

An illustration of a woman with brown hair, wearing a green top and dark pants, sitting on a stack of gold coins. She is holding a tablet. The background features a large calculator with the number '123,456' on its display, several stacks of gold coins, and various financial charts and graphs. One chart is labeled 'BUSINESS', another 'TAX', and another 'INVESTMENT'. The overall scene is set against a light blue background.

HOW TO USE ENTERPRISE VALUE (EV) TO COMPARE COMPANIES?

Enterprise value (EV) is an indicator of how the market attributes value to a firm as a whole.

Enterprise value is a term coined by analysts to discuss the aggregate value of a company as an enterprise rather than just focusing on its current market capitalization or market cap.

The market cap figure measures how much a public company is worth as determined by the stock market. It represents the total market value of all outstanding shares.



When sizing up a company, investors get a better picture of the real value with enterprise value compared to market cap.

Why doesn't the market cap properly represent a firm's value? First, it leaves a lot of important factors out, such as a company's debt and its cash reserves.

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



Simply put, EV is the sum of a company's market cap and its net debt. To compute the EV, total debt—both short- and long-term—is added to a company's market cap, and then cash and cash equivalents are subtracted.

Market capitalization is the share price multiplied by the number of outstanding shares.

This number tells you what you would have to pay to buy shares of the company. Therefore, rather than telling you the company's value, the market cap simply represents the company's price tag.



The Role of Debt and Cash

If the firm is sold to a new owner, the buyer has to pay the equity value and must also repay the firm's debts. Of course, the buyer gets to keep the cash available with the firm, which is why cash needs to be deducted.

Think of two companies that have equal market caps. One has no debt on its balance sheet, while the other one is heavily indebted. The debt-laden company will be making interest payments on the debt over the years.



So, even though the two companies have equal market caps, it would cost more to purchase the company with more debt.

Imagine two companies with equal market caps of \$250 million and no debt. One has negligible cash and cash equivalents (CCE) and the other has \$250 million in cash. The first company would have an enterprise value of \$250 million, while the second company's EV would be \$0.



Because the second company has \$250 million in cash, the buyer could theoretically use the cash to immediately recover the entire purchase price, thus resulting in the \$0 we see in the EV calculation.

If a company with a market cap of \$250 million carries \$150 million as long-term debt, an acquirer would ultimately pay a lot more than \$250 million to buy the company in its entirety.



With the \$150 million in debt, the total acquisition price would be \$400 million. Although debt increases the purchase price, cash decreases the price.



Enterprise Value Ratios

You can learn more about a company by comparing its EV to a measure of the company's cash flow or earnings before interest and taxes (EBIT).

Comparative ratios demonstrate nicely how EV works better than market cap for assessing companies with differing debt or cash levels or, in other words, differing capital structures.



Example of Enterprise Value Ratios

Let's look at the price of two stocks: Company A and Company B.

At \$45 per share, Company A had a market cap of \$13.5 billion, a price-to-earnings (P/E) ratio of 10 and nearly \$30 billion in net debt. So Company A's EV was \$43.5 billion, almost 13 times its \$3.4 billion in EBIT.



Company B has a share price of \$23 per share and a market cap of \$6.1 billion, and a P/E ratio of 20, twice that of Company A. But Company B owed a lot less—its net debt stood at \$3.5 billion, its EV was \$9.6 billion, and its EV/EBIT ratio was only 10.

By market cap alone, Company A looked like it was half the price of Company B. But based on EV, which takes into account important things like debt and cash levels, Company B was priced much lower per share.



As the market gradually discovered, Company B represented a better buy, offering more value for its price.



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