

Strategy & Corporate Finance Practice

The times for multiples: Why value creation always comes first

Beware of solving for enterprise multiples instead of value creation.

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It's your call: Which internal businesses or projects merit company capital? Managers frequently employ enterprise value multiples as a key yardstick. However, when evaluating potential strategies more comprehensively, it's essential not to rely on multiples alone or even primarily. The goal of strategy is maximizing long-term value, not optimizing multiples. Multiples are the result of good outcomes, but they are not the primary objective. Sometimes companies miss this essential point.

In particular, there are three instances when an overreliance on multiples can contribute to poor strategic decisions in capital allocation: (1) prioritizing multiples when investments at a lower multiple could generate more value; (2) ignoring the interplay between multiples, returns on capital, and cost of capital when allocating capital to a noncore business; and (3) extrapolating from a start-up's results when determining a conglomerate's potential for value creation.

The 'higher multiple' trap

A higher multiple is a head turner. Imagine you are the CEO of a company with an enterprise value (EV), excluding excess cash, of \$1.5 billion. The current core business generates net operating profit after taxes (NOPAT) of \$100 million; the

EV-to-NOPAT multiple is therefore 15. For purposes of this example, the company also has \$300 million of excess cash, and \$9 million of posttax earnings, which leads to an observed market multiple of 16.5. You understand that the company should invest for growth; a board member suggests more share repurchases in order to "stabilize the price."

You are faced with the choices in Exhibit 1.

Your team is excited about strategy 1, which involves an investment of \$100 million to grow a new, high-multiple business, which requires less capital, leaving \$200 million to buy back shares.¹ Executing on strategy 1 would expand your company's EV/NOPAT multiple of core operations (that is, the multiple, adjusted for cash holdings, observed today by investors) to 16.4. That's awfully tempting: strategy 1 generates value, produces a higher multiple, and enables buybacks. It looks like a win-win-win.

A junior colleague, however, proposes strategy 2: deploy all the excess cash into a lower-multiple business. Doing so shrinks the multiple, but it also creates more absolute shareholder value. This option has a higher return on capital (measured as earnings divided by the investment needed) than

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¹ We assume, for purposes of this example, that all assets and companies are fairly valued. Therefore, the stock buyback has no impact on the value of the core business, and the fair value of the growth businesses reflects all future growth opportunities.

Exhibit 1

A higher multiple isn't always the most value-creating choice.

Scenario comparison

Current business in 5 years		New business			Combined business	
Core business		New business	Scenario 1	Scenario 2	Scenario 1	Scenario 2
Enterprise value (EV), \$ million	1,500	Net fair value post investment, \$ million	300	700	1,800	2,200
NOPAT, ¹ \$ million	100	NOPAT, \$ million	10	63.6	110	163.6
EV/NOPAT, multiple	15×	EV/NOPAT, multiple	30×	11×	16.4×	13.4×
Excess cash		Investment needed, \$ million	100	300		
Enterprise value (EV), \$ million	300	Cost of stock buyback, \$ million	200			
Posttax earnings, \$ million	9					
EV/posttax earnings, multiple	33.3×					
		Net present value, \$ million	200	400		
Combined		Earnings/investment, %	10	21		
Value, \$ million	1,800					
NOPAT, \$ million	109					
EV/postttax earnings, multiple	16.5×					

¹Net operating profit after tax.

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strategy 1 and maximizes long-term value, which, from a shareholders' perspective, is paramount.

To be sure, this is a simplistic model. Yet something like it occurs quite often. For instance, a software company or other asset-light business with a relatively high multiple can hesitate to invest in strategically important assets that have a lower multiple (for example, a leasing business or data centers), even if doing so would create positive net present value (NPV).

To avoid this trap, you should always identify the total value created, as well as the underlying growth and return on capital that drive value. This will enable a robust discussion on achieving greater value creation as opposed to splashier, higher-multiple headlines.

The challenge of investing outside the core

In the next strategic cycle, the board asks you to investigate value creation by expanding the core business. Again, your team has come up with two proposals for investing the next \$100 million.

Both potential expansions grow at around 2 percent. However, business 1 seems to have potential for a higher multiple. Intrigued, you ask for more details. Could that potential be driven by fundamental differences in ROIC? At the same growth, a business with higher ROIC should have a higher multiple (Exhibit 2).

The details surprise you: at the same growth and the same investment, business 2 has a higher ROIC but a *lower* multiple. What's going on?

Exhibit 2

The interaction between growth, return on capital, and cost of capital can affect value creation.

Comparison of investments in two hypothetical businesses

	ROIC, ¹ %	Growth, %	WACC, ² %	ROIC–WACC spread, %	Implied multiple ³	Investment, \$ million	NOPAT, ⁴ \$ million	EV, ⁵ \$ million
Business 1	8	2	6	2	18.8×	100	8	150
Business 2	20	2	8	12	15.0×	100	20	300

¹Return on invested capital.

²Weighted average cost of capital.

³Enterprise value/net operating profit after tax.

⁴Net operating profit after tax.

⁵Enterprise value.

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It turns out that this counterintuitive outcome results from a subtle interplay between growth, return on capital, and cost of capital. Investing in business 2, at the same cost of capital, would indeed lead to a higher multiple. However, the difference in the cost of capital drives the multiple for investing in business 2 below that of investing in business 1.

Once again, to arrive at the solution, focus on value creation: Why does the team believe that the cost of capital is higher for investing in business 2? With a 5 percent risk premium and similar leverage, the 2 percent difference in weighted average cost of capital (WACC) comes from a 0.4 difference in (levered) beta, which is relatively large. While the disparity in cost of capital is possible because of differences in the underlying risks of business 2—for example, a regulated utility company entering into a new business outside its core could face much greater risks, a different beta, and, therefore, a higher cost of capital—the difference could also be due to the fact that the numbers reflect a less robust analysis. Sometimes, a team will arbitrarily apply a risk premium rather than conduct a more robust valuation using time-tested methodologies.

Consider a company that simply adds a 3 percent risk premium to any investment that is not in its core business, regardless of the underlying economics and cost of capital. That's an easier analysis, to be sure, but it's also a worse one. Assessments of risk are imprecise, outputs are opaque, and the lack of rigor can lead managers to systematically disregard opportunities they could have explored if they had dug deeper. As we've shown in multiple contexts (such as investing in emerging markets or in speculative R&D projects), the best, most transparent way to assess potential value is to reflect risks other than the cost of capital in cash flow projections and probability-weighted scenarios.

Conglomerates and small businesses

A third, common instance in which relying on multiples can lead to misunderstandings is when conglomerates assume that investors assess value creation by extrapolating the multiple from one (typically the largest) business in the portfolio. For example, managers of conglomerates often believe that investors will apply the multiple of one conglomerate business to its other businesses, as long as the higher-multiple business is larger

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than that of the rest of the conglomerate. We have seen this time and again as an argument for value creation in M&A.

Sophisticated investors don't make this mistake; they understand that there is no magic "multiple expansion." Instead, they value businesses by the sum of their visible parts.

A related and often more challenging issue arises when conglomerates assess the effect that investing in high-multiple new businesses will have on the conglomerate's own multiple. Consider a traditional industrial company without a product that addresses the energy transition. For purposes of this example, assume that the industrial company currently trades at a multiple of five times EBITDA, due to its shrinking volume and lack of growth prospects. Start-ups with dedicated products in energy transition, by contrast, see high growth and enjoy multiples of 30 times EBITDA.

Next, assume that the company in our example identifies an opportunity to invest \$1 billion into a new business expected to create \$200 million in earnings in five years. It's very tempting to justify this investment by assuming it will increase the

acquirer's own multiple considerably; after all, the energy transition business trades at a multiple of 30.

But that logic is flawed, for several reasons. First, earnings multiples will likely not remain at 30 in five years; as a start-up's growth slows, its multiple declines. Second, the core business is likely to shrink and therefore produce lower earnings than it does today. Finally, once the core business stops shrinking—assuming that some demand for its products remains—that core multiple will *increase*, because a no-growth business has a higher multiple than a shrinking one. Taken together, the most likely effect is that even as the new business grows, the conglomerate's overall multiple will stay about the same. This doesn't mean it's a bad investment; in fact, it might be critical for the company's survival. But time and again, we've seen that the promise of a higher overall multiple does not materialize.

Like other methodologies at a CFO's disposal, multiples have their uses, including decisions on capital allocation. But an overreliance on multiples can lead to suboptimal outcomes. Greater value, not higher multiples, should always be the objective.

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