Treatment of Cash When Calculating Enterprise Value

~ GUEST COLUMNIST ~

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Gilbert Matthews' article in the February/March issue of *Financial Valuation and Litigation Expert* (number 35) presents a very useful discussion about some differences in calculating enterprise value between investment bankers and valuation analysts. This article will attempt to provide some explanation of the practices adopted by valuation analysts, and will hopefully provide a bridge to understanding some of the differences in practice noted by Mr. Matthews.

Enterprise value is an important concept in investment banking and valuation, which are often considered two branches in the larger discipline of corporate finance. Enterprise value is often termed market value of invested capital by valuation analysts. A common presentation of enterprise value follows:[1]

EBITDA
x Multiple
Operating value
+ Excess assets
Enterprise value
- Debt
Market value of equity

An important difference between investment bankers and valuation analysts lies in the treatment of excess assets, including cash. As Mr. Matthews pointed out in his article, investment bankers tend to treat the entire cash balance as an additional increment of value, and deduct it from debt. While the investment banker calculation differs from that presented above, the net result is the same – an increase in market value of equity. The implicit assumption in deducting all cash from debt is that the company being valued has adequate lines of credit available to fund normal operating activities, and that the company's risk profile is not changed when cash is removed from the balance sheet.

Valuation analysts, on the other hand, take a different approach with cash balances. There are two schools of thought on the matter. The more dominant school of thought is that valuation analysts should distinguish between minority and controlling ownership interests. In the case of minority ownership interests, value should not be increased for cash balances, since a minority ownership interest cannot compel the company to distribute cash on hand.[2] In the case of controlling ownership interests, cash in excess of normal operating requirements is treated as an additional increment of value since a controlling owner can compel the company to distribute the cash on hand.

The other school of thought for valuation analysts is that all cash in excess of normal operating requirements is an additional increment of value – for both minority and controlling ownership interests. No distinction is made between minority and controlling interests because cash is, by definition, distribut*able* whether or not it will actually be distribut*ed*. This school of thought emphasizes that all valuation methods are a reflection of future distributable cash flows; and all distributable cash, whether on hand or forecasted in the future, should be reflected in value. The notion of distributable cash flow is very important in valuation. Note that the word isn't "distributed." We're not as concerned about how much cash is actually distributed as we are interested in a company's potential to distribute cash.[3]

Investment bankers tend to be very aggressive in their view of what is distributable. An excellent example is the leveraged buy-out boom of the mid to late 1980's. We saw many examples of assets being converted to cash and distributed to the new owners of acquired companies. During that time there was less regard for managing a firm's risk profile and an emphasis on cash flowing out to various constituencies.

Valuation analysts take a more incremental and risk-based approach to considering cash balances. Importantly, valuation analysts acknowledge that the risk profile of a firm could change if all cash on hand is distributed, even if adequate lines of credit are available to fund operations. That is because valuation analysts are very concerned about liquidity, particularly for smaller companies. They tend to see liquidity in capital markets as a variable effect – in some time periods there is a great deal of liquidity, but at other times liquidity can be scarce. And when liquidity is scarce credit availability falls, risk increases and value falls. The credit crunch that started in 2007/2008 is an excellent example

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of the liquidity effect on credit availability. So valuation analysts expect to see a certain level of cash on the balance sheet that can be used to fund normal operating activities, because lines of credit are not a certain or risk-free source of cash.

Additionally, lines of credit are not a cost-free source of cash. In order to use a line of credit for operating purposes, a company has to pay interest to a financial institution. The interest costs associated with using the line of credit as a source of operating cash must be deducted from earnings in calculating value. Instead of reducing value for the cost of obtaining operating cash, many valuation analysts find that treating a portion of cash as a necessary operating asset is a better reflection of a company's value.

The discussion of excess assets gets more nuanced as we move away from cash to other non-operating assets, such as real estate. Marketable securities are often considered an excess asset, since they are readily converted to cash. But real estate and other assets that cannot be readily converted to cash are subject to a number of considerations. Investment bankers tend to be more aggressive in their consideration of other non-operating assets as an additional increment of value. Valuation analysts focus on the facts and circumstances surrounding the valuation assignment to determine if other non-operating assets actually represent an additional increment of value.

1 A thorough presentation of this formula is included on page 268 of *Valuation: Measuring and Managing the Value of Companies* by Tim Koller, Marc Goedhart and David Wessels (2010, Wiley Finance).

2 Some analysts recognize the additional cash but discount the minority interest to reflect the inability to access it.

3 This lack of distribution would be reflected in any discounts applied.