$100 of Cash and Enterprise Value

- **Question the Other Day:**

- “If a CEO of a company picks up $100 of cash on the ground and puts it in the company’s bank account, what happens to the company’s Enterprise Value?”

- (In other words, does it **increase**, **decrease**, or **stay the same**?)

$100 of Cash and Enterprise Value

- **ANSWER:** Enterprise Value stays the same!
- Most common **follow-up question**:
- “But wait, you subtract cash in the Enterprise Value calculation. **How can Enterprise Value possibly stay the same?**”
- **Formula:** Equity Value + Debt – Cash + NCI + Preferred + Unfunded Pensions – Other Investments…

What Does Enterprise Value <u>Mean</u>?

- That’s how you **calculate** Enterprise Value, but it’s not **what it <u>means</u>**

- **Meaning:** Enterprise Value represents the value of a company’s **core business operations** to **ALL the investors** in the company

- **Equity Value:** Represents value of *everything*, but **only** to the Equity Investors

Implications of This Definition:

- So when you calculate Enterprise Value, starting with Equity Value…

- **Add Items When:** They represent *other* investors (Debt investors, Preferred Stock investors, etc.) or *long-term funding sources* (Capital Leases, Unfunded Pensions)

- **Subtract Items When:** They are not related to the company's core business operations (side activities, cash or excess cash, investments, real estate, etc.)

Back to the $100 in Cash…

- Is it part of the company's **core business?**
- No! Does **not** make the core business more valuable
- **But**… it is part of the "everything" the company has
- **Equity Value:** Increases; **Cash:** Increases
- **Enterprise Value:** The same! One part up, one down

About Equity Value…

- Why does Equity Value **increase** as cash increases?

- **Because:** Equity Value should <u>implicitly</u> reflect the company's cash balance already

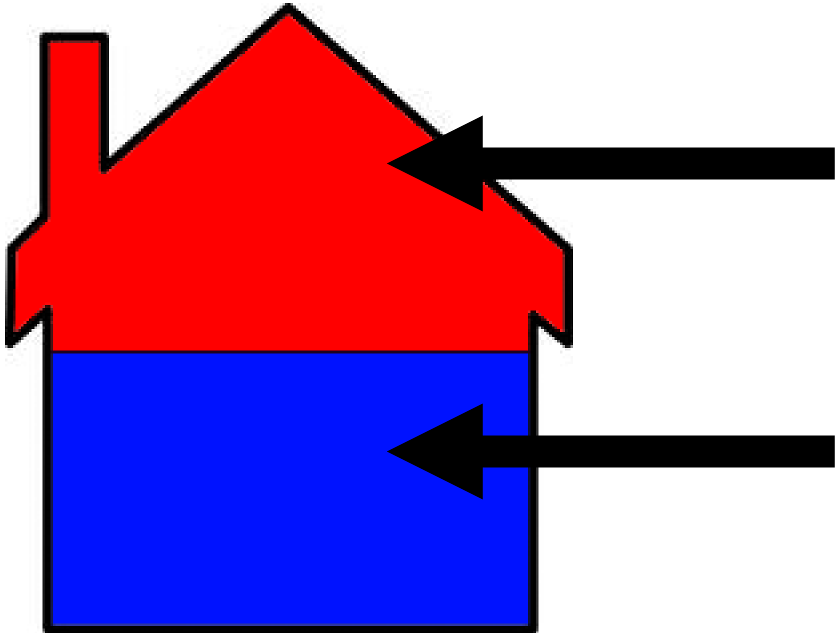
- If a company has $500 in cash, would it make <u>any sense</u> for all its shares to be worth <u>less than</u> $500?

- No! Should always be worth <u>at least</u> its cash on-hand

One Other Way to Think About This…

- **Common Analogy:** Buying a house, and Enterprise Value represents the total value of the house

- **House:** $500K, with 50% mortgage and 50% down payment



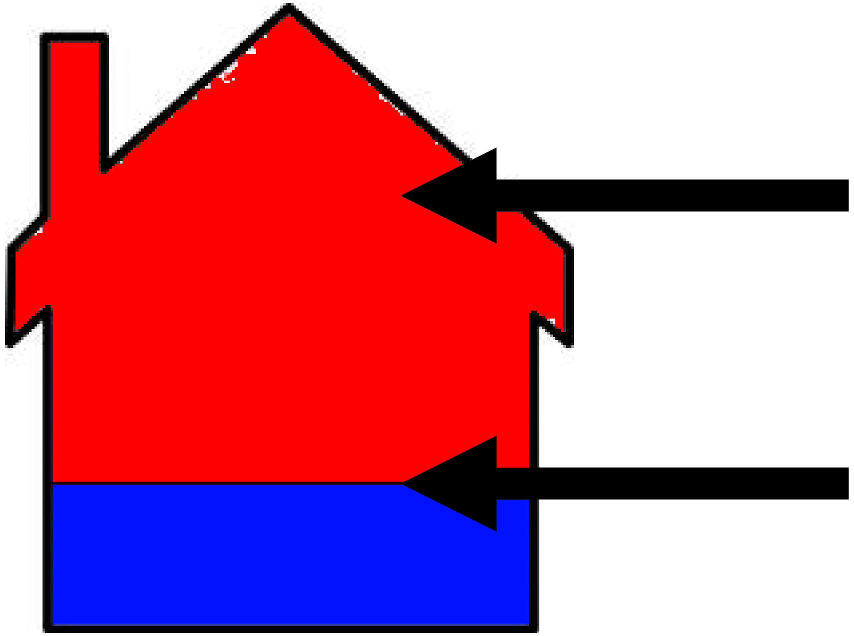
Mortgage = $250K

Equity = $250K

Total = $500K

One Other Way to Think About This…

- **House:** $500K, with 80% mortgage and 20% down payment



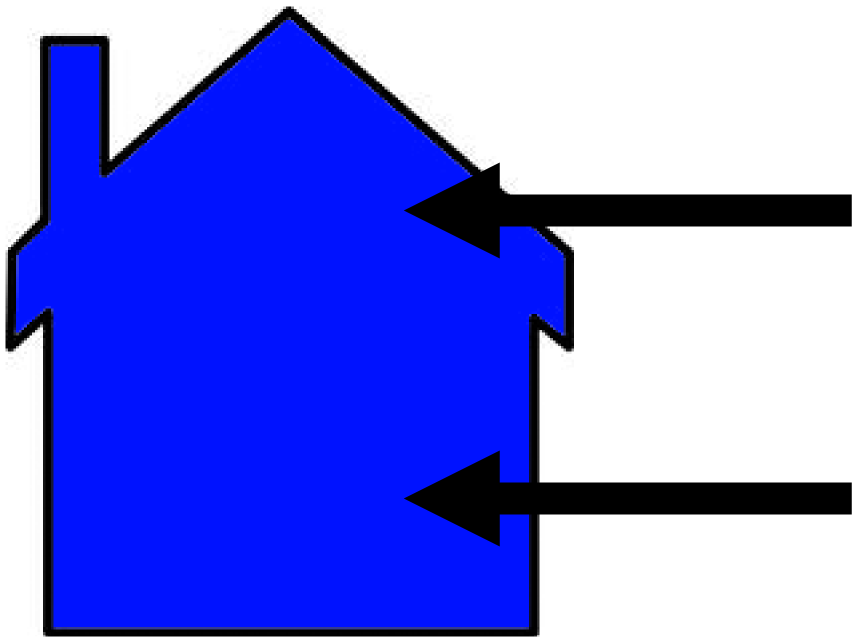
Mortgage = $400K

Equity = $100K

Total = $500K

One Other Way to Think About This…

- **House:** $500K, with 0% mortgage and 100% down payment



Mortgage = $0

Equity = $500K

Total = $500K

Question for You:

- What if you and the owner find an **extra room?** What happens to the home's price?

- **Answer:** Total Value goes up → House is now worth more; just like Enterprise Value increasing

- **But…** what happens if you find some extra supplies or gardening tools that you're going to sell anyway?

Extra Tools / Supplies:

- **Answer:** NOT core to the home’s value
- Yes, the upfront price may increase… but you’ll sell them and get the cash back anyway! No changes!
- So the home’s **Enterprise Value** stays the same
- Just like what happens when the CEO picks up $100 of cash on the ground

Moral of the Story:

- "What happens to Enterprise Value when X or Y changes?"

- **Don't think about the formula for Enterprise Value!**

- **Instead:** Think about whether or not that change is related to the company's <u>core business operations</u>

- **Test:** Will it affect revenue or EBITDA?

Moral of the Story:

- **Core Business Value Changes:** Enterprise Value will change in some way
- **Core Business Value Does Not Change:** Enterprise Value stays the same
- **Other Examples:** Cash, Debt, Preferred Stock, Share Count → None of these should impact Enterprise Value