

## VALUATION

### Enterprise Value and Equity Value

**The Enterprise Value (EV) is the value of an entire business, without giving any consideration to its capital structure. The Equity Value is the value that remains for the shareholders after any debts have been paid off.**

The EV, frequently referred to as firm value or asset value, is also the outcome when valuing a business by using the Discounted Cash Flow (DCF) approach. Thereby, the future expected unlevered free cash flows are discounted by a factor representing the firm's long term stable capital structure: The Weighted Average Cost of Capital (WACC). In consequence, the EV is the value of a company's core business operations for all its investors, such as shareholders, bond holders, creditors and others.

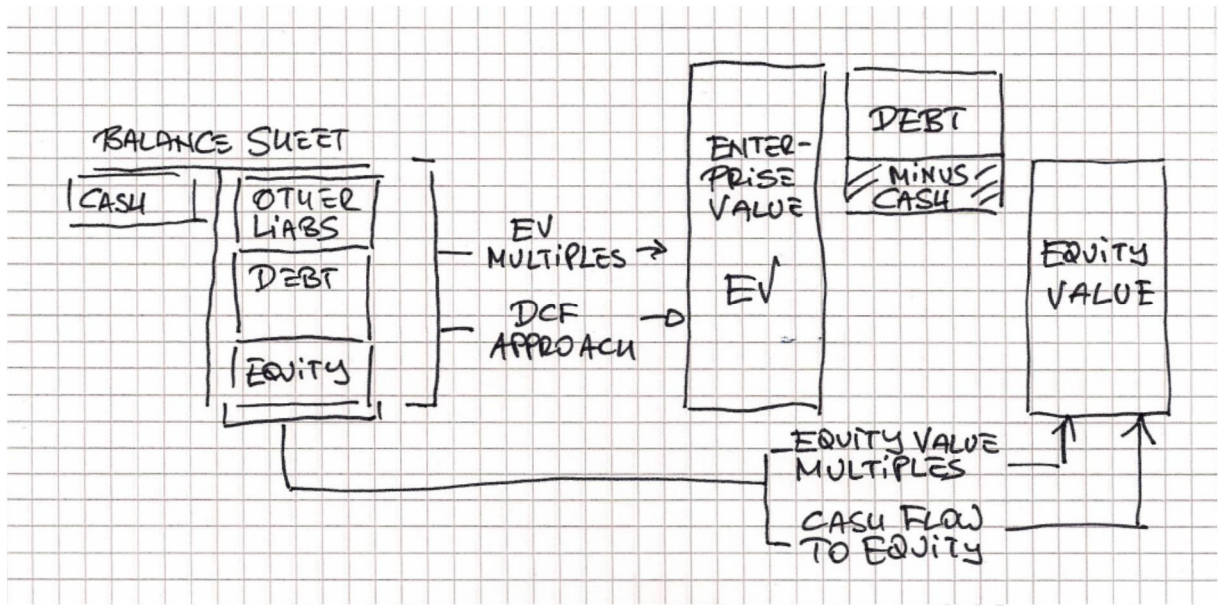
When calculating the EV on the basis of multiples, then foremost EV/EBIT, EV/EBITDA and EV/S are applied.

The Equity Value, also referred to as net asset value, equals the EV less net debt, whereby latter is defined as all interest bearing short and long term liabilities less cash. If a firm is listed, then its Equity Value – as seen by the market - is the firm's market capitalization or Market Value (MV), which is the product of the number of outstanding shares multiplied by its share price.

When applying the common DCF approach in using unlevered free cash flows and discounting them by the WACC, resulting in the EV, then the Equity Value can be derived by deducting the net debt from the EV. Alternatively, one could use the cash flows to equity and discount them by the cost of equity to determine the company's Equity Value. - In regards to multiples, the most relevant ones to be applied to get the Equity Value are: P/E and P/BV.

In theory, only changes to a firm's core business will affect the EV, however not changes to its capital structure. Neither does issuing or redeeming equity nor changes to the debt structure change a firm's EV. As can be seen in applying multiples to calculate the EV, the respective denominators used (revenues, EBITDA and EBIT) are all positioned above interest expense and interest income in the income statement. And, changes in the firm's capital structure would only have an impact on the net interest expense line, but not impact any items above it.

In reality, though, radical changes in a firm's capital structure may actually also impact its EV: As can be illustrated by the concept of the DCF approach, aggressive leveraging of a firm will eventually push up both, cost of equity (higher beta amid higher volatility) as well as cost of debt (higher risk of default and therefore default spread). Both components will drive up the WACC and in consequence result in a lower EV. – Also, excessive leverage will be acknowledged by the capital markets, in that in practice lower EV multiples will be applied.



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