The Compounding Effect of Size on Business Value

A Study into the Impact of the Size of Businesses on Earnings Multiples

It is generally accepted in the marketplace that larger companies are generally less risky than smaller ones. This is because of various factors that differ between large and small companies, which may include a lower level of dependency upon key individuals within larger businesses, their more diversified customer bases, and an overall reduced vulnerability to idiosyncratic shocks. It is also understood, by the market as a whole and among business valuation / corporate finance professionals, that these relative levels of risk are reflected in the profit multiples that can be achieved on a sale of a business.

But how significant are these factors when selling a business, and in particular, how will the value that can be generated when selling an SME (expressed as a multiple of profits) differ from the profit multiples that are seen among the headline-grabbing acquisitions of large, ‘household name’ companies?

To assess this, Menzies has conducted a study into acquisitions of UK companies over a ten-year period between January 2005 and January 2015, using information that has been made publicly available.

In this research, we have subdivided the available population of acquisitions into groups based upon their respective ‘enterprise values’ (that is, the value of the ongoing operations of the business that is implied by the purchase consideration, after adjusting for outstanding debt). The median averages of each of these groups’ observed enterprise value to EBITDA (earnings before interest, tax, depreciation and amortisation) multiples were then determined.

These findings, along with the implied ‘size discounts’ that the relative multiples suggest, are summarised in the table below.

Target Enterprise Value between:	*No. Observations*	*Median EV/EBITDA*	*Implied size discount (relative to comparables)*						
Above £500m	150	16.4x							
£100m - £500m	367	15.8x	***4%***						
£50m - £100m	254	15.0x	***9%***	5%					
£20m - £50m	492	12.3x	***25%***	22%	18%				
£10m - £20m	441	10.6x	***35%***	33%	29%	14%			
£5m - £10m	430	8.5x	***48%***	46%	43%	31%	20%		
£2m - £5m	384	8.6x	***48%***	46%	43%	30%	19%	-1%	
£0 - £2m	242	4.6x	***72%***	71%	69%	63%	57%	46%	47%

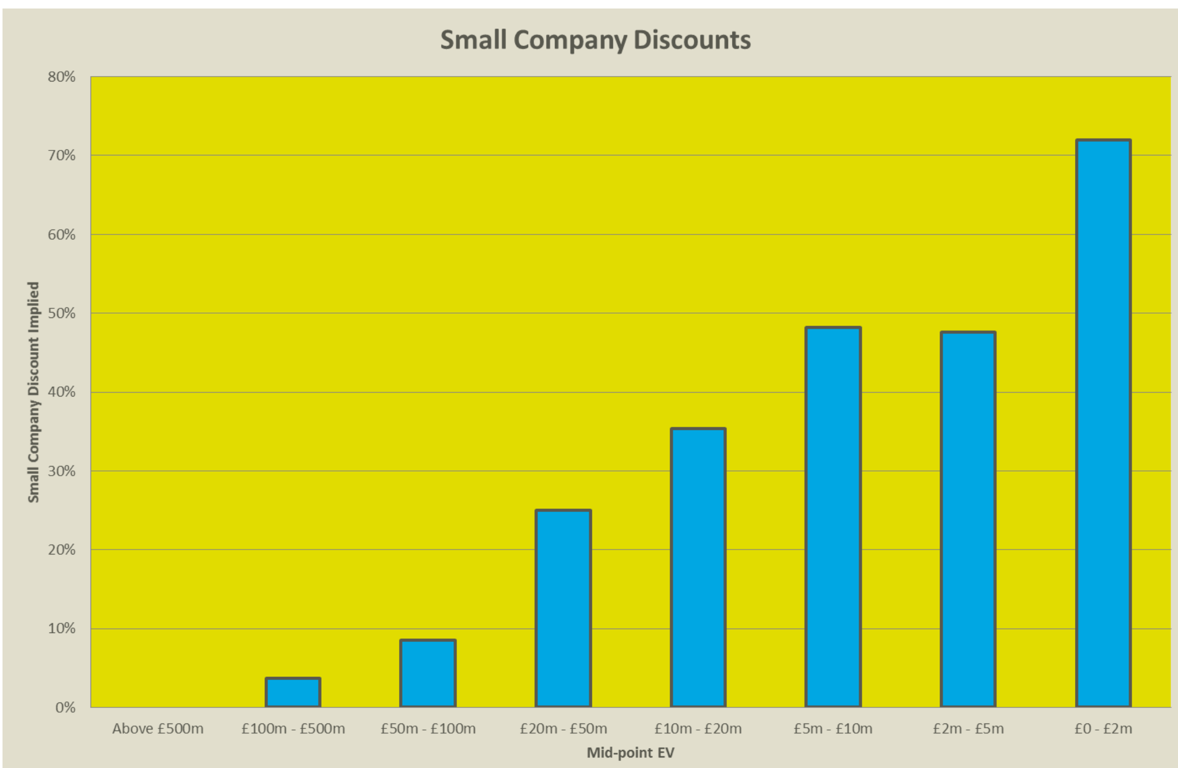
As shown, the median average EV/EBITDA multiple observed in the period among the 150 acquisitions of companies worth over £0.5bn was 16.4x. This multiple dropped to a median average of only 4.6x among micro-businesses worth less than £2m.

In order to interpret the above table, we use an example of an SME owner with a business that is believed to be worth between £5m and £10m. This owner sees one of its competitors sell at an EV of c.£75m, and is interested in what this meant for the multiple that their business could achieve. To estimate this, they should follow the row relevant to the comparable company (being £50m - £100m) along to the arrow. They should then track this down to their own range, and accordingly conclude that the likely multiple they could achieve would be in the region of 43% lower than that of its comparable transaction.

Of course, this should not be viewed in isolation as there will be numerous other factors to consider! As a guide though, it would be a useful starting point.

One thing that is clear from these findings, is that the impact of company size on achievable earnings multiples can be surprisingly dramatic. Furthermore, this effect is particularly noticeable as companies drop below an enterprise value of £10m. It may surprise many to know, for example, that if a business is valued at between £10m and £20m, our findings suggest that it is likely to generate an earnings multiple in a sale that is approximately two-and-a-half times that of a micro-business with an enterprise value less than £2m (the implied size discount being 57%). Conversely, such a business would only contain an earnings multiple of approximately two-thirds of that obtained by a large business with an enterprise value over £0.5bn (implied size discount 35%).

The relationship between size and earnings multiples is also, generally speaking, demonstrably consistent as the implied size discounts tend to increase as enterprise values fall. However, as noted above the impact of the size discount is most keenly felt for the smallest companies. This is clearly seen in the following chart, which shows the implied median small company discounts applicable against EV/EBITDA multiples observed for large companies with an EV above £0.5bn.



In practical terms, all of this means that the multiples generated in very public, large acquisitions should (unfortunately) be treated with a very large pinch of salt by SME owners who are thinking about a sale of their businesses.

But, where there are substantial growth opportunities that can be exploited, this evidence suggests a clear incentive to exploit these prior to a sale. This is because the possibility of a higher earnings multiple on a sale will compound the impact on a sale price of the increased profits alone.

If you require any further information on any of the issues raised above, please email David Stears at dstears@menzies.co.uk