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Corporate Finance Insights

Market Value of What?

In my last newsletter, we spent a little time with valuation multiples and how they relate to corporate finance theory. In this newsletter I would like to take the conversation further to deal with an issue that often comes up when working with multiples – what is being valued when a multiple is used?

The general answer is, "the company, of course." But it isn't quite that straight-forward. Depending on which multiple I use, and how I use it, I can estimate either the market value of equity or the market value of invested capital ("MVIC") for the same company. Each one is different and there are specific ways to estimate each.

MVIC Explained

As an example, a price-to-earnings multiple can be used to estimate the market value of a company's equity directly. Just take their adjusted after tax earnings and multiply it by a P/E ratio and you can get an estimate of the market value of the company's equity.

A common multiple everyone hears about is the EBITDA (earnings before interest, taxes, depreciation and amortization) multiple, but this is best suited to estimate MVIC, not the market value of equity directly. So if I ultimately want to estimate the market value of a company's equity, I need to take an additional step if I am using an EBITDA multiple. Here is what the formula looks like when you're using an EBITDA multiple to estimate MVIC and then the market value of equity:

	EBITDA
x	Multiple
	Operating value
+	Non-operating assets
	Market value of invested capital
-	Debt
	Market value of equity

As the formula shows, MVIC represents the value of the equity and debt of a company. So if I want to estimate the value of a company's equity I need to subtract debt from MVIC. Multiples such as EBITDA, EBIT, Sales or Gross Profit are intended to be used when valuing MVIC because they all

"Communicating with dead people is easy. Communicating with live people is hard!"

Corporate Value Partners, Inc.

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- Assisting with the acquisition or sale of a business, business unit or product line;
- Assisting with the placement of debt financing;
- Preparing business valuations;
- Assisting creditors in corporate bankruptcies;
- Assisting attorneys with the financial aspects of lawsuits.

Corporate Value Partners
Ronald D. DiMattia
President
1340 Depot Street,
Suite 102
Rocky River, OH 44116
(440) 333-1910 Office
ron@corporatevaluepartners.com
www.DealDesk.com

Corporate Value Partners, Inc.
1340 Depot Street, Suite 102
Rocky River, OH 44116

exclude the effect of interest expense, which is tied to debt. Using one of these multiples to value a company's equity directly can create significant problems, especially if the company being valued has a capital structure that differs from industry averages.

Comparability

Importantly, by working with MVIC we have a consistent way to talk about valuation for different companies with very different capital structures. If we talk about market value of equity only, valuation comparisons between companies are far less insightful. To illustrate this point, the following example shows two companies that are identical in every respect except for their capital structure:

		Company A		Company B
EBITDA		$100,000		$100,000
Multiple	x	4	x	4
Operating value		400,000		400,000
Non-operating assets	+	10,000	+	10,000
MVIC		410,000		410,000
Debt	-	50,000	-	300,000
Market value of equity		**$360,000**		**$110,000**

Even though the companies are the same in every other respect, because they are financed differently they have dramatically different equity values. It is not uncommon to see companies that are very similar in terms of operations, yet very different in terms of how much debt they carry. There are a number of reasons why each company in our example would have a different capital structure (perhaps one company had much higher owner distributions over the years, while the other did not).

By focusing on MVIC we get a picture of value that is independent of how the owners of a company have chosen to finance it. You don't necessarily get such a clear picture if the equity is being valued directly. The beauty of working with MVIC is that it allows us to focus on operations and to deal with a company's capital structure – including its debt – separately.

Please contact Ronald DiMattia at Corporate Value Partners at (440) 333-1910 or ron@corporatevaluepartners.com with any questions or to discover how CVP can help you get the most out of your assets.

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