("EBITDA")). P/E ratios and EBITDA multiples are generally determined by reference to comparable companies or comparable transactions.

Multipliers based on earlier transactions

If there have been other share transactions in the past concerning the entity to be valued this will often provide the most obvious starting point for looking to assess potential multipliers to apply to a current proposed valuation. Clearly the relevance of any historic transactions and their implied multiplier will depend on the circumstances of the previous share transactions. Any number of factors will affect the relative relevance, such as:

- Whether any previous share transfers were made on a commercial basis and for full consideration – acquisitions of shares made under option schemes, for example, are often at a pre-determined tax-efficient price, and do not necessarily reflect market value;
- Whether an earnings based approach was adopted for valuing the shares transferred in the earlier transaction;
- Whether the business has essentially remained the same since the date of the earlier transfer, in other words, it has continued to do what it was doing at that time;
- Whether there has been a change in the prospects of the underlying sector in which the business operates or in the prospects of the business itself – this might be particularly relevant in those businesses with profits that rely on product life cycles (for example, in the automotive industry);
- Whether there has been a change in management – this is particularly important in those businesses that rely on a small key management team;
- The amount of time that has since passed; etc.

Any changes in circumstances since the previous share transfer will need to be factored in if it is considered appropriate to extrapolate or benchmark a multiplier on the basis of an earlier share transfer.

Multipliers derived from other available sources

A suitable capitalisation ratio may sometimes be determined based on comparison with quoted public companies and these can, at least, give an indication of the level of interest rates and yields on shares operating in the same industry as the target company. However, there may be no or only a few quoted companies in a similar sector and often it will be the case that the quoted company will operate in other sectors and with wider geographic markets. If so, a quoted company, or companies, may not provide a reliable starting point for assessing a multiplier. Where a number of quoted companies operate in the same sector (building companies are an obvious example), there may be a significant spread in quoted P/E multiples for these, and it will then be necessary to tiptoe around the spread in order to determine what might be deemed an appropriate multiple for the sector as a whole.

Other sources also exist that can provide useful market data on potential multipliers although it should be borne in mind that these will reflect "exit" P/E ratios, in other words they reflect shares valued on a sale of the entity as a whole. Exit P/E ratios can be obtained from databases maintained by the likes of Bloomberg and Thomson Reuters. In much broader terms, other indices exist which can be useful in establishing wider average market multiples and multiples for smaller entities.

For example, BDO publishes an index of EBITDA multipliers; its Private Company Price Index ("PCPI index"). The average deal size included within the research is currently around £12 million, this obviously being much lower than the capitalised value of quoted companies. Between 2010 and 2014 its average EBITDA multiple has varied between 8 and 12, and is currently around 8.8. By way of interest, the multiplier appears to have fallen in the last two quarters (along with the number of deals!).

Data has also been published by the UK200 Group (which comprises accounting and legal practices servicing the SME market) where the typical deal size was around £2.7 million. Between 2010 and 2013, its average EBITDA multiples have varied between 4.9 and 4.5.

Adjusting P/E ratios

Quoted sector P/E ratios reflect small share transfers in very large quoted companies and it is therefore necessary to adjust these P/E ratios to take account of the following types of factors:

- Quoted P/E ratios are derived from small, un-influential minority interests – consequently, if seeking to value an entire company, or at least a controlling shareholding, it may be necessary to inflate the comparable quoted P/E ratio to reflect a "control premium";

- Against this, there are a number of factors that generally suggest that the P/E ratio of a smaller, unquoted company would be lower than its quoted equivalent, such as:

    - Quoted companies are usually larger and more diverse, and less reliant on individual customers, suppliers, and geographical markets;

- Shares in quoted companies are readily marketable;
- Quoted companies tend to be subject to greater regulation; this may mean, amongst other things, that their reported results are inherently more reliable (recent press regarding Tesco notwithstanding!);
- Quoted companies will also tend to have material asset backing;
- Quoted companies have more ready access to capital markets; and
- Quoted companies will not tend to be reliant on one or a few key individuals.

Another factor to consider will be dividend policies; often quoted companies will have a policy of paying regular dividends. Where the business you are considering has no dividend history, or an erratic one, then this could justify a further discount.

Ultimately the assessment of a multiplier will come down to applying a degree of judgement based on a consideration of wider market knowledge and the specifics of the business being considered.