Enterprise Value: Why You Add and Subtract Certain Items (Version 2.0)

How to Tax-Effect Your Way to Success

The Enterprise Value Calculation

Yes, this is an update of an earlier tutorial in this channel…

…the previous version didn't do a great job laying out the rules, and accounting changes since that time mean that some ***updates*** *are required.*

The Enterprise Value Calculation

Most common question we get:

*"I understand the **mechanics** of the Enterprise Value calculation, but not the **'why'** behind it. Can you explain **why** you add and subtract certain items to calculate it?"*

The Short Answer

- **Enterprise Value:** Represents the company's **core business operations** (Net Operating Assets) to **all investors** in the company

- **Equity Value:** Represents **everything** the company has (Net Assets) but only to **common shareholders** in the company

- **Start With:** Equity Value, or Share Price * Shares Outstanding

- **And:** *Add* L&E line items on the Balance Sheet when they represent *additional investor groups* in the company

- **And:** *Subtract* Assets on the Balance Sheet when they represent *non-core* or *non-operating* Assets

The Short Answer

- **Typical Subtractions:** Cash, Financial Investments, Equity Investments (AKA Associate Companies or Joint Ventures), Net Assets Held for Disposal, and Net Operating Losses

- **Commonality:** All *non-core* (not required for the business)

- **Typical Additions:** Debt, Preferred Stock, Noncontrolling Interests, Unfunded Pensions, and *sometimes* Leases

- **Commonality:** All represent *additional* investor groups

- **Basic Categories:** Always, Never, “Yes, but something more complicated is required,” and “Maybe”

Plan for This Tutorial

- **“Always” Items:** These will be fairly simple; Cash, Debt, Preferred Stock, etc.

- **“Never” Items:** Working Capital, industry-specific items like “Content Assets” for Netflix, Vivendi, etc.

- **“Complicated” Items:** Net Operating Losses and Unfunded Pensions

- **“Maybe” Items:** Lease Liabilities (all types), Restructuring/Legal Liabilities, and Deferred Tax Liabilities

"Always" Items: The Approach

- **First:** Go to the company's Balance Sheet and get all the numbers from there for Cash, Debt, Preferred Stock, etc.

- **And:** If you have extra time, search for "Fair Value" or "Fair Market Value" in the filings to get the current market value of items like Debt and Preferred Stock

- **But:** In most cases, this will represent a ~5-10% difference, so it's not a huge deal if you can't find the market values

“Never” Items: The Approach

- **Category 1:** Working Capital line items (AR, AP, Inventory, DR, DC, etc.) – these are all operational in nature

- **Category 2:** Long-term assets like Net PP&E, Goodwill, and Other Intangible Assets – all operational

- **Category 3:** “Accruals” of items like income taxes, interest, etc. – these are operational or represent simple timing differences

- **Category 4:** Lease Assets (any type) – the *Assets* are operational; question is what to do with the *Liabilities*

- **Category 5:** “Industry-specific items” like Content Assets

“Complicated” Items: Examples

- **Net Operating Losses:** Yes, subtract these if they’re shown within the Deferred Tax Asset, but…

- **Adjustments:** May reduce these proportionally by the Valuation Allowance; also, if the NOL number is **not** within the DTA (i.e., off-Balance Sheet), multiply by the Tax Rate

- **Unfunded Pensions:** If Pension Liabilities > Pension Assets for a *defined-benefit plan* with set payouts in the future, these effectively represent another “investor group” (the employees)

- **So:** Add the Unfunded amount… but you may have to adjust it first, depending on the country’s tax laws

“Complicated” Items: Examples

- **Unfunded Pensions:** If pensions into the plan are *tax-deductible* in the company’s country, multiply it by (1 – Tax Rate)

- **Tax-Deductible:** MAX(0, Pension Liabilities – Pension Assets) * (1 – Tax Rate)

- **Non-Tax-Deductible:** MAX(0, Pension Liabilities – Pension Assets)

- **Also:** In metrics like EBITDA, deduct *only* the service cost associated with the pension, not the financing/other costs

"Maybe" Items: Leases

- **Finance Leases (Capital Leases):** You *normally* add these because under both major accounting systems, the Lease Expense is split into Interest and Depreciation

- **So:** Metrics that pair with TEV, like EBITDA, completely exclude the Lease Expense already (need a small adjustment for EBIT)

- **Operating Leases:** Easier to add these under IFRS and *not* add them under U.S. GAAP

- **U.S. GAAP:** Simple rental expense that's already deducted in EBIT, EBITDA, etc., so you'd have to add it back if you wanted to add the Operating Lease Liability in TEV

“Maybe” Items: Restructuring Liabilities

- **Restructuring/Legal Liabilities:** We usually say, “No” because these do not represent a separate investor group

- **Counter-Argument:** “But these liabilities may result in a large cash outflow in the future!”

- **Response:** OK, but that same logic could apply to almost any liability… what’s different this time?

- **Also:** Even if there is a large cash outflow, it often shows up only on the CFS, so how will you deduct or add it back in Income Statement-based metrics like EBITDA?

“Maybe” Items: Deferred Tax Liabilities

- **DTLs:** “These represent another future cash outflow, and it might be large! Therefore, it should increase the company’s Enterprise Value!”

- **But:** Again, you could apply this logic to standard operational liabilities as well, and they don’t count

- **And:** The timing of cash payments for deferred taxes is uncertain, and the company won’t necessarily raise capital to make these payments

- **And:** These are not interest-bearing liabilities

Recap and Summary

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- **"Maybe" Items:** Lease Liabilities (all types), Restructuring/Legal Liabilities, and Deferred Tax Liabilities