THE UNIVERSITY OF AUCKLAND
BUSINESS SCHOOL

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Valuation Multiples

Jai Basrur

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Discussion Outline

- Participant Objectives
- Trends and current issues
- Principles
- Valuation Methods and Considerations
- Cases
- Questions and Discussion

Market observations!!

Why is the company not making money valued so high?

What multiple did FB pay for WhatsApp? And why?

My friend's company is trading at 10X, mine should be at least 15X

We are a unique company and have no comparables. How can our company be valued?

Market multiples are 12X in this sector. Surely we should get this multiple?

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What's happening- Some themes

- Opportunities and potential are being priced
- Patent Cliff causing distortions
- IP focus
- Defensive acquisitions
- Investments assessed on a binary basis are causing 'multiple mania'
- Divergence between potential investment value and intrinsic values
- Markets are pricing opportunities and potential not business in place

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Overview

View or judgment at point in time

Benefits (Cash Flows)

- Achievement
- Sustainability
- Growth
- Sustainability

Risks

- Industry
- Business
- Environmental
- Technology
- Regulatory

Capabilities (Growth)

- Assets
- Arrangements
- Business Models
- Strategic choices

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Valuation Lifecycle

State	Approach
Idea or concept	Potential market opportunity
Strategic Investment opportunity	Valuable Option which may or may not be exploited
Established business with assets in place and cash flow	Business Valuation Methods

Valuation Methods

- Income (Residual income, EVA, Multiple)
- Guideline Comparable Company
- Asset based
- Real Option/ Probability Based methods

  - Addressable Market Potential
  - Industry benchmarks
  - Blended techniques

Multiple approach overview

- Value = Earnings (or key statistic) * Multiple
- Earnings provide an ‘estimate’ of the normalised cash flows which the firm is likely to generate from the assets in place
- Multiple represents the risk and growth expectations of the business
- Could be treated as a comparable company method or an income based approach based on relative/fundamental multiples used
- Market multiples are a result of valuation – not a cause

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Types of Multiples

Enterprise	Equity
EBITDA	Price to Earnings
EBIT	Price to Book
NOPLAT	PE to earnings growth
Invested Capital	
Customer	

Why Multiples

Pros	Cons
Practical guides to relative values	Simplistic aggregation into a single value
Simplicity	Difficult to compare (multiples can vary for various reasons)
Relevance	Static
Valuation based on key statistics less affected by accounting differences	Do not recognise growth from investments
	Normally based on accounting numbers and not cash flows and are subject to accounting differences

Steps

- Determine purpose of valuation
- For an acquisition consider the investor perspectives
- Analyse the company being valued
- Analyse comparable companies and industry for relevant multiples
- Normalise earnings to derive maintainable earnings
- Develop capitalisation rates using comparable/fundamental approaches - choose the right multiple or what feels right!!
- Determine enterprise value
- Adjust to derive equity value
- Make adjustments for liquidity and minority interests if needed
- Check if this makes sense!!

Practical considerations

- Has to be reflective of future earnings potential
- Historical or perspective values (trailing or forward)
- Comparable company data not available
- Capitalisation rates – fundamental or relative
- Earnings normalisation and adjustments
- Balance sheet normalisation and adjustments
- Treatment of non operating and non core assets (discontinued or divested businesses)
- Double counting of risks in cash flows and capitalisation rates
- Non cash transactions which do not have an actual cash movement (option schemes, leases, pensions)

Typical Adjustments -SME focus

- Shareholder salary
- Business and personal separation
- Write offs
- Operational or non operational assets
- One off revenue adjustment

Balance sheet adjustments

- Working capital
- Net debt
- Shareholder loans and shareholder current account

Illustration of seasonal working capital adjustment

Seasonal adjustment example

Description	December	January
EBITDA	30	30
EBITDA Multiple	5	5
Enterprise Value	150	150
Less Net Debt	45	35
Equity value	105	115
NWC	45	35
Average NWC	30	30
Adjustment for NWC	15	5
Adjusted equity value	120	120

Choosing an appropriate multiple

- Matter of individual judgment and common sense
- Be careful in using transaction multiples as they represent specific investor perspectives/control/specific synergy considerations
- Check multiples correspond to equivalent stages in company's development
- Consider relative and fundamental multiples

Buildup approach

- Risk free rate
- Risk premium
- Small company risk adjustment
- Specific risk adjustments for investment stratification, key person dependencies
- Pragmatism

Valuation Adjustments

- Discount and premium adjustments
- Liquidity
- Marketability
- Restricted stock
- No blanket rule!!

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Case: Acquisition valuation

- F and B business
- Strong value chain
- Established presence in a growing beverage category
- Involved in contract processing and own brand production
- At cross roads; exiting shareholder
- Strategic assessment of options

Acquisition Example

Multiple Build up

Calculations			
Equity beta	0.99	1.06	
Cost of equity	9.7%	10.1%	
Specific risk premium	4.0%	5.0%	
Cost of equity with specific risk	13.7%	15.1%	
Debt premium	2.50%	3.50%	
Cost of debt	6.20%	7.20%	
Post tax cost of debt	4.46%	5.18%	
Post tax discount rate (weighted average cost of capital)	11.36%	13.09%	
Implied NOPAT multiple	8.8	7.6	
Pre- tax discount rate and multiples			
Pre tax discount rate	15.8%	18.2%	
Implied EBIT multiple without growth	6.3	5.5	
Maintainable Depreciation to EBIT ratio	28%	25%	
Implied discount rate used for deriving EBITDA multiple	20.19%	22.73%	
Applicable EBITDA multiple without growth	5.0	4.4	Used for contracted manufacture
Growth assumptions			
Forecast Sales Category Growth	30%	25%	
Expected Gowth of OM products as multiple of category growth	1.20	1.00	
Maintainable EBITDA margin	10.00%	12.00%	
Implied EBITDA growth	3.60%	3.00%	
Applicable EBITDA multiple with growth	6.03	5.07	

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Acquisition Example

Value Framework

VALUE FRAMEWORK	Own		Contracted		TOTAL	
Agreed EBITDA split	50%		50%			
EBITDA projected for 2012 with growth of 3%						
Earnings before tax and other income					1,296	
Add: Depreciation					352	
Projected EBITDA with growth of 3%					1,697	27%
	Own		Contracted		TOTAL	
Allocated to	849		849		1,697	
	Own		Contracted		TOTAL	
	High	Low	High	Low	High	Low
Applicable multiple	6.0	5.1	5.0	4.4		
Value as is	5,117	4,301	4,204	3,733	9,321.2	8,034.3
Assumed ongoing operational efficiencies as percentage of EBITDA	10%	10%				
Ongoing operational cost efficiencies ($)	85	85			85	85
Value of efficiencies	512	430			512	430
Value with efficiencies	5,629	4,731	4,204	3,733	9,833	8,464
Savings in manufacturing margins			500	500		
Capitalised value of savings in manufacturing margins			2,477	2,199	2,477	2,199
Value of before strategic premium considerations	5,629	4,731	6,681	5,933	12,310	10,664
Strategic premium	15%	10%	-35%	-25%		
Value of strategic premium	844	473	- 2,338	- 1,483		
VALUE OF BUSINESS TO INVESTOR	**6,473**	**5,204**	**4,343**	**4,450**	**10,816**	**9,654**

Where to….

- Changing business models require different valuation approaches – industry models
- Complex Debt Instruments make WACC estimation difficult
- Assets in place and opportunities
- Behavioural finance implications
- Accepted financial models are getting questioned
- Basis of transactions is changing
- Market reflecting a collection of specific transactions and investor perspectives

Summary

- Practical and accepted method
- Balanced view and assessment
- Clarify valuation objectives and parties involved
- People considerations
- Be careful in using comparables
- Cash flow! Cash flow! Cash Flow!
- Does it feel right!!

Questions and Sharing

Thank you for the opportunity to share!!

Jai Basrur

CGB Consulting Limited

Auckland

Tel: **(09) 366 5072**

Mob: **021 707 775**

E-mail: **jai@cgb.co.nz**

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