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Valuing The Growth Rate in the Sale of a Technology Company

By Dave Kauppi, President, MidMarket Capital, Inc.

In the sale of privately held businesses there seems to be no mechanism and certainly no attempt on the part of buyers to account for the selling company's growth rate. In the public market this factor is widely recognized and is accounted for with an improvement on the PE multiple, the PEG or Price Earnings Growth multiple. Because there is no exact translation between EBITDA multiple (the primary valuation metric for privately held companies) and Earnings Per Share and PE multiple (the primary valuation metric for publicly traded stocks), the purpose of this article is to try to calculate an adjustment factor that can be applied against the EBITDA valuation metric in order to present a more accurate accounting for differences in growth rate for the valuation of privately held companies.

Experienced business buyers are masters of setting the rules for how they calculate the value of a business they are attempting to acquire. You may think that a 5 X multiple of EBITDA or 1 X Sales would be pretty cut and dried, but in practice it is open for creative interpretation. For example, if you just had your best year ever and your EBITDA was \$2 million and the market valuation was 5 X, then you would expect a \$10 million offer. Not so fast. The buyer may counter with, "That last year was an anomaly and we should normalize EBITDA performance as an average of the last three years." That average turns out to be \$1.5 million and like magic your purchase offer evaporates to \$7.5 million. On the flip side, if you just had your worst year at \$1 million EBITDA, you can bet the buyer will use that as your metric for value.

The three owners paid themselves \$100,000 each in salary, but the buyer asserts that the fair market value salary for a replacement for each senior manager is really \$150,000. They apply this total \$150,000 EBITDA adjustment and your valuation drops by another \$750,000. If the family owns the building separately and rents it to the business for an annual rent of \$200,000 when the FMV rental rate is \$300,000, the resulting adjustment costs the seller another \$500,000 in lost value.

Another valuation trap for a seller is that they want to hire additional sales resources to pump up their sales just prior to the sale. This is almost always a bad move. Most technology sales reps take a year or longer to ramp up to

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productivity. In the interim, with salary and some draw or guarantee, they actually become a drain on earnings. The buyers do not care about the explanation, they just care about the numbers and will whack you with a value downgrade.

The least understood valuation trap, however, is there seems to be no mechanism and certainly no attempt on the part of buyers to account for the selling company's growth rate. In the public market this factor is widely recognized and is accounted for with an improvement on the PE multiple, the PEG or Price Earnings Growth multiple. The rule of thumb is that if the stock is valued with a PEG of less than 1 then it is a good value and if it is over 1 it is not as good.

Because there is no exact translation between EBITDA multiple (the primary valuation metric for privately held companies) and Earnings Per Share and PE multiple (the primary valuation metric for publicly traded stocks), please allow me a measure of imprecision in my analysis. My purpose is to try to calculate an adjustment factor that can be applied against the EBITDA valuation metric in order to present a more accurate accounting for differences in growth rate for the valuation of privately held companies.

I have chosen two stocks for my analysis, Google and Facebook. The reason I choose these two is that they are widely known, very successful, in the same general market niche, and are at different stages of their growth cycle. Google sells at a PE multiple of 33.37 while Facebook sells for a PE multiple of 113.71. The PEG of Google which = PE Multiple/5 year growth rate is $33.37/16.85$ for a PEG of 1.98. I actually backed into the growth rate using the readily available PE multiple and the PEG from my Fidelity account.

Facebook sells at a PE multiple of 113.71 and has a PEG ratio of 3.62 (may be some irrational exuberance here), which translates into a 5 year growth rate of 31.41%. For our comparison we should also include the average PE multiple for the S&P 500 of about 15. Let's make the assumption that on average, this assumes that these companies will grow at the growth rate of the U.S. Economy, say 3%.

So to calculate a normalized PE ratio for these two companies, we are going to create an adjustment factor by dividing the 5 year compound growth rate of Google and Facebook versus the anticipated 5 year compound growth rate of the S&P 500. For Google the 16.85% growth rate over 5 years creates a factor or

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2.178 or a total of 217.8% total growth over the next 5 years. The S&P factor is 1.16. So if you divide the Google factor by the S&P factor you get 1.878. If you multiple the market PE multiple of 15 by the Google factor, the result is a PE of 28.2. Not too far off from the current PE multiple of 33.37

Facebook is a little off using this method resulting in a normalized calculated PE of 50.65 versus their current rate of 113.71. This will appropriately seek a level over time and settle into a more rational range. My point here is that the public markets absolutely account for growth rates in the value of stocks in a very significant way.

Now let's try to apply this same logic to the EBITDA multiple for valuing a privately held technology company. If the rule-of-thumb multiple for your company's valuation is 5 X EBITDA but you are growing at 10% compounded, shouldn't you receive a premium for your company. Using the logic from above we assign a 3% compound growth rate as the norm in the 5 X EBITDA metric. So the 10% grower gets a factor of 1.61 versus the norm of 1.16. Dividing the target company factor by the normalized factor results in a multiple acceleration factor of 1.39. Multiply that by the Standard 5 X EBITDA multiple and you get a valuation metric of 6.95 X EBITDA.

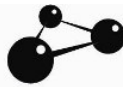
A little sobering news, however, you will have a real challenge convincing a financial buyer or a Private Equity Group to veer to far away from their rule of thumb multiples. You will have a better chance of moving a strategic technology company buyer with this approach. A discounted cash flow valuation technique is superior to the rule of thumb multiple approach because it accounts for this compound growth rate in earnings. If the technique produces a higher value for the seller, the buyer will keep that valuation tool in his toolbox.

Perhaps the best way to negotiate a projected high growth rate and translate that into transaction value is with a hybrid deal structure. You might agree to a cash at close valuation of 5 X EBITDA and then create an upside kicker based on hitting your growth targets.

So for example, your EBITDA is \$2 million and your standard industry metric is 5X EBITDA. You believe that your 10% growth rate (clearly above the industry average) should provide you a premium value of 6 X. So the value differential is \$10 million versus \$12 million. You set a target of a 10% compounded growth in Gross Profit over the next 4 years and you calculate an earn out payment

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methodology that would provide an additional \$2 million in transaction value if you hit the targets. It is a contingent payment based on actual post closing performance, so if you fall short of targets you fall correspondingly short on your earn out. If you exceed target you could earn more.

Successful buyers do not remain as successful buyers if they over pay for an acquisition. Therefore, the lower the price they pay, the greater their odds of chalking up a win. This is a zero sum game in that each dollar that stays in their pocket is one less dollar in your pocket. They will utilize every tool at their disposal to convince the seller that "this is market" or this is "how every industry buyer values similar companies." It is to your advantage to help move them toward your value expectations. That is a very hard thing to accomplish unless you have other buyers and can walk away from a low offer. Believe me, if they are looking at you, they are doing the same dance with at least a couple of others. You must match their negotiation leverage by having your own options.

Dave Kauppi is the editor of The Exit Strategist Newsletter and a Merger and Acquisition Advisor and President with MidMarket Capital, Inc. MMC is a private investment banking, merger & acquisition firm specializing in providing corporate finance and intermediary services to entrepreneurs and middle market corporate clients in information technology, software, high tech, and a variety of industries. Dave began his Merger and Acquisition practice after a twenty-year career within the information technology industry. His varied background includes positions in hardware sales, IT Services (IBM's Service Bureau Corp. and Comdisco Disaster Recovery), Software Sales, computer leasing, datacom, and Internet. The firm counsels clients in the areas of merger and acquisition and divestitures, achieving strategic value, deal structure and terms, competitive negotiations, and "smart equity" capital raises. Dave is a Certified Business Intermediary (CBI), is a registered financial services advisor representative and securities agent with a Series 63 license. Dave graduated with a degree in finance from the Wharton School of Business, University of Pennsylvania. For more information or a free consultation please contact Dave Kauppi at (630) 325-0123, email davekauppi@midmarkcap.com or visit our Web page <http://www.midmarkcap.com>

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