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Beware of Distortions of Market Multiples During a Recession

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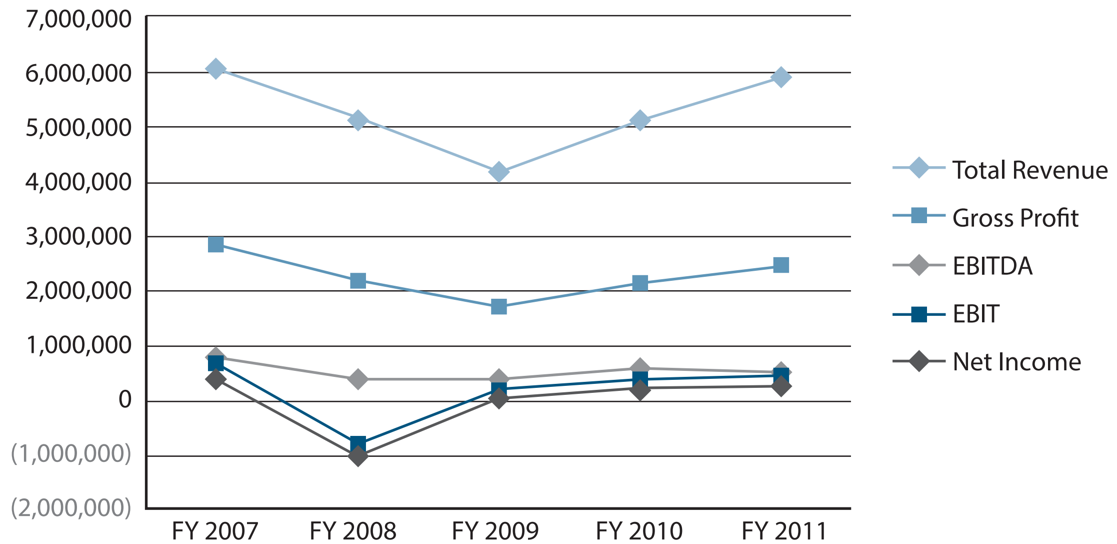
Valuation multiples are distorted during times of recession and high market volatility, such as the period from 2008 through 2011. To demonstrate this, I developed a mini case study based on an actual valuation we performed a couple of years ago. The subject company was a midsize, closely held property management firm, and the valuation date was Dec. 31, 2010. The economy was still struggling then, and the property management industry was suffering from the collapse of the real estate market. In fact, it was still considered a recessionary period for the property management industry.

Our search for guideline companies revealed five less-than-perfect "comparables" that were very large and diversified. Finding good publicly traded guideline companies for a privately held property management company is always challenging, but our case proved especially so because the subject company:

- Specialized in the multifamily segment of real estate properties, as compared to the much larger public players in the property management business that may manage both commercial and residential properties and, within those categories, several subcategories of properties (e.g., offices, malls, etc.);

- Was very small compared to some much larger public players in the property management businesses;

Exhibit 1. CBRE Group Financials



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- Operated in the U.S. only, as opposed to some larger, more diversified public property managers that operate worldwide;

- Derived a large portion of its management fees from a handful of clients, a risk that large, diversified public companies do not have; and

- Had the risk of a loss of a key person in its owner and CEO, another risk that large, diversified public companies do not have.

The trends identified in the valuation multiples during the recessionary years were similar for the five public companies. For the purpose of this case study, however, I am presenting only two of the five companies: CB Richard Ellis (CBRE) and Jones Lang LaSalle (JLL).

Exhibits 1 and 2 illustrate the level and evolution of the economic fundamentals for the two public guideline companies between 2007 and 2011. For CBRE and JLL, most income measures, including revenues, EBITDA, EBIT, gross profit, and net income, were down in 2008 and 2009, then up in 2010 and 2011, but still below 2007 levels. The exception was the revenues for JLL, which were higher at the end of 2011 as compared to 2007.

We computed several valuation multiples for CBRE and JLL for 12 months ending with Dec. 31, 2010, and were surprised to discover they were very high in the midst of the economic recession and collapse of the real estate market. For comparison and to find an explanation for the apparent anomaly, we then computed multiples for 2007 through 2009 and for 2011.

Exhibits 3 through 8 present the levels and trends identified over 2007-2011 in the following valuation multiples for CBRE and JLL:

- Enterprise value to revenues;
- Enterprise value to EBITDA;
- Enterprise value to EBIT; and
- Price to earnings.

In 2009 and 2010, the valuation multiples calculated as enterprise value at the end of the year divided by the income for the last 12 months were generally much higher than either before (2007-2008) or after (2011). For instance, the enterprise value/EBIT multiple for JLL was two to three times higher than it was in 2007, before the recession started (see Exhibit 9). We wondered if it would be reasonable to apply these multiples to our subject company. Our company analysis revealed that the subject company was not better than the market; in fact, it was tracking the public group performance, as shown in Exhibit 10.

The multiples for 2009 and 2010 were much higher due to the calculation manner for the multiple. We divided price as of December 2010 by the past earnings. In this case, the price reflects expectations of future growth. In 2009 and 2010, those expectations of future growth were significantly different than past growth, and as a result,

Exhibit 2. Jones Lang LaSalle Financials

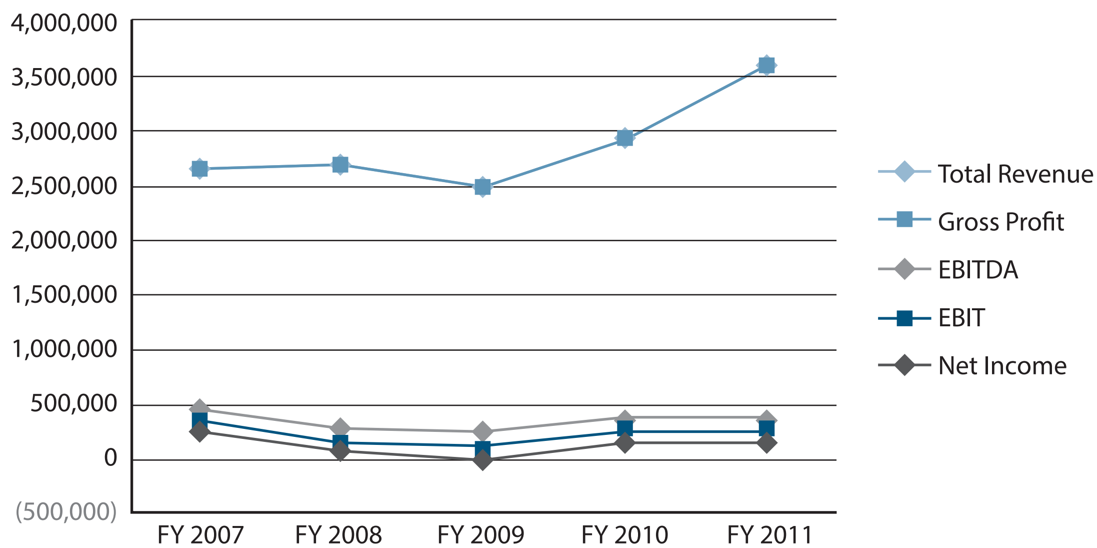
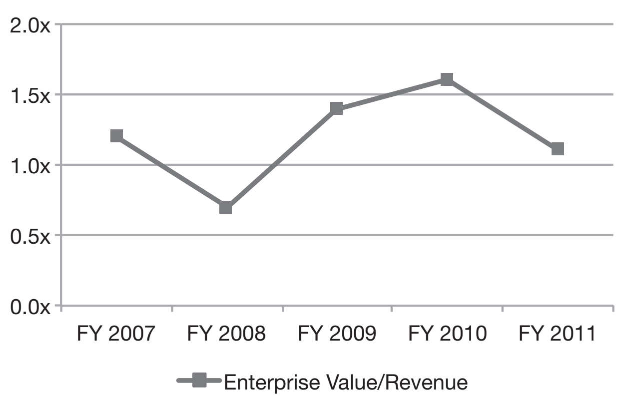
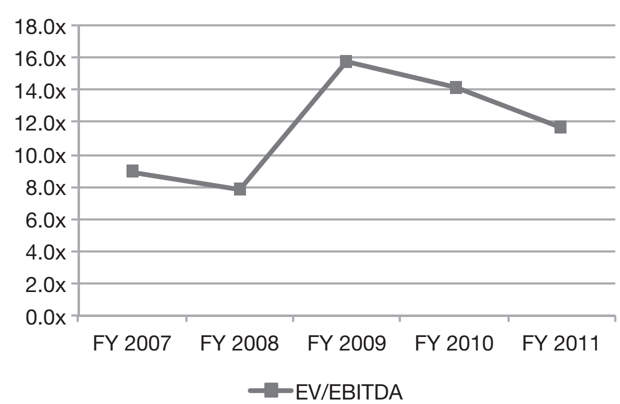


Exhibit 3. CBRE Enterprise Value/Revenue



	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
Enterprise Value/ Revenue	1.2x	0.7x	1.4x	1.6x	1.1x

Exhibit 4. CBRE Enterprise Value/EBITDA



	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
EV/EBITDA	8.9x	7.8x	15.7x	14.2x	11.7x

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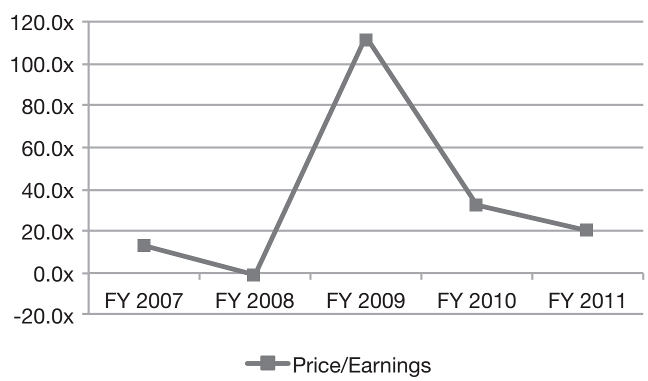
the multiples were distorted. They mismatched the current prices with past earnings at a time when past growth and future growth expectations are dramatically different. The price as of Dec. 31, 2010, reflects expectations of future growth and earnings that are higher than the growth date and earnings realized in calendar 2010. Had the price as of Dec. 31, 2010, been divided by the forecasted earnings for calendar year 2011, with the higher earnings and growth rate expected, that calculation would have resulted into a lower valuation multiple.

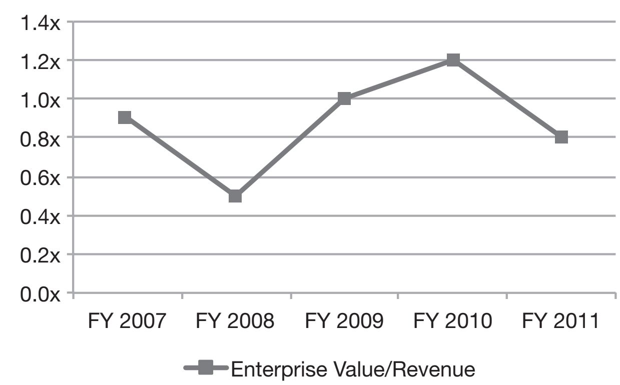
As a result, we decided that these multiples were not reasonable and that if we applied them as calculated, it would result in a serious overvaluation of the company as of Dec. 31, 2010. Instead, we computed multiples based on expected earnings. We calculated enterprise value at the end of 2010 and divided that by expected earnings for 2011.

Exhibit 5. CBRE Price/Earnings



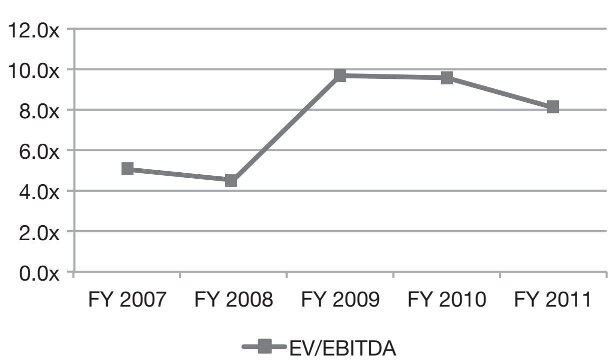
	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
Price/Earnings	12.6x	-0.9x	112.9x	32.1x	20.3x

Exhibit 6. JLL Enterprise Value/Revenue



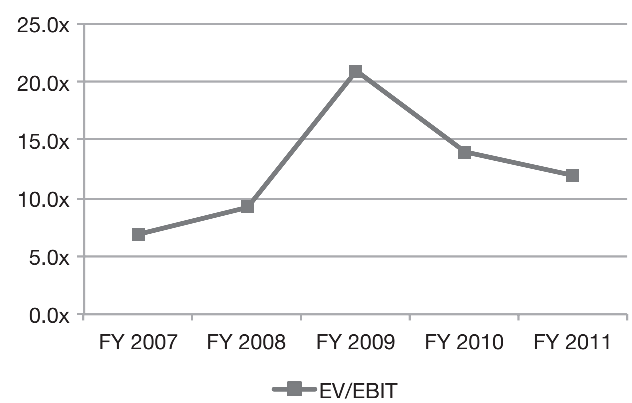
	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
Enterprise Value/ Revenue	0.9x	0.5x	1.0x	1.2x	0.8x

Exhibit 7. JLL Enterprise Value/EBITDA



	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
EV/EBITDA	5.1x	4.5x	9.7x	9.6x	8.1x

Exhibit 8. JLL Enterprise Value/EBIT



	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
EV/EBIT	6.9x	9.2x	20.9x	14.0x	11.9x

What would happen if instead we had blindly applied these multiples to the subject company's fundamentals? As mentioned, the company was down in 2009 and slightly up in 2010—not significantly better than the market (see Exhibit 10).

Exhibit 10 is a graphic illustration of the huge swings in value we would see if we applied the raw valuation multiples from the public market to derive indications of value for the subject company. Exhibit 11 shows in percentages the huge jumps in the resulting values for the subject company from year to year.

Exhibit 12 focuses on the difference in resulting values between 2007 and 2010. According to this exhibit, the value for the company was greater at the end of 2010 when compared to the end of 2007. Remember that 2010 was still considered "the middle of the recession" for

Exhibit 9. Subject Company Performance 2007-2011

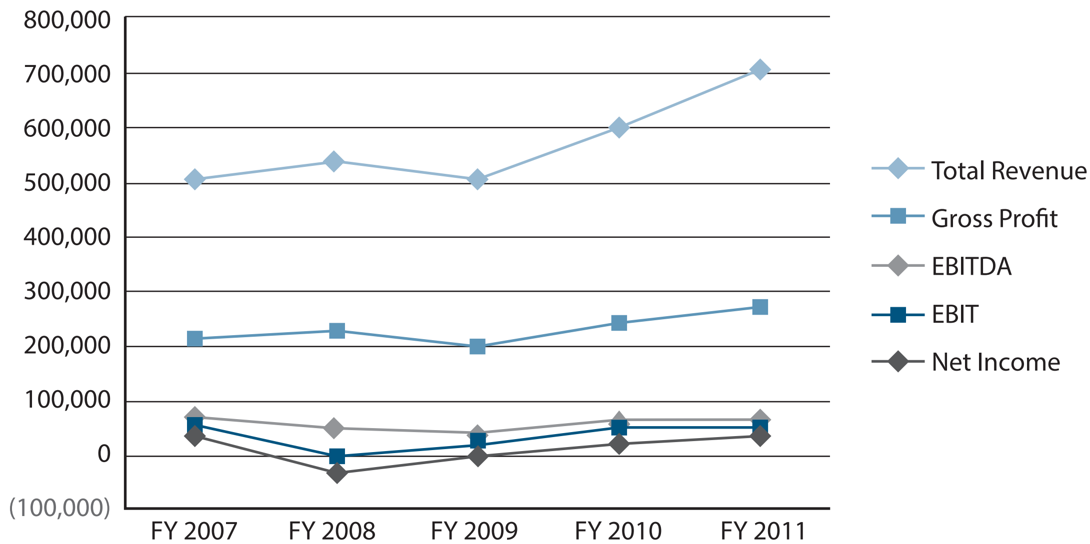


Exhibit 10. Subject Company Resulting Values From Application of Distorted Valuation Multiples

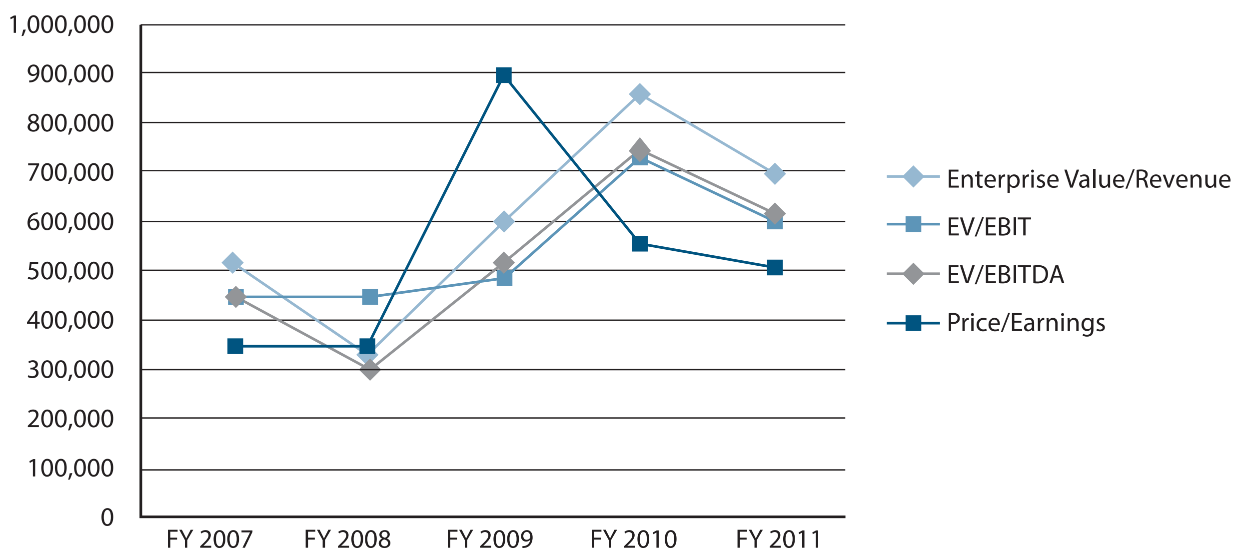


Exhibit 11. Subject Company Annual Percentage Changes in Resulting Values From Application of Distorted Valuation Multiples 2007-2011

	FY 2007	FY 2008		FY 2009		FY 2010		FY 2011	
EV/Revenue	$514,449	$326,708	-36%	$601,925	84%	$855,723	42%	$691,928	-19%
EV/EBIT	$444,735	NEG	nm	$484,571	nm	$732,548	51%	$597,584	-18%
EV/EBITDA	$459,945	$306,251	-33%	$513,146	68%	$752,734	47%	$618,656	-18%
Price/Earnings	$343,452	NEG	nm	$890,277	nm	$545,215	-39%	$508,872	-7%

this particular industry, and the company itself was not doing significantly better between the two dates. Had we applied the 2010 multiples, we see that we would be getting values higher by 60% more when compared to 2007. Again, our conclusion was that most likely, no, it would not be reasonable to go ahead and apply these multiples.

Exhibit 12. Subject Company Percentage Changes in Resulting Values From Application of Distorted Valuation Multiples 2007-2010

	FY 2007	FY 2010	
EV/Revenue	$514,449	$855,723	66%
EV/EBIT	$444,735	$732,548	65%
EV/EBITDA	$459,945	$752,734	64%
Price/Earnings	$343,452	$545,215	59%

Conclusion

If you have a valuation during the recession (2008-2011), calculate valuation multiples for your guideline companies for the years before and after the valuation date and see if they make sense. Graphing them makes it easier to see patterns. During recession, the preference should be toward multiples of forecasted fundamentals versus historical fundamentals (for example, price/next year's earnings versus price/LTM earnings).

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