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Public vs. Private Valuation Multiples

When valuing a privately held company, I will often study market multiples of publicly traded companies. They can be eye-popping. It is common to see EBITDA (earnings before interest, taxes, depreciation and amortization) multiples in the range of 14-15X for public companies.

Generally, such high multiples are rare for small companies, and there are several solid, technical reasons for this difference. Let's take a look at some of them.

Size Effect

One reason is known as the size effect. In the 1980s and 1990s several researchers studied stock returns and noted that smaller publicly traded stocks are, on average, valued more conservatively than are larger publicly traded stocks (Banz, Barry and Brown, Fama and French, Ibbotson). They also found that the smaller a public company is, the more conservatively it is valued, all else equal.

Researchers attribute the size effect to a number of factors, including that larger companies tend to have deeper/better management teams, are less sensitive to economic downturns, have more influence over supply channels, have a more diverse customer base, and have more diverse product lines, among other reasons. All of these factors add up to give big companies a big advantage.

"Is it better to invest during a bull market or bear market? Depends...would you rather be gored or mauled?"

Liquidity - Access to Capital Markets

An element of the size effect, liquidity, is another important advantage that large companies have over small companies. One aspect of liquidity is that larger companies simply have much better access to capital markets to obtain funding.

Because they are seen as being very creditworthy, large public companies can tap into capital markets quickly and cheaply, which provides them with a tremendous advantage over all other companies. As many privately held companies can attest, obtaining capital can be a rather drawn-out affair that often doesn't result in the most desirable conclusion. Not so for large publicly traded companies.

But it is not only speed and cost that create a liquidity advantage for large public companies. It is also the range of capital they can access. From short term debt to preferred stock and common stock issuances, all options are on the table for large public companies. For many privately held companies, particularly smaller companies, their options for obtaining additional capital are often quite limited.

Liquidity - Demand for Shares of Stock

A split between large companies and small companies also exists regarding the relative liquidity of their ownership interests. In general, the stock of a large publicly traded company is quite liquid when compared to a smaller private company for three primary reasons.

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First, there are a wide range of buyers for large public stocks, including mutual funds, pension funds, sovereign wealth funds, investment firms and individual investors, among others. A ready market exists for shares of stock in large public companies because they are generally seen as being a relatively safe investment that provides upside potential.

Second, when an investor sells shares in a large public company, they can execute the sale order oftentimes in minutes (or less), and then it only takes two days for the trade to settle. Investors don't have to wait an extended period of time to get their cash if they want to reallocate their investments.

Third, transaction costs are very low when selling stocks of large, publicly traded companies. This adds to their appeal.

As a result, investors flock to buy stock in large publicly traded companies. Demand for their shares helps support their stock price, which in turn helps support their higher valuation multiples.

Conclusion

Large publicly traded companies enjoy a series of self-reinforcing advantages over small privately held companies. The combination of advantages helps support their much higher valuation multiples. That doesn't mean that it is impossible for a small privately held company to achieve equally high valuation multiples, but it does show why it is rare for it to happen.

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Please contact Ronald DiMattia at Corporate Value Partners at (216) 741-1330 or ron@corporatevaluepartners.com with any questions or if you need help with a valuation or corporate finance matter.

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