TECHNOLOGY ACQUISITION UPDATE

Revenue Multiple Mistakes

As a boutique investment banker, I am often queried about revenue multiples—by entrepreneurs, investors, CEOs and venture capitalists. "What is the latest multiple of revenues in this sector?" is the usual query. Sometimes they are asking in the context of an M&A transaction and sometimes regarding valuation for an investment transaction.

The multiple of revenue is not a good way to think about value. In fact, it is totally bogus for any transaction that is strategic. The multiple promotes wrong thinking and decision making because it is based on a faulty premise. The faulty premise is that value and revenue are highly correlated. The correlation is loose at best.

First, let me differentiate between financial transactions and strategic transactions. In a financial transaction value is based on a company's financial performance. In this case, value is determined by financial metrics, typically the multiple of net earnings and the multiple of operating profit. These multiples are highly correlated with value and are quite sound. In addition, these multiples can be legitimately compared to other transactions and to publicly-traded companies.

A strategic transaction, on the other hand, is one in which the value is based on a company's key assets, such as technology. Certainly revenues are good; they give you credibility. However, the value is in the technology, not the revenues. Think about it—revenues could be triple or revenues could be half and the technology is still the same. The very fact that someone is talking about the multiple of revenue indicates that it is not a financial transaction because if the company had earnings, they would use a multiple of earnings.

By definition the value of a strategic transaction depends on the strategic importance of the company to the buyer. For example, the same company might sell for $3 million, or $7 million, or $11 million depending on how buyers view the strategic importance to them. Value is not a function of revenues, but a function of how important and how useful the technology (or other assets) is to a buyer.

There are two primary reasons why revenue multiples are not valid:

1. Revenue multiples do not account for growth or profitability. Last I checked, growth and profitability are significant attributes of any business and are important components in determining the value of a company. How could a valuation metric that does not consider either profitability or growth be of any use?
2. Revenue multiples are not comparable from one transaction to another. People are very familiar with comparing value metrics and they assume that ratios are comparable. They compare house prices and they compare car prices—two examples from our daily lives. People assume that if there is a valuation metric that it is comparable. Multiples of revenue simply are not comparable.

Why are multiples of revenue not comparable? Because there is not a real, or deep, market for technology companies. There are many buyers for houses and many buyers for cars so deep markets do exist and comparable market data is valid. However, for a strategic transaction there may be only five or eight companies in the whole world that truly are viable acquirers for a specific technology firm at a point in time.

A third minor point is that even if revenue multiples were comparable, the range is so wide as to be of no help. Multiples of revenue range from about .4 times to about five times. What use is this? This is analogous to saying that your house is worth somewhere between $400,000 and $5 million. This is not the least bit helpful in determining how to set a price for your house.

How Buyers Really Think

Buyers may *talk* in terms of revenue multiples, but buyers do not *think* in such terms. Buyers think in terms of how much value they can create with an acquisition, the additional operating profits they can generate, and how the acquisition might speed entry into an adjacent market.

If Acme Widget needs a particular technology, they can develop it in house or acquire a technology company (Omega Corp.) that has already developed the technology. The acquisition team can estimate how much it would cost to develop it internally and add a time premium if they can utilize the technology immediately. Let's say that Omega's competitor, Beta Company, was acquired last year. The price of that transaction is irrelevant to Acme's decision-making. One or two data points do not make a market. Just because Beta Company sold for 3.5 times revenue, why should Acme Widget pay 3.5 times revenue for Omega?

Let's take a quick sidebar. Notice the language. The phrase "Beta Company sold for 3.5 times revenue" is meaningless. Actually Beta sold for $10 million; it did not sell for 3.5 times revenue. Sure, one can divide the $10 million price by the $3 million of revenues and come up with a 3.5 times multiple but it is meaningless. One could do a similar calculation dividing the sales price by the average employee weight to get a multiple, obviously not meaningful. Language can play subtle tricks and this is an example of one that people buy into.

But I digress. So, why should Acme Widget pay a similar multiple as Beta? It shouldn't, of course, because there is no connection. A buyer paid $10 million dollars for Beta because that was what they thought the company was worth to them. All that matters to Acme Widget is the value that they perceive from the acquisition of Omega.

Sometimes revenue multiples are interjected as a negotiating ploy. A buyer may cite the revenue multiple to make his offer sound credible or appear attractive. Don’t be fooled by a buyer who quotes revenue multiples. Many entrepreneurs assume that buyers think in terms of multiple revenues; they don’t.

Intel acquired CognoVision for $17 million a few years ago. CognoVision develops video analytics software and had revenues of about $1 million. Was 17 times revenues the appropriate revenue multiple? Were similar transactions completed at 17 times revenue? Did Intel ask its investment bankers what the appropriate multiple was? Of course not; Intel determined the price by figuring out how much value CognoVision would contribute to its operations. Multiples of revenues had nothing to do with it.

Summary

One of the reasons the revenue multiple myth persists is because human beings do not like uncertainty and they crave numbers for value. People also like to sound smart and tossing around multiples of revenue makes them sound like they know what they are doing.

Determining the value of a technology company with minimal earnings is quite difficult and inexact. The only way to know what the value is to you is to analyze and think it through to determine what the value is to your company.

One can make wrong decisions when thinking incorrectly about value. When considering the best time to sell, entrepreneurs often have a dollar goal in mind. "If we double our revenues and we can get our target number." This is not necessarily so. Another mistake that CEOs make relates to competitors who have sold. "We won't sell unless we get a higher multiple than our competitor who sold for 2.5 times revenues last year because our technology is better than theirs." This can be troublesome to say the least.

So, the next time you start to utter the term revenue multiple, remember that this is a ratio calculated after the fact, not a valid rationale for value.

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