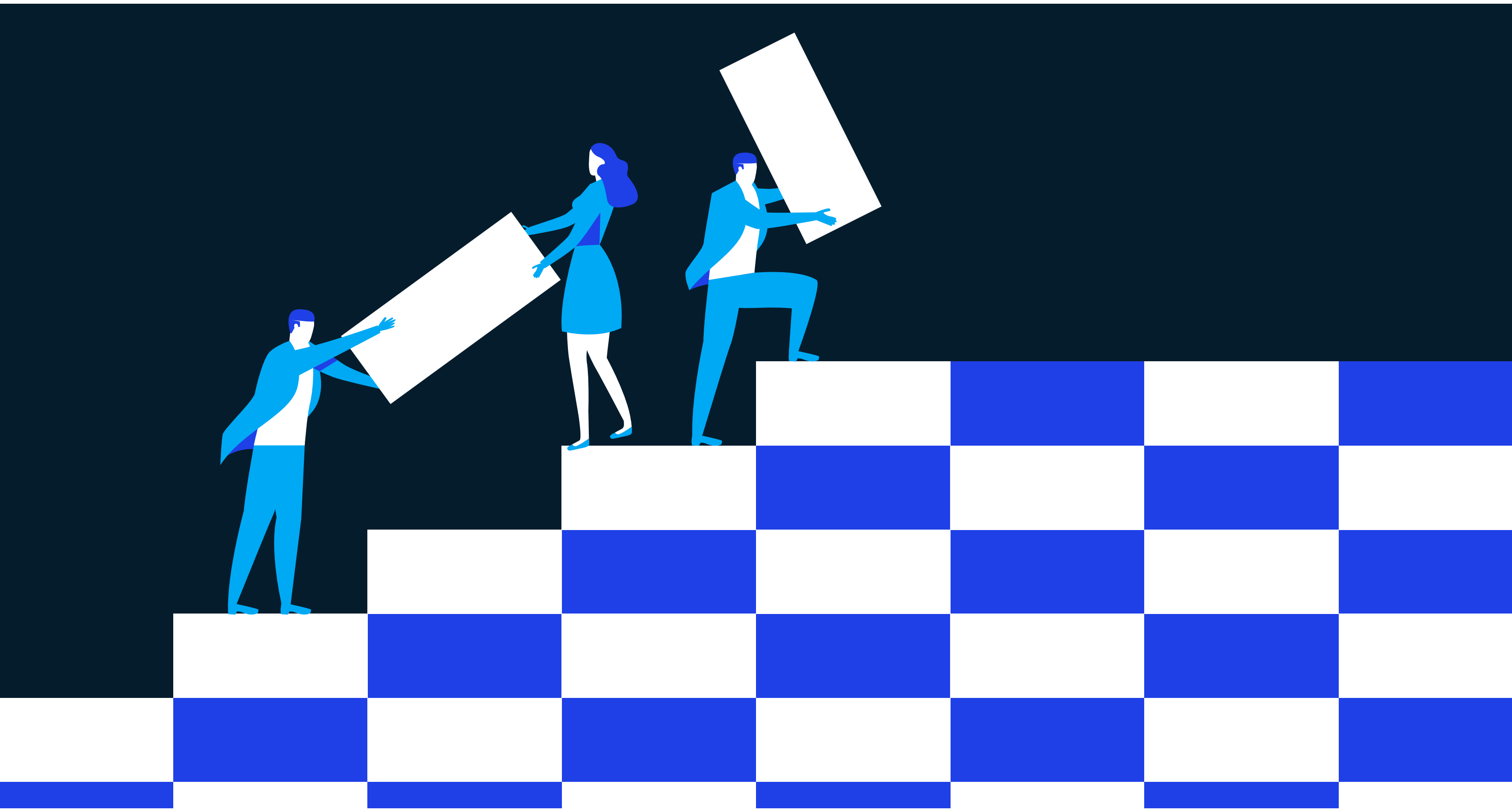
Strategy & Corporate Finance Practice

Multiples analysis: Industry labels don't matter, performance does

Our research highlights the variability of multiples within and across industries and refutes the idea that there is a shortcut to higher valuation.

by Alok Bothra and Zane Williams



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We hear executives theorize all the time about whether a change in industry classification[1] could boost their companies' valuation, even if underlying performance didn't change very much. For instance, if an insurance company were classified as a "wealth manager" rather than an "insurer," it could trade at higher multiples, and its valuation would increase. Right?

Not so fast.

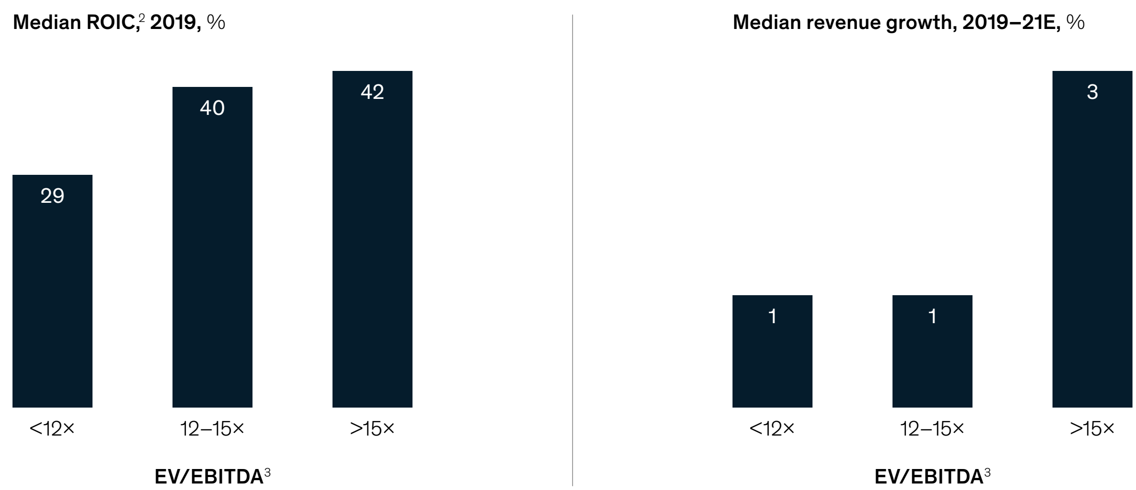
Our research underlines the degree to which corporate performance and multiples are inextricably linked. Companies in the packaged-food-and-meat industry, for instance, generally trade at multiples lower than 15 times EV/EBITDA.[2] But the higher performers—those companies that consistently deliver superior returns on invested capital and revenue growth—steadily trade at a multiple of more than 15 times EV/EBITDA (Exhibit 1). What's more, multiples are highly variable within industries themselves, reflecting the differing growth rates and profitability of different parts of the economy (Exhibit 2).

The numbers suggest that there are no shortcuts to higher valuation.[3] For a company to realize the industry-average multiple, it must match the industry-average expected performance. There's not much executives can do to directly

Exhibit 1

Underlying performance drives variation in multiples.

Industry example: Multiples used in packaged food and meat[1]



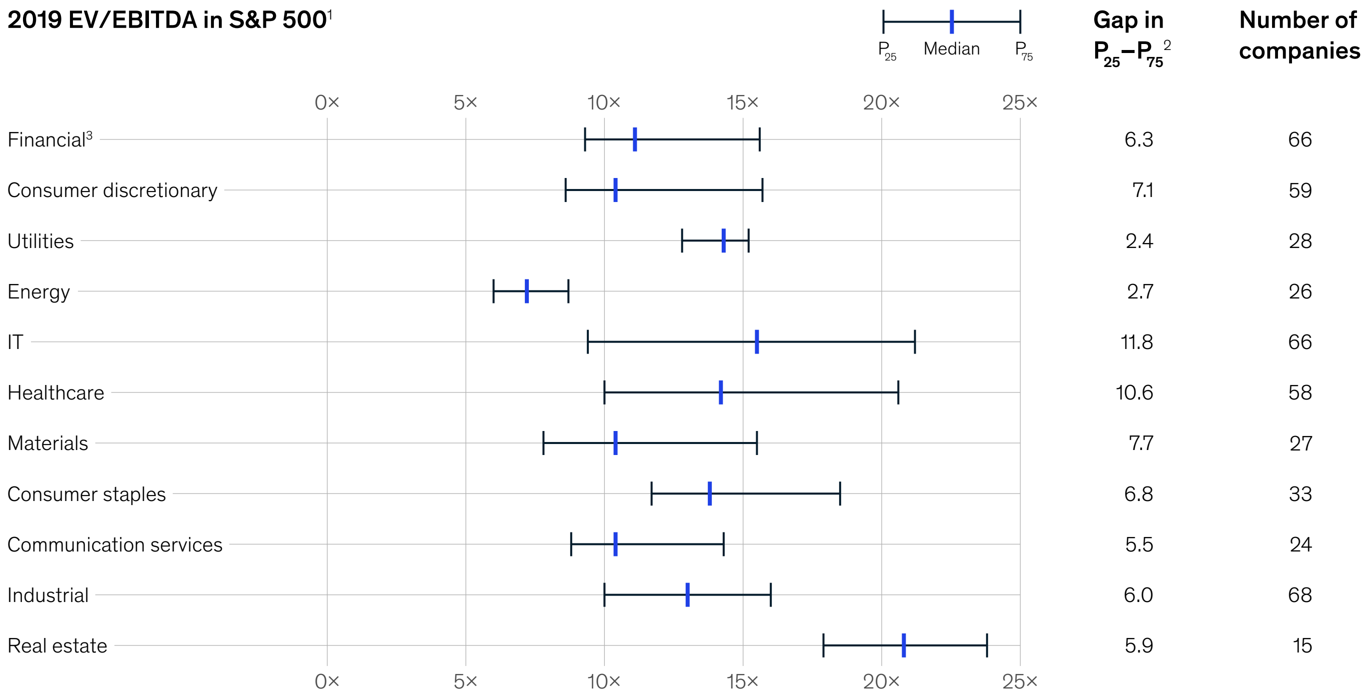
[1] Based on a sample of 19 US-based packaged-food-and-meat companies with a market cap of ≥$1 billion.
[2] Return on invested capital. Excludes goodwill and nonoperating intangibles.
[3] EV = enterprise value; EBITDA = earnings before interest, taxes, depreciation, and amortization. Based on EV and analysts' consensus EBITDA estimate as of June 7, 2019.

Source: S&P Capital IQ; McKinsey analysis

[1] Industry classifications group companies together based on an economic taxonomy that considers similarity of products, processes, behaviors, and other factors.
[2] "EV/EBITDA" refers to the ratio of enterprise value to earnings before interest, taxes, depreciation, and amortization. This is a measure of the cash flow available to a company.
[3] Susan Nolen Foushee, Tim Koller, and Anand Mehta, "Why bad multiples happen to good companies," May 2012, McKinsey.com.

Exhibit 2

Multiples vary significantly within different sectors.



[1] EV = enterprise value; EBITDA = earnings before interest, taxes, depreciation, and amortization. Based on EV and analysts' consensus EBITDA estimates as of June 7, 2019. S&P 500 companies with meaningful P/E multiples (470 in total) divided by sector.
[2] Difference between 75th percentile and 25th percentile values.
[3] Using 2019 estimates of P/E multiples for financial companies.

Source: S&P Capital IQ; McKinsey analysis

affect industry classifications and market variability, but they can control their companies' efforts to create more growth, higher margins, and greater capital productivity. Business leaders must do the hard work of revising business strategies, reallocating resources, monitoring outcomes, and otherwise enhancing corporate performance over the long term. Doing so will steadily improve a company's share price, even if it doesn't immediately result in higher multiples.

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