Edison Explains

Enterprise versus equity valuation

What are enterprise and equity valuations and why have they proved so useful for analysts?

What are equity and enterprise valuations?

Advancements in technology and automation have changed the way we do business and accountants have had to find new ways to value companies as they are sold.

Until the 1920s, value was placed on assets and liabilities alone. This changed following prohibition and the introduction of income tax, when the US Internal Revenue Service demonstrated basic valuations' shortcomings.

During prohibition, compensation paid to companies affected by the alcohol ban, such as breweries, had to consider the impact on capital assets as well as the effect of future cash flow disruption. This led to the introduction of a cash flow-based methodology.

Valuations based on future cash flows remain fundamental; however, with the proliferation of companies in the 20th century, diversity underlined the necessity to define a standard method for both relative and absolute valuation. The result was enterprise and equity valuations.

What is the difference between enterprise and equity valuations?

Equity value solely represents shareholders' interests in the assets of a company. Enterprise value considers all sources of funding, including debt as well as equity.

The enterprise value (EV) of a business is defined as the cost of buying the whole business, free of its debt and other liabilities. EV is a more comprehensive valuation method than equity value, which only considers the shareholders' liabilities.

Enterprise valuation methods tend to be preferred when companies have varying capital structures, high or variable debt levels, or for cross-sector analysis.

Analysts comparing companies on an international basis also tend to prefer enterprise valuations to their equity counterparts, as multiples using EV (eg EV to earnings before interest, tax, depreciation and amortisation (EBITDA)) allow for differences in international accounting standards to shine through.

Analysts attempting to better understand a company's value introduce multiples by comparing either equity or EV to a metric on a company's financial statement.

What is the most common enterprise valuation multiple?

EV/EBITDA is the most common EV multiple, where depreciation and amortisation are the value the company loses as assets age.

Analysts using the EV/EBITDA multiple are attempting to see how a company's operational performance drives the value of the entire business.

To do this, they use figures in the income statement, also known as the profit and loss (P&L) statement. The income statement records what a company sells and the cost of sales over a specific time, normally one year.

EBITDA is the profit figure in the income statement that functions as a proxy for operating cash flow, which is then used to fund both debt and equity financing.

EBITDA is naturally best compared to EV, as the EBITDA line of the income statement includes both interest and net profits (or dividends).

Edison Insight

'Both enterprise- and equity-based valuation approaches are invaluable tools in the analyst's armoury. The reality is that one metric rarely suits all circumstances, so a set of multiples as well as detailed understanding of the company are necessary to truly understand valuation.'
Richard Williamson (TMT director)

How do analysts use equity multiples?

Equity value is commonly compared to income statement metrics, such as earnings, dividends and the value of a company's assets (book value).

The key element of income for equity multiples is a company's profit after tax (PAT), which is the profit attributable to equity holders. A company's retained earnings are calculated from the PAT.

PAT can be paid out in its entirety as shareholder dividends (even if this is not usual) or earnings retained to grow the business. Both price and earnings,

therefore, relate solely to company shareholders, creating a natural comparison.

One of the most common equity multiples is the price/earnings multiple, also known as P/E.

Due to the influence of various accounting and economic factors, equity multiples such as interest, tax, depreciation and amortisation tend not to be suitable for cross-sector and cross-border analysis. This is because these factors are subject to greater differences in accounting treatment than EV multiples.