

Why Mid-Market Companies are Valued Lower Than Their Public Company Peers

By [Derek van der Plaats](#), April 11, 2013

Takeaway: Private companies are valued based on a multiple of EBITDA, with the multiple typically being lower because they are considered riskier than their public company peers.

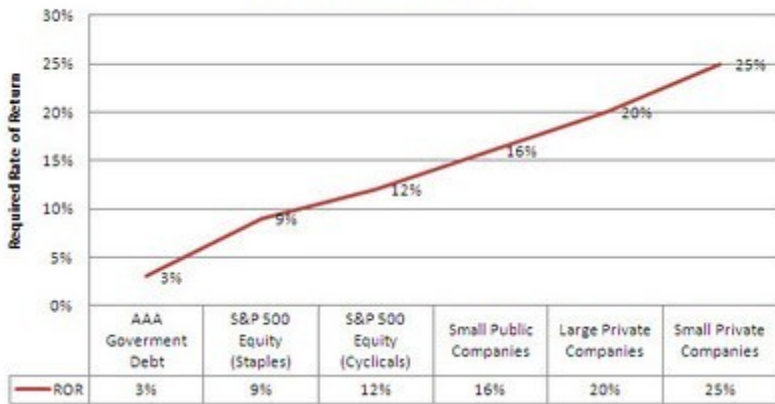
For public companies, analysts express the value of a company as a [multiple](#) of earnings. It is called the price-earnings ratio or P/E ratio. If the price of a stock is trading at a low multiple (say eight times earnings) and its prospects are strong, it would be good value; at 50 times earnings that same company would probably be expensive. For private companies we typically look at a multiple of [EBITDA](#). Let's say a company has been valued at \$20 million; it can sustainably generate \$5 million in EBITDA, then it is valued at four times EBITDA. As I noted earlier, four times EBITDA is equivalent to generating a 25% [return on capital](#) per annum; more if cheaper debt is used to lever the equity.

How do you decide if that is a proper risk adjusted rate of return for your capital? Risk adjusted is the key word here. To figure this out we have to start at the risk-free rate and build on layers of risk to see where comparable assets should be priced. We start with the risk-free rate. The risk free rate is the rate generated by the most secure assets possible. The proxy for this is typically federal governments. They can print money at will so you can be assured you will get your money back (what it will be worth is another matter). Countries such as Canada, Germany, Austria, and the Netherlands are rated AAA by S&P and are as close to risk free as you can get and therefore set the proxy.

Let's say the 10 year risk free rate is 3%. What is the next bucket of riskier assets? State bonds, Municipal bonds, AAA corporate debt, AAA preferred shares? All riskier, but lets jump straight to S&P 500 equity. What is the risk premium of a top tier, multi-billion dollar S&P 500 company? About 5% to 7% (note: even within the S&P 500, there are riskier subgroups. i.e. cyclicals vs. consumer staples). Adding this risk premium to the risk free rate, you get approximately 10%. So getting back to my introduction, buying a S&P stock at 10 times earnings may very well achieve a proper risk adjusted return.

The concept of the risk-return curve is that it measures the risk premium required for riskier assets. The idea is that you should be indifferent between different asset classes on the curve because you are being properly compensated for the additional risk.

The Risk Return Curve



Intuitively, it makes sense that a small private company is riskier than a S&P 500 company but what are the specific drivers of this? A small private company typically has fewer customers, more customer concentration, comparatively a less established brand, a limited R&D budget, less access to funding sources (be it banks or equity investors) and much less liquidity for the holders of its equity to name a few key drivers and, as such it is riskier than an S&P 500 company.

So is four times EBITDA a fair value for a small private company? It could be, but it depends on many company specific risk-return factors such as its growth prospects, the nature of its revenues (highly recurring or project based) and the size and diversity of its customer base.