<u>What Is An Earnings Multiple?</u>

The professionals who deal in mergers and acquisitions (M&A) often use an **earnings multiple** to establish the value of a business.

The annual earnings of a business multiplied by the multiple equals the earnings value of the entity. For example, if the annual earnings is $200,000 and the earnings multiple is 5, then the earnings value of the company is $1,000,000.

The **earnings multiple** is the reciprocal of the **capitalization rate** of the business based on its business risk factors. As perceived risk increases, the capitalization rate increases and the value of the business decreases. Earnings value can also be derived by <u>dividing</u> earnings by the capitalization rate.

Capitalization Rate	Earnings Multiple
10%	10
15%	6.7
20%	5
25%	4
30%	3.3

Using earnings multiples has some sharp edges that may cause lay people to come to wrong conclusions. Here are some pitfalls to be aware of:

1. An earnings multiple is relevant only if a business is generating earnings at a level appropriate for its equity investment. Multiples don't work if a business is marginally profitable, breaking even or operating at a loss.
2. A going concern business has a <u>minimum turnkey value</u> that is independent of earnings.
3. An earnings multiple must be applied to <u>normalized</u> earnings, not the statutory earnings reported to the IRS.
4. An earnings multiple does not recognize total asset value.
5. An earnings multiple needs to be established for the <u>specific</u> entity. General "rules of thumb" produce distortions as business operations become more complex.
6. Earnings multiples used by buyers are based on <u>their</u> subjective investment criteria and may not reflect the true value of the business. Sellers (and their intermediaries) must perform their own calculations.

-

Copyright 2008
Magellan Advisors, Inc.
630-541-5307
magellanadvisors-il.com