

# Does Size Really Matter?



**About the Author:** Michael Jacobs is president of Jacobs Capital, an M&A and business valuation advisory firm based in Atlanta. He served as director of corporate finance policy at the U.S. Treasury Department from 1989 to 1991, and he is the author of *Short-Term America* and *Break The Wall Street Rule*. He can be reached at [mjacobs@jacobscapital.net](mailto:mjacobs@jacobscapital.net).

There is finally an answer to the age old question pondered by business men and women for centuries: Does size really matter? For those of you with your minds in the gutter, the issue pertains to whether larger companies are worth more, i.e., valued at higher multiples, simply because they are larger. The answer to this question is a resounding "yes."

There is sufficient empirical evidence today to conclude that larger companies are valued at higher multiples, everything else being equal. There have been a number of academic studies performed by Price Waterhouse Coopers, Houlihan Lokey and other firms that specialize in business valuations which uniformly conclude that there is a discount in the multiples applied to the values of smaller companies.

Following one of my recent articles that showed that average EBITDA (earnings before interest, taxes, depreciation and amortization) multiples have risen from about five two years ago to about seven today, one of my observant clients fired off an e-mail to me suggesting that he would be delighted to let me sell his company for a seven multiple of EBITDA. Unfortunately, averages can be very misleading. The Chattahoochee River may only be four feet deep on average, but a lot of five- and six-foot tall adults have drowned in it over the years.

Most people understand that the multiples paid for a company when it is sold are higher for businesses that are growing faster. After all, the sale price of a company is simply the buyer's estimate of all the cash flows that it will achieve in the future as the owner, discounted for the risks that those cash flows will materialize and the time value of money. Multiples are a simpler mathematical way to express this discount rate (higher discount rates produce lower multiples.) But the studies show that multiples are impacted by size, not just growth rate.

Why is this the case? There are a number of reasons:

- Smaller companies generally are more dependent on one or two key individuals. The loss of the founder or CEO can have a material impact on the

prospects of a smaller company, especially if that individual has important customer relationships, technical or design skills, or simply the loyalty of employees. Because the risk of achieving future cash flows impacts purchase price multiples, smaller companies dependent on fewer key leaders are typically going to be valued more conservatively.

- Another risk factor is market power. A small company generally lacks the ability to influence the market for its goods or services. For example, if you owned a small company that produced soft drinks, you would not have the same leverage in negotiating the sale price for a case of cola to Wal-Mart that Coca-Cola would have. Consequently, your margins would probably be lower. You might be able to compete by targeting a specialized niche with a unique product, but then you are creating value by product differentiation. If a small company produces the same or a similar product as its larger competitors, it will suffer from less bargaining power with the customers.
- Big companies enjoy bargaining power in many areas, not just with customers. Larger companies can generally negotiate lower insurance costs per employee; they may run larger, more efficient

factories than a small company; they may have a broader product offering which gives them the opportunity to establish stronger partnerships with suppliers, and they can spread the costs of key executives over a larger sales base.

- Smaller companies typically lack the same access to capital that larger businesses enjoy. This is true not only when it comes to accessing the equity capital markets through a public offering of stock (which requires a certain minimum enterprise value), but it is also true of the debt markets. I recently arranged an acquisition line of credit for a client and received proposals from six banks. The larger banks offered the most competitive terms because they had more sophisticated underwriting capabilities. If my client had been too small to get the attention of the larger banks, it would have had to pay a higher rate and settle for more onerous requirements for collateral and guarantees.
- The buyout market itself is much more competitive when larger deals are involved, which allows the seller to negotiate a more favorable price. The private equity funds that participate in the buyout market raise their capital from large

endowments, pension funds and insurance companies. These sources of capital have a lot of dollars to put to work, and those dollars can be more efficiently deployed in larger transactions. It takes just as much time and effort to negotiate and structure a small deal as it does a large deal; sometimes more because the small clients are often less sophisticated.

A given number of buyout professionals can do only so many deals in a year. So the cost of a buyout professional can be spread over many more dollars in a large transaction than it can in a small transaction. Similarly, the legal costs to draft a purchase agreement, a new operating agreement, loan documents, etc. are about the same regardless of the deal size. On a small transaction, the expenses of putting the deal together are a significantly higher percentage of the transaction value than on a larger deal. Consequently, the price that is paid must be lower to achieve the same percentage returns.

Naturally, more institutions put their money into large buyout funds than small ones. If you were investing on behalf of the BellSouth pension fund and invested \$10 million into a small buyout fund, no matter how successful it was, the fund's results would have no impact

on the billion dollar pension fund's overall return. With this being the case, the sophisticated investors who put up the capital to support the buyout world are more inclined to invest in larger funds that seek transactions of at least \$25 to \$50 million on the low side. So if you are peddling a smaller deal, there are a lot fewer buyout funds that will look at it.

- The same case could be made for selling to a strategic buyer, i.e., another company in a related business. To use the prior example, if you have a

\$5 million beverage company to sell, Coke is probably not a logical buyer because the potential impact your business will have on Coke's bottom line does not justify the time and energy that would be required by the corporate development department to put a deal together. Therefore, you have fewer buyers who will look at the deal, thus you have a lower chance of securing an attractive multiple when the company is sold.

Does this phenomenon suggest that growing larger is always the best corporate

strategy? Not at all. You can create shareholder value any number of ways, especially by offering a unique product or service. But if you do offer a product or service similar to much larger players, you can expect to receive a lower multiple when you sell your company. Even if you do differentiate yourself in the marketplace, if you sell a small company to a private equity fund you can expect a lower than average multiple. And today, it is the buyout funds that are setting the values for the overall M&A market, which is the subject for another column. **C**