Sizing Up Value

What the ProSales 100 can teach LBM business owners about two key valuation factors

This month marks the 25th anniversary of the ProSales 100, an unmatched barometer of the size, health, and momentum of the LBM industry. This key anniversary is a good time to consider the impact of two distinct factors—size and age—on the valuation of a company.

To begin, size does not equal profitability. Two companies with $5 million in EBITDA will be viewed differently by the market if one of them has $50 million in revenue and the other requires $75 million in revenue to achieve that EBITDA mark. The EBITDA margin is used to determine profitability per dollar of revenue. The higher the EBITDA margin, the stronger the valuation multiple tends to be.

That being said, a greater amount of EBITDA also tends to drive a higher EBITDA multiple. The number of companies in a given size category decreases as the revenue level increases. In the case of any desired good, the price of that good tends to increase as supply decreases. Buyers are willing to "pay up" to gain ownership of a larger chunk of EBITDA.

Owners of small businesses often believe their company has such strong potential that it deserves an EBITDA multiple similar to a larger firm. This does not usually occur. A small company usually only has a higher EBITDA multiple than a larger company when the small company is unprofitable. In such a case, the company may be acquired based on asset value.

Dividing the asset value by EBITDA can imply an unusually high EBITDA multiple. However, if the small company were operating profitably, a true EBITDA multiple–based valuation would yield a higher dollar valuation but would be driven by a lower EBITDA multiple. Mixing the asset and EBITDA valuations can produce misleading results.

Does the relationship between size and valuation mean that smaller companies are not readily salable? Definitely not. The smallest company on this year's ProSales 100 has roughly $37 million in revenue. If a company that size is profitable and has a good management team and a loyal base of customers, it is very salable. In fact, businesses many active acquirers will consider single-location businesses with just $5 million in revenue.

The product mix and the geography have to be a great fit with the buyer's criteria. Also, the buyer may require that the company have space to add storage buildings or truck turnarounds, allowing the location to serve as a base for expansion. With the addition of new products, it may be possible to double or triple the size of a newly-acquired small location within a year or two. Thus, virtually any profitable LBM distribution business may be an attractive acquisition candidate to the right buyer.

Our last valuation factor is the age of a company. Age does not increase valuation unless its manifests itself in a beneficial way. Two companies that are identical in every other factor will generally enjoy the same valuation even if they were founded decades apart. An older company will enjoy a better valuation if its years have resulted in strong brand recognition. A firm with a long history will be more likely to have a seasoned management team, which hopefully will have dialed in a set of best practices.

A firm with a long history likely enjoys preferential treatment by longstanding vendors and customer relationships that span decades. This contributes to valuation but must be accompanied by a track record of adding new customers. If the majority of customers have a 10- or 15-year history with the LBM supplier, customer acquisition is likely stale.

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