

## Does Size Matter in Business Valuation?

*North Bay Business Journal – June 22, 2009*

As a business broker I hear lots of interesting comments and questions about the value of businesses. Recently a business owner said to me, “*Peet’s Coffee, (Nasdaq:PEET)* trades for 20 times earnings, so should I be able to sell my *Mike’s Coffee Company* for that?” It’s a great question. Besides brand recognition and the liquidity of public vs. private company shares, size is the obvious difference between Peet’s and Mike’s. So how much *does* the size of a company and its earnings affect valuation multiples? Quite a lot as it turns out. Smaller companies tend to sell at lower multiples of most financial measures than larger companies in the same industry.

Companies under \$50 million typically sell for considerably lower price-to-earnings multiples than companies from \$50 to \$500 million, and companies over \$500 million typically sell for higher multiples than those from \$50 to \$500 million. According to business valuation expert Shannon Pratt, who has authored many seminal works and is widely recognized as the “father” of privately held business valuation, “Larger companies are less risky, and therefore, are priced in the market reflecting lower discount rates and higher market multiples.” Conversely, the smaller the company, the lower the average market valuation multiple.

This relationship between price multiples and company size holds true for smaller businesses as well. Middle Market companies with \$1 to 5 million of EBITDA (normalized annual earnings before interest, taxes, depreciation and amortization) are easier to sell and command higher pricing multiples on average than companies with less than \$1 million EBITDA. In my experience with private businesses at the low end of the Middle Market, those with higher revenue and earnings are clearly more marketable, command higher price multiples, involve less risk, and are more readily financed.

The following table illustrates the relationship between two price multiples and company revenues, using data from a study of thousands of sales of small and very small businesses across all industries:

Size of Company	Sale Price / Revenue	Sale Price / Discretionary Earnings*
Up to \$1 million revenue	0.51	2.2
\$1 to 5 million revenue	0.62	2.9

\* Discretionary Earnings is defined as EBITDA plus market compensation to a general manager (usually the business owner). It is interesting to note that in many of these very small transactions EBITDA (Discretionary Earnings less a reasonable GM salary) is actually zero or negative, and EBITDA shouldn’t be used as a basis of comparison. The purchaser essentially buys a job.

Business valuation theory is consistent with the data. In his book, *The Market Approach to Valuing Businesses*, Shannon Pratt says “This conclusion (that smaller companies sell for lower multiples), reached from analysis of market data, is consistent with income approach (cost of capital) research, which shows that smaller companies have higher costs of capital (higher discount rates) than larger companies.

Higher discount rates in the income approach should mean lower multiples in the market approach, and this relationship does, indeed, hold true.”<sup>1</sup>

Since size does affect business value, using prior transaction data or indirect industry rules of thumb derived from companies that are much larger or smaller than your company can result in incorrect conclusions about business value. Any market data used to estimate the value of your company should be limited to an appropriate size range.

### **So what’s at stake?**

Errors in business valuation can lead to poor decisions about buying, selling, merging, gifting, tax planning, investing in or loaning money to a business. If you’re selling for example, you risk undervaluing your business and leaving hard-earned money on the table, or you risk overpricing it and wasting precious time and resources and experiencing undue market exposure and potential loss of confidentiality. For the small business owner, when making important decisions involving your life’s work and perhaps your most valuable asset, it makes sense to value it right the first time.

• • •

Al Statz is President of Exit Strategies Group, Inc., a business brokerage, mergers, acquisitions and valuation firm serving closely-held businesses in California. He can be reached confidentially at 707-778-2040 or [alstatz@exitstrategiesgroup.com](mailto:alstatz@exitstrategiesgroup.com).

---

<sup>1</sup> Shannon P. Pratt, *The Market Approach to Valuing Businesses*, (New York: John Wiley & Sons, Inc., 2000)