VALUING THE SHARES IN A COMPANY USING "EARNINGS MULTIPLES"

- A company that has traded for many years can have a significant value based on its customer base and sustainable profitability.

- Multiples of earnings are often used to value a business.

- For example, a dental practice can be valued at 2.5 times annual fee income. So if a dental practice has annual recurring fee income of €200,000, it's value in a potential merger would be €200k x 2.5 = €500k.

- The value of the trade carried on by a private company is similarly arrived at using "Price/Earnings" or P/E multiples.

So what is a P/E Multiple?

- We have seen how Earnings Per Share is computed when we considered Capital Gearing as a topic. EPS was arrived at by dividing the after tax earnings by the number of shares in issue:

- EPS = Profit After Tax / No. of shares.

- The shares of companies listed on the Stock Market tend to trade at a price that is a consistent multiple of their reported "after tax" profits. This multiple is called the Price/Earnings or P/E Multiple.

- Some examples (taken for the Business Page of The Guardian newpaper):

Marks & Spencers	11.0 times
Morrisons	12.9 times
Sainsbury	15.8 times
Vodafone	13.5 times.

- On account of small private companies not being as efficient as Public Limited Companies (don't operate on the same scale), it would be normal to mark down the P/E to a range of 5-8 times earnings.

EXAMPLE:

X Limited, a small private company, enjoys annual profits of €300,000 after tax. There are 1000 Ordinary Shares in issue. Companies listed on the stock market that trade in the same sector have reported Price / Earnings ratios of 10.

The company does not hold any non trade assets such as investment properties and therefore has no loans on property either. What is the value of this company?

SOLUTION:
The company is solely a trading entity and does not hold and non trading assets or related debts. Therefore, all that is for sale is the trade carried on.

The value of this trade is the annual sustainable earnings (after tax) multiplied by the P/E multiple that should apply:

Annual earnings x P/E = value of company

Total value of the company is €300,000 x 10 = €3,000,000.

The value of each share is €3,000,000 / 1000 shares = €3000 per share.

Other considerations:

- The total value of X Limited will be greater if there exists non business assets.
- The value will similarly be reduced if there are any borrowings taken out to acquire the non business assets.
- If cash balances have built up on account of shareholders not takings significant dividends of bonuses over the years, this will be added to the value of the company.

In Summary:
The total value of the company is arrived at as follows:

- Value of the business is annual earnings multiplied by the P/E multiple.
- This will be increased by undistributed bank and cash balances taken over.
- This will be increased further by the value of non business assets (buildings and investment properties)
- and will be reduced by any borrowings to acquire non business assets.

QUESTION

Paul and Joe Duffy each hold 50% of the capital of Anglo Motors Limited. Paul has decided to retire and to cease all involvement in the company. Hs is prepared to offer his 500 shares to Joe for €850,000 therefore making the total value of the company to be €1,700,000.

Joe has asked you to advise him whether this offer is acceptable. To this end, he provides you with the most recent annual results:

PROFIT AND LOSS ACCOUNT	
Profit before interest and tax	321,000
Interest	18,000
Profit before tax	303,000
Taxation	40,000
Profit after tax	263,000

BALANCE SHEET	
Property & non business assets	560,000
Stocks	20,000
Debtors other receivables	132,000
Bank and Cash Balances	158,000
	870,000
Ordinary Shares (€1.00 each)	1000
Retained Profits	429,000
Term Loans	280,000
Creditors & Accruals	160,000
	870,000

A typical price earnings ratio of a publicly quoted company in this sector is 8, but it is agreed to apply a multiple of 5.2 on account of the company'.

a. Calculate the:
   - Gearing Ratio (4 marks)
   - Interest Cover (4 marks)
   - Earnings per share (4 marks).

b. Calculate the value of the company and determine whether the offer of €850,000 should be accepted by Joe. (13 marks)

TOTAL 25 MARKS.

SOLUTION:

A: RATIOS:

Gearing ratio	$\frac{\text{debt}}{\text{debt + equity}} \times 100$	$= \frac{280000}{280000 + 430000} \times 100 = \frac{280k}{710k} \times 100 = 39\%$
Interest Cover	$\frac{\text{PBIT}}{\text{interest}}$	$= \frac{321000}{18000} = 17.8$ times
Earnings per share	$\frac{\text{Profit after tax}}{\text{No. of shares}}$	$= \frac{263000}{1000} = €263$ per share

B: VALUE OF THE COMPANY:

VALUE OF THE TRADE USING P/E MULTIPLE OF 5.2 TIMES:
Earnings Per Share x No. of shares x P/E Multiple

€263 x 1000 shares x 5.2 times = €1,367,600

NON TRADE ASSETS:

Property & non business assets	560,000
Less related loans	-280,000
Equity	**€280,000**

UNDISTRIBUTED CASH AND BANK BALANCES:

Per Balance Sheet **€158,000**

TOTAL VALUE OF THE COMPANY = 1,367,600 + 280,000 + 158,000

= **€1,805,600**

VALUE OF PAUL'S 50% SHAREHOLDING = 1805600 x 50% = €902,800

Paul is offering his shares to Joe for €850,000 which is less than this valuation and therefore Joe should accept this offer.