Links Capital's Perspectives

EBITDA Multiples

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Using EBITDA multiples is just one of many methodologies valuation experts consider when they value positive cash flow businesses. Whether EBITDA multiples are based off the trailing 12 months (TTM) EBITDA or the forecasted EBITDA, this approach has been widely used to value both private and public companies.

As discussed in a previous newsletter, EBITDA is defined as earnings before interest, taxes and depreciation/amortization. If one uses a multiple of EBITDA to value a business they are employing a business valuation absent of the capital structure of the business (debt vs no debt), the tax position of the company (taxable or not) and the capital assets / expenditures (do they use them or not) of the business.

How many times have you heard someone quoting what multiple they sold their business for and they suggest some EBITDA multiple? An EBITDA multiple is simply the inverse relationship of an investor's required rate of return. The required rate of return is a minimum return an unrelated party would expect to earn for investing in and buying a specific business. If you are thinking of your business in terms of multiples, step back and ask yourself, what percentage return would a reasonable investor expect to earn if they invested in my business? Dividing one by the expected return and you have an estimate of your business's EBITDA multiple. As an example, if an investor required a 20% rate of return for investing in the risk profile of a certain firm, the implied EBITDA multiple would be 1.0/.20 = 5.0x.

Investor's Required Return	EBITDA Multiple
20%	5.0
17%	6.0
14%	7.0
13%	8.0
11%	9.0

Not to say that a business owner's estimate of a required rate of return is correct or not but there are data sources who provide accurate current industry EBITDA market multiples. These multiples are based on different benchmarks and will differentiate between public versus private companies and are used by professional advisors. It is critically important that one also considers many other factors when determining what EBITDA multiple to apply to a company. Data sources will provide an average multiple including a range of the multiples that have transacted. Areas a professional advisor may take into consideration to determine an appropriate company multiple include:

- Total revenues
- Growth rate in revenue and EBITDA
- Forecasted revenue and EBITDA
- Gross margin analysis
- EBITDA % of revenue
- Capital expenditure budgets
- Tax position of the company
- Sufficient working capital
- Strategic positioning and competitive profile
- Customer and supplier relationships
- Standard deviation of the EBITDA multiple

Links Capital specializes in the divesting and financing of businesses in the Canadian middle market.

Links Capital's philosophy is to preserve value throughout the entire transaction process. Senior partners handle all aspects of the transaction from inception to close and beyond, maximizing proceeds.

Being experts in private equity markets and corporate finance enhances value to our clients through extensive buy and sell-side experience.

EBITDA Multiples

Links Capital are specialists working with private equity firms, institutional investors and strategic purchasers in raising capital and divesting of businesses

When considering the required rate of return and EBITDA multiples in the current environment, increases in interest rates are expected throughout this year to try and control the increasing inflation rate. One should expect as interest rates increase, this will increase investor's required returns resulting in lower EBITDA multiples and business valuations.

Company A Financial Summary (in millions)	Audited 2019	Audited 2020	Audited-TTM 2021	Forecast 2022
Revenue	80.0	60.0	62.0	68.0
EBITDA	12.4	9.8	10.5	11.6

Assuming a purchase price for Company A of $72.5 million what is the EBITDA multiple paid for the business? EBITDA industry market multiples are usually quoted on the TTM EBITDA. Comparing industry market multiples to a period other than the TTM will likely result in an incorrect business valuation. In this case, assuming the audited statements are the TTM, the EBITDA multiple would be 6.9x (72.5/10.5).

EBITDA Summary (in millions)	EBITDA	Purchase Price	EBITDA Multiple
Forecast	11.6	72.5	6.3
Trailing 12 Month (TTM)	10.5	72.5	6.9
Forecast + TTM Average	11.1	72.5	6.6
2 Year Average + Forecast	10.6	72.5	6.8
3 Year Average + Forecast	11.1	72.5	6.5

In the above example, it illustrates how using different time periods for EBITDA may result in substantially different EBITDA multiples.

Business owners typically think in the past when EBITDA has decreased and focus on the future when EBITDA is increasing. It is not unusual for business owners who miss the top of a valuation cycle to try and value their business on an EBITDA that was generated several years in the past. However, this is not practical as EBITDA generated two or three years ago has little relationship with the current industry market multiples.

When EBITDA has been increasing in the business, some buyers may try to apply an EBITDA average of several years trying to lower the EBITDA to apply against current TTM market multiple which is clearly wrong. A more practical approach may be to value the business at the lower end of the EBITDA multiple range than to smooth EBITDA over a period of years that has no relationship to the current market multiple.

Past performance and multiple bias can be one of the largest obstacles in concluding a transaction. It is important that business owners understand that values move up and down and applying current multiples to anything other than the trailing 12 months EBITDA may not result in the most appropriate valuation.

There are also many items that are not included in the EBITDA multiple calculation that have significant value for the shareholder and may get overlooked. Some of the areas that should be considered where shareholders can attain additional consideration include:

- Earnouts - consideration paid to the shareholders based on future performance
- Working capital surplus – additional working capital in the business that can be removed for the shareholder's account
- Redundant assets - assets not related to the business that can be removed from the business for the shareholder's account

Sometimes business owners get too fixated on the EBITDA multiple they are receiving. An experienced advisor will help them understand their value drivers to a buyer, the appropriate multiple range, additional potential consideration and negotiate on their behalf to ensure they are unlocking all the value embedded in their business.

Links Capital Partners is focused exclusively on selling businesses, raising capital and assisting our clients acquire businesses. Links Capital are specialists in working with private equity firms, institutional investors and strategic purchasers in raising capital and divesting of businesses.

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