

CHAPTER 4

Business Enterprise Value: What Does It Represent?

It is not always possible to know the true value of a company's assets and the extent of its liabilities based simply on what is disclosed in a press release by either the buyer or seller as they negotiate a transaction. Understanding what the seller is giving up and what the buyer is receiving in a transaction, in terms of the related assets and liabilities, translates into the value of a company. This chapter will explore Business Enterprise Value in relation to broad valuation principles, which will be built upon in later chapters that cover more specific valuation concepts.

Valuation 101—Book Value Does Not Necessarily Equal Market Value

One of the most common mistakes that many attorneys make with respect to the valuation of a business enterprise is assuming that the accounting-based book value of a company is equivalent to market value. This is simply not an accurate assumption. While it is possible for book value and market value to be identical, they typically are not.

Illustration 4.1 shows that the book value of equity of ABC Company is \$60. From an accounting standpoint, the book value of equity (sometimes referred to as net book value) equals the total assets as reflected on the balance sheet less total liabilities. One primary reason that book value does not necessarily represent market value is that balance sheets in the United States are prepared in accordance with generally accepted accounting principles (GAAP), which are based on historical cost. In other words, if a company bought land 20 years ago for one million dollars and has no other assets or any liabilities on its balance sheet, its book value of equity would still be one million dollars today. Obviously, in this fact pattern, given appreciating property values, the market value of this company's equity would be significantly greater than one million dollars, considering the increased value of its only asset, land.

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Illustration 4.1
ABC Company at Book Value

ASSETS		LIABILITIES AND EQUITY	
Current Assets		Current Liabilities	
Cash	\$ 50	Accounts Payable	\$150
Accounts Receivable	250	Accrued Expenses	190
Inventory	<u>200</u>		<u>340</u>
	500		
Net Fixed Assets	300	Long-Term Liabilities	
		Interest-Bearing Debt	400
		Shareholders' Equity	<u>60</u>
Total Assets	<u>\$800</u>		<u>\$800</u>

The book value of a company reflected on its balance sheet may also understate market value because certain intangible assets of the company may not be reflected on the balance sheet at all. For example, a company that regularly invests dollars in research and development typically will have developed significant technology or perhaps some patents, but these assets generally do not appear on the balance sheet. Or a company could have invested heavily in advertising and promotions over the last 50 years, thus developing a well-known trade name or trademark that has significant value in the form of dominant market share or price premiums. Again, these assets would not appear on a balance sheet even though they are potentially very valuable. A company's internally generated intellectual property and other intangible assets do not appear on the balance sheet, thus causing book value to significantly understate market value.

However, it is possible for an intangible asset to appear on a company's balance sheet that is prepared in accordance with GAAP. When one company acquires another, accounting principles require an allocation of the purchase price to all of the assets it acquired at fair value (i.e., a form of market value), including certain intangible assets. However, just like the earlier example with land, the value reflected on the balance sheet will still be stated at its historical cost.

Book values can also overstate market value if the company has liabilities that are not listed on the balance sheet. A common example of this would include environmental liabilities.

Now that we have established what market value is not, we need to understand: (1) how to translate book value to market value; and (2) how to interpret what market value really represents. The first step in this process is to understand the concept of Business Enterprise Value.

What Does the Term *Business Enterprise Value* Represent?

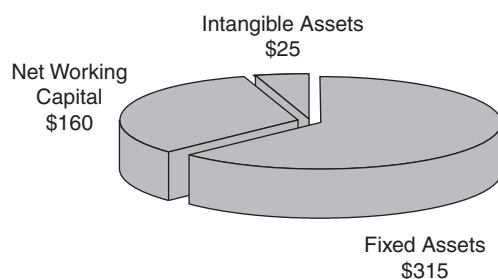
The Business Enterprise Value ("BEV") of a company can be thought of in a couple of different ways. As shown in Illustration 4.2, the BEV of a company

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Illustration 4.2
Business Enterprise Value of ABC Company
ABC Company at Market Value

ASSETS	LIABILITIES AND EQUITY	
Current Assets	Current Liabilities	
Cash	\$ 50	Accounts Payable \$150
Accounts Receivable	250	Accrued Expenses 190
Inventory	200	340
	500	
Net Fixed Assets	315	Long-Term Liabilities
Intangible	25	Interest-Bearing Debt 400
Total Assets	\$840	Shareholders' Equity
		100
		\$840

Illustration 4.3
Business Enterprise Value of ABC Company



can be viewed as the market value (as opposed to book value) of all of the assets of a company less the company's operating liabilities. The assets of a company typically include items such as cash, accounts receivable, inventory, fixed assets, and intangible assets such as patents, trade names, customer lists, assembled work force, and goodwill. The term "operating liabilities" includes items such as accounts payable, accrued expenses, and other liabilities of the company incurred in its day-to-day business operations. Operating liabilities exclude all of the company's interest-bearing debt, which is more appropriately thought of as a financing type liability as opposed to an operating liability.

The BEV of ABC Company in Illustrations 4.2 and 4.3 is \$500. Said another way, the BEV of ABC Company is comprised of the following assets: \$160 of net working capital, \$315 of fixed assets, and \$25 of intangible assets. Net working capital in this context is comprised of the company's current assets, which are short-term type assets that are utilized in the business, less current liabilities, which are liabilities incurred in the operations of the business that are payable in less than a year.

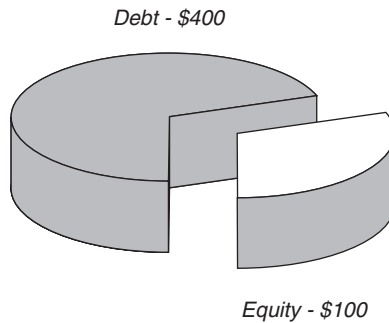
A second way to think about the BEV of a company is to consider the other side of the balance sheet. As shown in the shaded area of Illustration 4.4, the BEV of \$500 is equal to the value of interest-bearing debt plus equity capital.

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Illustration 4.4
ABC Company at Market Value

ASSETS		LIABILITIES AND EQUITY	
Current Assets		Current Liabilities	
Cash	\$ 50	Accounts Payable	\$150
Accounts Receivable	250	Accrued Expenses	190
Inventory	200		
	500		340
Net Fixed Assets	315	Long-Term Liabilities	
Intangible Assets	25	Interest-Bearing Debt	
	100	Shareholders' Equity	
Total Assets	\$840		\$840

Illustration 4.5
Business Enterprise Value of ABC Company



The importance of understanding what BEV represents becomes clear when you consider how to interpret a headline in the newspaper that reads: “Hoosier, Inc. is sold to ABC Company for \$100 Million!”

What does that headline mean? Does the amount simply represent the value paid for the equity (i.e., the stock) of the target company, or does this amount include the value of not only the stock but interest-bearing debt assumed by the buyer in the deal as well?

In most situations involving attorneys where there is a valuation issue, whether it be related to a shareholder dispute, a divorce, estate planning, a buy-sell agreement formulation, or advising on a transaction, to name a few, the typical issue ultimately at hand is the value of equity capital. To convert a BEV to an equity value, interest-bearing debt is simply subtracted from the BEV. As shown in Illustration 4.5, the value of ABC Company’s equity is \$100.

While the book value of ABC Company’s equity is \$60 (Illustration 4.1), the market value is \$100 (Illustrations 4.2 and 4.5). The next thing to consider is the financial basis that causes market participants to place value on a business that is greater than the amounts reflected on the balance sheet.

What Is the Amount of Business Enterprise Value (BEV) Based Upon?

In very general terms, the BEV of any company (or any asset) is equal to the present value¹ of all *future cash flows* expected to be generated from that company (or asset). There are a few important points to take away from this statement.

First, the value of any business or asset is related to the cash flow it generates, not the net income as reflected on the company's income statement or tax return. As will be discussed in greater detail in Chapter 6, the net income reflected on a company's income statement is based on GAAP, which is premised upon accrual accounting concepts. In this regard, revenue is recognized when it is earned, not when the cash is received. Similarly, expenses are recognized in such a way so as to match the revenue stream they relate to, as opposed to being recognized when the cash is paid out.

This is where the often used "cash is king" statement is derived. While accounting-based net income may be one input into the calculation of cash flow, it cannot be relied upon without adjustments (and sometimes significant ones) in the valuation process.

The second major point to emphasize regarding the general determinants of a company's BEV is that the value of a company is based on its *future prospects*. This concept is often overlooked.

When a business owner sells a business, he or she is giving up the right to enjoy the future cash flow associated with that business. Likewise, the buyer is essentially purchasing the right to enjoy the future cash flows expected to be earned from that business.

Does this fact make the historical performance of the company irrelevant? The answer is no. But the point is that a "blind" extrapolation of the past into the future is not appropriate because although the past may provide an indication of where the company is going, the future will not necessarily match the past.

For example, consider a situation where the company is a pharmaceutical concern that derives a significant portion of its income from a patented drug product. The patent expires in two years. This company presumably charges premium prices and earns healthy profit margins because the patent keeps competitors at bay. After the patent expires, it would be typical for competitors to flood the market with generic lower-priced products, thus putting pricing pressure on the pharmaceutical company's profit margins and *prospective future cash*

1. Present value concepts are discussed in more detail in Chapter 8. In short, for purposes of this general framework valuation discussion, consider that taking the present value of future cash flow incorporates two general concepts. First, it incorporates the time value of money, which is the concept that the value of a dollar today is worth more than the value of one dollar 10 years from now simply because of inflation. Second, it considers business risk associated with the cash flows. A buyer considering paying for the rights to the prospective cash flow of a company will require a rate of return on this investment as a reward for taking the risk that the cash flows projected do not materialize.

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flows. In this example, it would clearly not be appropriate to extrapolate the company's historical results into the future. To do so would overstate the cash flows and associated BEV of the company.

The opposite also could occur. A company may have major new business in the pipeline in a product area that earns higher profit margins than what its traditional core products earned in the past. In this situation, a blind extrapolation of historical results into the future could actually understate the prospective cash flows and the related BEV.

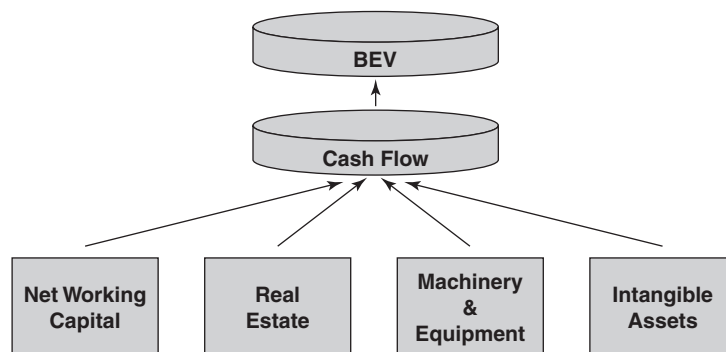
Relationship between BEV and the Company's Underlying Assets

We discussed earlier that the BEV of a company represents the value of all of a company's operating assets, net of operating liabilities (i.e., non-interest bearing debt). We also discussed that the BEV of a company is based upon the present value of all future cash flow expected to be generated by that business. Putting these two statements together results in another important concept to consider in understanding what the valuation of a business is premised upon.

As shown in Illustration 4.6, the underlying operating assets of a company theoretically all generate income and contribute to the cash flow of the company. It is this cash flow that ultimately is considered in the derivation of the BEV of a company. The point of all of this is, that when the BEV of a company is estimated based on the aggregate cash flows generated by the business, the analyst is implicitly capturing the value of all of the operating assets that together generate the cash flow of the business.

It is not uncommon to hear an attorney state that he has "hired an appraiser to value the real estate of a company" and now he needs to "hire a business valuation specialist to capture the business aspect of value." Based on the previous

Illustration 4.6
Relationship between BEV and Operating Assets



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discussion, hopefully the potential fallacy in this statement is obvious. If all the attorney needs for the client's purpose is a value of the business, then all he would need to have completed is a business valuation analysis. A separate valuation of the real estate is not needed as the BEV analysis implicitly captures the value of real estate (and all other operating assets). The only reason the attorney would need to hire a real estate appraiser in this example would be if the attorney needs, for purposes of his planning, not only the BEV (i.e., the "pie"), but also what portions of the pie should be allocated to specific assets (i.e., the "pieces" of the pie).²

Summary of Key Concepts

The following is a summary of key concepts in this chapter:

- Accounting-based book value does not necessarily equal market value.
- $BEV = \text{net working capital} + \text{fixed assets} + \text{intangible assets}$
- $BEV = \text{debt capital} + \text{equity capital}$
- $\text{Net working capital} + \text{fixed assets} + \text{intangible assets} = \text{debt capital} + \text{equity capital}$
- Valuation is based on prospective results, not blind extrapolation of historical results.
- Cash flow is king.
- The value of a business (or BEV) is made up of operating assets that theoretically each generate a return or cash flow to the business.

2. This discussion assumes that the cash flow being generated by the business is sufficient to support the return requirements of the underlying assets (i.e., the business is worth more as a going-concern than it would be in a liquidation of its underlying assets). To the extent this is not the case, as discussed in more detail in Chapter 12, the BEV may very well be equal to the sum of the underlying asset values of a business as determined by real estate appraisers and machinery and equipment valuation specialists, in which case the attorney may very well need a business valuation specialist as well as real estate and machinery and equipment appraisers.

