



ENTERPRISE VALUE (EV)

What Is Enterprise Value (EV)?

Enterprise value (EV) measures a company's total value, often used as an alternative to market capitalization.

EV includes in its calculation the market capitalization of a company but also short-term and long-term debt and any cash or cash equivalents on the company's balance sheet.



Components of Enterprise Value (EV)

- Market cap: The total value of a company's outstanding common and preferred shares.
- Debt: The sum of long-term and short-term debt
- Cash and cash equivalents: The total amount of cash, certificates of deposit, marketable securities, money market funds, short-term government bonds, or Treasury bills a company possesses.



Enterprise Value Formula and Calculation

Enterprise Value

$$\text{EV} = \text{Market Cap} \\ + \text{Debt} \\ - \text{Cash}$$

To calculate market capitalization—if not readily available online—you would multiply the number of outstanding shares by the current stock price.



Next, total all debt on the company's balance sheet, including both short-term and long-term debt. Finally, add the market capitalization to the total debt and subtract any cash and cash equivalents from the result.



What Does EV Tell You?

Enterprise value (EV) differs significantly from simple market capitalization in several ways, and many consider it to be a more accurate representation of a firm's value.

EV tells investors or interested parties a company's value and how much another company would need if it wanted to purchase that company.



There is one other consideration: a company's EV can be negative if the total value of its cash and cash equivalents surpasses that of the combined total of its market cap and debts. This is a sign that a company is not using its assets very well—it has too much cash sitting around not being used.

Extra cash can be used for many things, such as distributions, buybacks, expansion, research and development, maintenance, employee pay raises, bonuses, or paying off debts.



EV as a Valuation Multiple

Enterprise value is used as the basis for many financial ratios that measure the performance of a company.

EV/EBITDA

The enterprise multiple (EV/EBITDA) metric is used as a valuation tool to compare the value of a company and its debt to the company's cash earnings, less its non-cash expenses.

As a result, it's ideal for analysts and investors looking to compare companies within the same industry.

EV/EBITDA is useful in several situations:

- The ratio may be more useful than the P/E ratio when comparing firms with different degrees of financial leverage (DFL).
- EBITDA is helpful in valuing capital-intensive businesses with high levels of depreciation and amortization.

- EBITDA is usually positive even when earnings per share (EPS) is not.

EV/EBITDA has a few drawbacks:

- If working capital is growing, EBITDA will overstate cash flows from operations (CFO or OCF). Further, this measure ignores how different revenue recognition policies can affect a company's OCF.

- Because free cash flow to the firm captures the number of capital expenditures (CapEx), it is more strongly linked with valuation theory than EBITDA. EBITDA will be a generally adequate measure if capital expenses equal depreciation expenses.

EV/Sales

EV/Sales ratio is regarded as a more accurate measure than the Price/Sales ratio since it considers the value and amount of debt a company must repay at some point.

It's believed that the lower the EV/Sales multiple, the more attractive—or undervalued—the company is.



The EV/Sales ratio can be negative when the cash held by a company is more than the market capitalization and debt value. A negative EV/sales implies that a company can pay off all of its debts.



Enterprise Value vs. Market Cap

Why doesn't market capitalization properly represent a firm's value? It leaves a lot of essential factors out, such as a company's debt and cash reserves.

Enterprise value is a modification of market cap, as it incorporates debt and cash for determining a company's value.



Here's an example: imagine two identical widget manufacturers, Company A and Company B, have the same stock price of ₹4.32 per share. Each has 1 lakh outstanding shares with a market cap of ₹43.2 lakhs.

Debt and Cash Change the View

Now, imagine Company A has ₹500,000 in cash and cash equivalents and ₹250,000 in total debt. Its EV (total worth) is $₹4,320,000 + ₹250,000 - ₹500,000 = ₹40.7$ lakhs



Company B has ₹10 lakhs in cash and ₹250,000 in debt. It's EV is $₹4,320,000 + ₹250,000 - ₹1,000,000 = ₹35.7$ lakhs.

The companies looked identical using a market cap, but a much different picture appears when EV is calculated.

Enterprise Value vs. P/E Ratio

The price-to-earnings ratio is sometimes known as the price multiple or the earnings multiple. The P/E ratio doesn't consider the amount of debt that a company has on its balance sheet.



Limitations of EV

As stated earlier, EV includes total debt, but it's essential to consider how the company's management utilizes the debt. For example, capital-intensive industries such as the oil and gas industry typically carry significant amounts of debt, which is used to foster growth. The debt could have been used to purchase a plant and equipment.

As a result, the EV can be skewed when comparing companies across industries.



This is essential to consider if the company being looked at is undergoing a merger or acquisition. This is because the acquiring company will need to account for the amount of debt it is taking on in the merger.

Investors can use this information to evaluate what the merged companies will look like in the future.

As with any financial metric, it's best to compare companies within the same industry to better understand how the company is valued relative to its peers.



Example of EV

Let's calculate the enterprise value for MRF LTD.

Outstanding shares = 42 lakhs

Share price as of 17/06/2023 = ₹99,780

Market cap = ₹41,907 crores

Short-term debt = ₹1,606 crores

Long-term debt = ₹824 crores

Total debt = 1,606 + 824 = ₹2,430 crores

Cash and Cash equivalents = ₹258 crores

Enterprise Value = ₹41,907 + ₹2,430 - ₹258 = ₹44,052 crores



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