Math Behind the Multiples

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This article is the first in a series designed to help staffing company business owners get a better understanding of the current M&A market and terminology. Although the term "multiple" is commonly used in business valuations, this article is intended to provide some additional clarity to the concept.

Buyers ("Investors") make decisions based on an anticipated return on investment. An investment in a diversified stock mutual fund over the past few years averaged about 9% per year, while a lower risk bank CD might have only averaged 2% during that same period. Risk is the key variable that separates one investment from another, and in turn, one rate of return from another. An investment in a business comes with a high degree of risk, thus investors require a relatively high return on investment. Investors make investment decisions balancing risk against opportunity.

Multiples are shortcuts and probably have the most value when comparing companies in a similar industry. Mathematically speaking, a multiple is nothing more than the inverse of an interest rate – frequently referred to as a capitalization rate ("cap rate"). For example, a multiple of 4.0 = 25% cap rate (1 /.25); a multiple of 6.0 = 16.7% cap rate (1/.167); a multiple of 8.0 = 12.5% cap rate (1/.125) and so on. As multiples go up – cap rates go down. It may appear that buyers who are willing to pay higher multiples are willing to accept a lower return on investment. But keep in mind there are many other strategic, financial and economic issues that factor into business valuations.

Key issues affecting valuations for all businesses:

- Financial performance (primarily EBITDA and GP%)
- Customer concentration
- Owner dependence
- Scalability/Growth Opportunity
- Size of market
- Strategic fit/Synergies

Additional issues affecting valuations for staffing businesses, include:

- % Revenue dependent on Vendor Management Systems (VMS) platforms
- % Revenue dependent on H-1B visas
- % Revenue dependent on 1099 contractors

Dependence on any of the three issues above will cause many buyers to lower valuations due to a perceived added risk.

The following table is an estimate of the current market (November 2018):

Adjusted EBITDA	**$1mil**	**$3mil**	**$5mil**	**$10mil**
Multiple Range	3.75 – 5.0	6.0 – 6.5	7.0 – 7.5	8.0 - 10.0+

Data Source: Stony Hill Advisors transactions, other advisors' published data, input from several large strategic active buyers in the market. These multiples are more representative of healthcare and technology staffing companies since they make up a large percentage of the transactions in the current market.

Note about Adjusted EBITDA:

Lower-middle market businesses (especially those with annual revenues between $10mil and $100mil) are valued based on a multiple of adjusted EBITDA (Earnings Before Interest, Taxes (on Income), Depreciation and Amortization). EBITDA is intended to approximate cash flow (i.e. return) and cash flow is the return investors receive for their investment. Understanding why the word "adjusted" is included in the definition is critically important to potential sellers. Give ten CPAs an Income Statement and ask them to compute EBITDA and all will give you the same answer. Give ten CPAs an Income Statement and ask them to compute adjusted EBITDA and you might get ten different answers – it can be very subjective.

(More to come on adjusted EBITDA in an upcoming article.)