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CORPORATE FINANCE PRACTICE

Why bad multiples happen to good companies

A premium multiple is hard to come by and harder to keep. Executives should worry more about improving performance.

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Earnings multiples, particularly the price-to-earnings (P/E) ratio, are a common shorthand for summarizing how the stock market values a company. The media often use them for quick comparisons between companies. Investors and analysts use them when talking about how they value companies.

That there are generally more detailed models behind the shorthand seldom makes the headlines, and this contributes to a problem: executives who worry that their multiple should be higher than the one the market currently awards them. "We have great growth plans," they say, or "We're the best company in the industry, so we should have a substantially higher earnings multiple." Their logic isn't necessarily wrong. Finance theory does suggest that companies with higher expected growth and returns on capital should have higher multiples. And the theory held true when we analyzed large samples of companies across the economy.

However, within mature industries, our analysis showed that regardless of performance, multiples vary little among true peers. Companies may occasionally outperform their competitors, but industry-wide trends show a convergence of growth and returns that is so striking as to make it difficult for investors, on average, to predict which companies will do so. As a result, a company's multiples are largely uncontrollable.

Managers would be better off focusing instead on growth and return on capital, which they can influence. Doing so will improve the company's share price, even if it doesn't result in a multiple higher than those of its peers.

The trouble with multiples

Many executives who worry that their multiples are too low are simply comparing their company with the wrong set of peers. In one case, we found that executives were comparing their company's earnings multiple with those for a set of companies in a faster-growing segment of the market than their own. While the company aspired to shift more activity to this segment, its current level of activity was generating less than 10 percent of its revenues at the time of the analysis. Because investors evaluate companies based on what they are, rather than what they aspire to be, the multiples analysis was flawed. The only relevant comparable companies, for the purposes of multiples analysis, are those that compete in the same markets, are subject to the same set of macroeconomic forces, and have similar growth and returns on capital.

Some multiples are also better than others for comparing performance. Ubiquitous as the P/E ratio is, it is distorted in its traditional form by differences in capital structure and other non-operating items. For example, as Exhibit 1 illustrates, when one company is financed partially with debt and the other is financed only with equity, the one with higher debt will have a lower P/E ratio, all else being equal, even though they have the same ratio of enterprise value to

Exhibit 1

Leverage distorts P/E multiples.

The operations of 2 companies are equivalent, except that 1 is financed partially with debt and the other is financed only with equity

In this example (which excludes taxes), the company with higher debt will have a lower P/E[1] ratio

	Company with debt	Company with only equity
Earnings (EBITA[2])	50	50
Interest	–20	0
Net income	30	50
Enterprise value (EV)	1,000	1,000
Debt	–500	0
Market capitalization	500	1,000
EV/EBITA	20.0x	20.0x
Debt/interest	25.0x	N/A
P/E ratio	**16.7x**	**20.0x**

[1]Price-to-earnings ratio.
[2]Earnings before interest, taxes, and amortization.

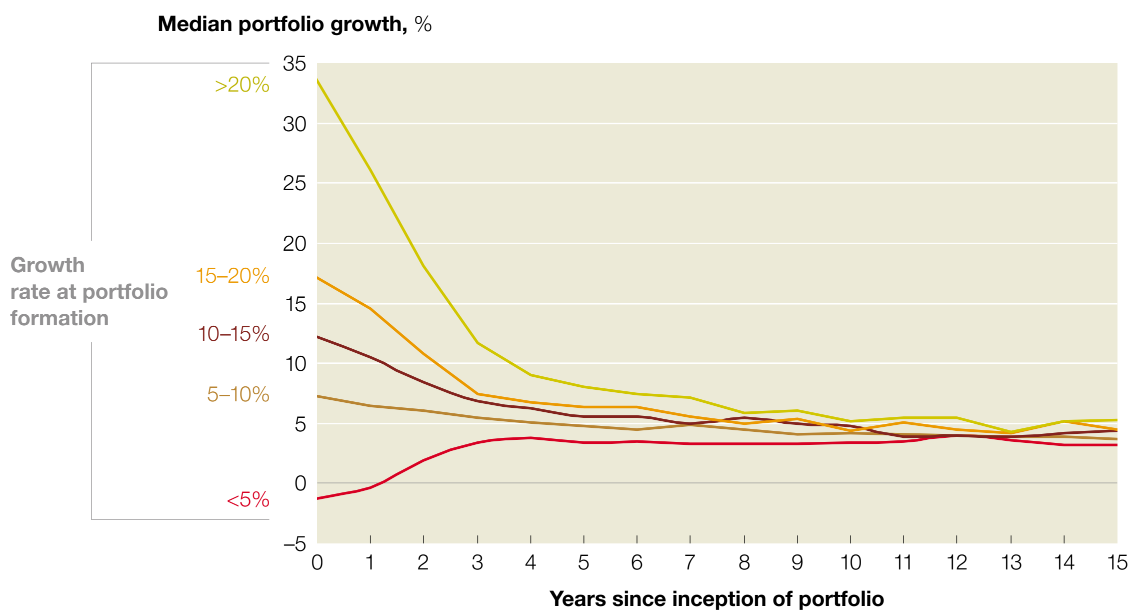
earnings. As a result, most sophisticated investors and bankers compare companies relative to peers using an enterprise-value multiple[1]—usually either EV/EBITA or EV/EBITDA.[2] Such multiples are preferable because they are not burdened with the distortions that affect earnings ratios.

Yet comparisons based on enterprise-value multiples typically reveal a very narrow range of peer-company multiples. A closer look at the US consumer-packaged-goods industry is illustrative. From 1965 to 2010, the difference in EV/EBITA multiples between top- and bottom-quartile companies was, for the most part,[3] less than four points, even though the industry is fairly diverse, including companies that manufacture and sell everything from household cleaners to soft drinks. When we examined more closely matched peers at a given point in time, we found even narrower ranges: for a sample of branded-food companies, for example, EV/EBITA multiples ranged from 10.6 to 11.4. For medical-device companies, the range was 8.4 to 9.7. In ranges this narrow, any differ-

Exhibit 2

Outperforming peers on revenue growth can be difficult to sustain.

US nonfinancial companies[1] grouped by comparable revenue growth at time of portfolio formation



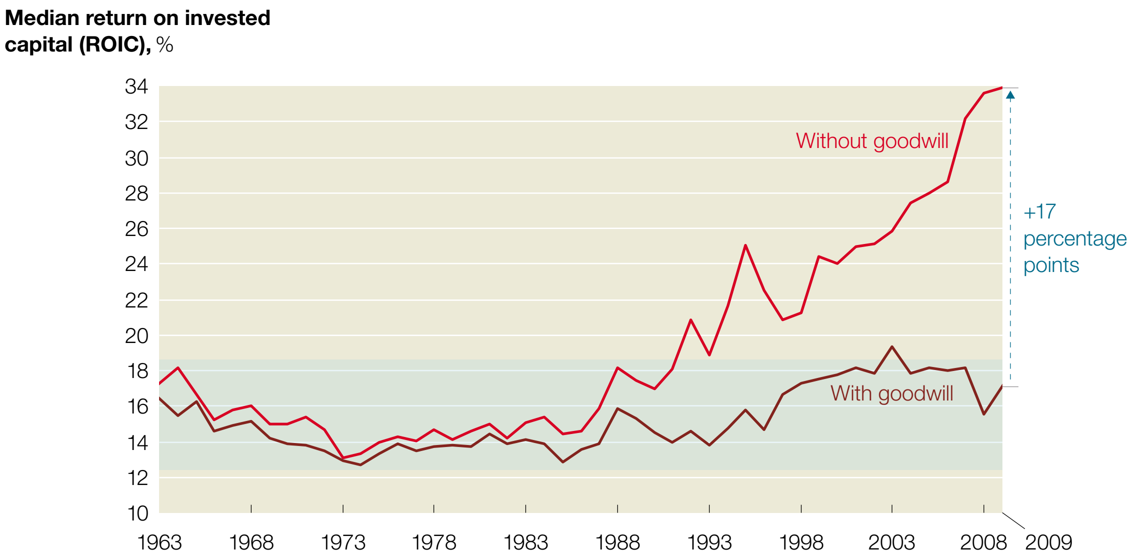
[1]Companies with inflation-adjusted revenue ≥$200 million that were publicly listed from 1963–2000. We divided companies into 5 portfolios based on their growth rate at the midpoint of each decade (1965, 1975, 1985, and 1995). We then aligned the portfolios chronologically from Year 0 to Year 15 and compared their median growth rates.

Source: Compustat; McKinsey analysis

Exhibit 3

Investors may be skeptical of high ROICs that exclude goodwill.

Example of US packaged-goods companies,[1] n = 109



[1]Companies with real annual revenue >$1 billion for any year between 1962 and 2009; excludes companies with ROIC >10%, with or without goodwill.

ences between true peers at a given point in time are typically unremarkable. A company's position in the ranking is likely to be quite variable simply as a result of normal share-price fluctuations.

One explanation for the narrow range of multiples is that investors, as a population, tend to assume that all peers will grow at roughly the same rate. Whether or not executives think this is reasonable, the evidence is on the side of the investors. Companies that are growing faster than their peers today are not likely to continue growing faster than their peers for the next five years. Across the economy, we have found substantial convergence of revenue growth across companies (Exhibit 2). Even energetic efforts to communicate to investors that a company will grow faster probably won't help, since almost all companies predict they will outgrow their market.[4] And while equity analysts sometimes forecast that companies will grow at different rates, investors know that analysts are consistently overly bullish as well.[5]

According to finance theory, companies with higher returns on capital than their peers should also have higher multiples—but in fact, these companies' multiples are not as high as one might expect if investors believed their stronger returns were sustainable. As with revenue growth, the logic could be that investors assume that incremental returns on capital across the industry will converge or that competition will bring them down toward the cost of capital. Once again, the investors have some evidence on their side, As companies with high total returns to shareholders know, executives should focus on the amount of value they create—with regard to growth, margins, and capital productivity

and the packaged-goods industry is illustrative (Exhibit 3). To be sure, the power of their brands has helped companies in the industry increase their operating returns on capital over the past 15 years. But operating returns exclude an important piece of the balance sheet—the premiums over book value paid in acquisitions, or goodwill. Some companies in the industry have used the cash flow that comes from having high return on invested capital to make acquisitions with lower return on capital. As a result, the industry median return on all capital including goodwill has remained within a tight band, between 15 and 19 percent. Investors as a whole appear to assume that acquisitions will continue to eat away at returns on capital. And they tar all companies in the sector with the same brush. Companies might argue that they are more disciplined than their peers, but investors aren't buying it.

There are exceptions, of course, among a few companies with a truly durable competitive advantage. For example, from the mid-1980s to the middle of the last decade, Wal-Mart's unique business model earned it premium multiples as it consistently posted double-digit top-line growth, far higher than for most other retailers. But today, Wal-Mart has become so large that it is less likely to outgrow the economy, and its multiple has fallen into line with those of its peers. Starbucks, similarly, earned premium multiples for over a decade beginning in the mid-1990s, during a period of rapid expansion. But as its rate of store openings and top-line growth have slowed, its multiple has also fallen.

Keeping the focus on value

Of course, not all investors will be so skeptical about a company's ability to outperform its peers. After examining the company's track record, its competitive position, strategy, management strength, and credibility, sophisticated investors—including those we have elsewhere called intrinsic investors[6]—do place their bets that some companies will outperform others. These investors are looking to purchase the shares at an attractive price and minimize their downside risk. Sometimes they turn out to be right, though they may not have enough buying power to push the companies' multiples to a sustainable premium to peers. And in fact, they are likely to stop purchasing if share prices rise to include even a small premium.

Clearly, executives focused on having the highest multiple are missing the point. Rather, as companies with high total returns to shareholders (TRS) know, executives should focus on the amount of value they create—with regard to growth, margins, and capital productivity. Doing so won't necessarily lead to a higher earnings multiple, given the trends we have outlined. Take, for example, the TRS of US household-products manufacturer Church & Dwight compared with the broader consumer-goods sector. Over a 15-year period, the company grew, both organically and through acquisitions, as it effected a turnaround and reshaped its portfolio of businesses. The company's EBITA margins increased by 13.9 percentage points, compared with only 2.5 percentage points for the median company in the sector, and its TRS beat the sector and the S&P 500 handily—yet its earnings multiple fell from 16 to 10. This is likely because its multiple had been high at the outset, in spite of low earnings, suggesting that investors had assumed earnings would gravitate toward the median for the sector.

Finally, executives should have realistic expectations about how much they can raise their share price above those of peers through investor communications. Although such communications seem like a natural first step if investors truly fail to see the value in, for example, a company's product pipeline or geographic expansion, jawboning has its limits. Eventually, investors as a group are likely to revert once again to their perceptions of convergence. That doesn't mean companies should abandon communications entirely. Communicating with the right investors, and making sure they understand the company's performance and strategies, can at least keep a company's share price aligned with peers'.

[1] For a discussion of enterprise-value multiples, see Richard Dobbs, Bill Huyett, and Tim Koller, *Value: The Four Cornerstones of Corporate Finance*, Hoboken, NJ: Wiley, 2010, pp. 241–4.
[2] For more on how to choose the right multiple, see Marc Goedhart, Tim Koller, and David Wessels, "The right role for multiples in valuation," *McKinsey on Finance*, Number 15, Spring 2005, pp. 7–11.
[3] In the late 1990s, the multiples of the largest consumer-packaged-goods companies rose during the overall valuation boom for big companies.
[4] See Peggy Hsieh, Tim Koller, and S. R. Rajan, "The misguided practice of earnings guidance," *McKinsey on Finance*, Number 19, Spring 2006, pp. 1–5.
[5] See Marc Goedhart, Rishi Raj, and Abhishek Saxena, "Equity analysts: Still too bullish," *McKinsey on Finance*, Number 35, Spring 2010, pp. 14–7.
[6] See Robert Palter, Werner Rehm, and Jonathan Shih, "Communicating with the right investors," *McKinsey on Finance*, Number 27, Spring 2008, pp. 1–5.

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