



## New Dimension in Equity Valuation

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### Abstract

*The studies on market efficiency clearly depict that it is very difficult to find out the undervalued securities. On the other hand, such undervalued securities cannot be left due to practical difficulties in their identification. There are many models available used to identify the mispriced securities. One of the methods prominently used for the valuation of securities is price-earnings ratio. Investors have been dependent on the price-to-earnings (P/E) ratio as a tool to decide investment in a particular stock for several years. It has emerged as a simple way to get a sense of how market value of a company's stock compares to its earnings. However, there is a considerably significant problem with this ratio as neither the company's stock price is the true representative of a company's value in the real world nor the earnings of a company are reliable as the same can be easily manipulated. Thus, if an investor wants to really get a glimpse of a company's value as compared to others, he needs new dimension in value philosophy. The present paper describes the very less talked dimension in equity valuation i.e., Enterprise Value. Enterprise value is described as a value that, in theory, represents the entire cost of a company, if someone acquires it. It offers more accurate estimate of takeover cost than market capitalization because it includes a number of important factors such as preferred stock, debt, and cash reserves that are ignored otherwise. The paper also highlights how application of this new dimension in equity valuation helps tremendously in investment decisions, particularly during different phases of market, by taking up a case study of equities from a common industry.*

**Keywords:** Equity Valuation, Price-earnings Ratio, Enterprise Value, JEL Classification: G11, J32.

### Introduction

Investors have been dependent on the price-to-earnings (P/E) ratio as a tool to decide investment in a particular stock for several years. It has emerged as a simple way to get a sense of how market value of a company's stock compares to its earnings. However, there is a considerably significant problem with this ratio as neither the company's stock price is the true representative of a company's value in the real world nor the earnings of a company are reliable as the same can be easily manipulated. The studies on market efficiency clearly depict that it is very difficult to find out the undervalued securities. On the other hand, such undervalued securities cannot be left due to practical difficulties in their identification.

Thus, if an investor wants to really get a glimpse of a company's value as compared to others, he needs new dimension in value philosophy. The present paper describes the very less talked dimension in equity valuation which includes a number of important factors such as preferred stock, debt, and cash reserves that are ignored otherwise. Instead, if an investor wants to really get a sense of a company's value relative to other firms, he needs new dimension in value philosophy. It's very easy to see why this new dimension carries importance in investment decisions. Assuming two companies that both have a market capitalization of Rs.500 million (Rs.10 stock price multiplied by Rs.50 million shares outstanding) and Rs.50 million in

profits. The first company has Rs.100 million in cash while the other carries Rs.100 million in debt. Surely investor would prefer that cash rich company, all other things being equal.

### Enterprise Value

Enterprise value is described as a value that, theoretically, represents the net consolidated cost of a company, if someone acquires it. It offers more accurate estimate of takeover cost than market capitalization because it includes a number of important factors such as preferred stock, debt, and cash reserves that are ignored otherwise. According to Wikipedia, "Enterprise value (EV) is an economic measure reflecting the market value of a whole business. It is a sum of claims of all the security-holders: debt holders, preferred shareholders, minority shareholders, common equity holders, and others."

It can be formulized as: Enterprise Value = Market Capitalization + Net Debt - (Cash and Cash Equivalents). Enterprise value is calculated by adding a corporation's market capitalization, preferred stock, and outstanding debt together and then subtracting out the cash and cash equivalents found on the balance sheet. In other words, enterprise value is what it would cost to buy every single share of a company's common stock, preferred stock, and outstanding debt. The cash is subtracted because if complete

ownership of the company has been acquired, the acquirer becomes the owner of the cash balances.

This means that the enterprise value is the actual cost of buying a share after adjusting external liabilities and cash assets. Enterprise value has the term 'Value', but in nature, it is opposite of value and rather a cost of business acquisition or a cost to become owner. For certain level of sales, earnings, and cash flows, lower is the enterprise value, the better a stock is.

Enterprise value has four major components. Firstly, market capitalization which is calculated by taking the number of outstanding shares of common stock multiplied by the current market price-per-share. Secondly, preference shares those can act as either equity or debt depending upon its type. A preference share redeemable at a certain date at a certain price is, for all intents and purposes, debt. In other cases, when preference shareholders have the right to receive a fixed dividend plus share in a portion of the profits, it is as good as equity. However, in every case, the existence of preference shares represents a claim on the business that must be considered into enterprise value. Thirdly debt, which is also acquired as a part and parcel of the business if entire business is being acquired. In an instance of buying all the outstanding shares of a company, the debt of the acquired business becomes the liability of the buyer. The acquirer actually pays equal to market capitalization which has come out of his pocket today, but he becomes responsible for repaying the debt out of the cash flow of the business in future. This cash flow otherwise could have been used otherwise. Debt also includes minority's interests, at market price. Fourthly Cash and Cash Equivalents, which are transferred to the buyer once the business is purchased. After acquiring complete ownership, buyer can simply use this cash to replace some of the money he paid to buy the business. In effect, it helps in reducing his acquisition price; for that reason, it is subtracted from the other components when calculating enterprise value.

## Review of Literature

This dimension has not been talked much amongst the investors' fraternity. David Sterman<sup>1</sup> in his article titled 'The Best Alternative to the Flawed P/E Ratio' explained the investors' dependence on the price-to-earnings (P/E) ratio for more than seven decades as a simple way to get a sense of how a company's market value compares to its earnings. He also highlighted the problems with P/E.

Hans Wagner<sup>2</sup> in his work titled 'With This Ratio, Cash Flows Are King' emphasized the cash flows in equity valuation. Joel Greenblatt<sup>3</sup> described the Magic Formula Investing (MFI) strategy in his book 'The Little Book that Beats the Market'. One of the useful decisions he made in his

book was to use company's enterprise value instead of market capitalization while calculating the earnings yield used to find cheap stocks.

Bradley James Bryant<sup>4</sup>, in his article 'How to Calculate Enterprise Value' described the computation of enterprise value and clarified the possible doubts regarding different components of enterprise value.

## Relevance of Enterprise Value

Enterprise value is used to assess and discuss the aggregate value of a company as an enterprise rather than just focusing on its current market capitalization, which simply represents the company's price-tag for the potential buyers and in most cases which is not an accurate measure of a company's true value.

Enterprise value considers much more than just the market value of a company's outstanding equity. In case of company acquisition, an acquirer would have to accept the acquired company's debt, and at the same time, it would also receive all of its cash. The debt increases while cash reduces the cost of buying the company. Debt and cash can have a tremendous impact on a particular company's enterprise value. For this reason only, two companies with the same market capitalizations may have very different enterprise values.

Here, a company with Rs.50 million market capitalization, no debt, and Rs.10 million in cash would be cheaper to acquire than the same Rs.50 million company with Rs.30 million of debt and no cash. The price-earnings ratio and other methods commonly used to measure value do not typically take cash and debt into consideration. However, comparison of earnings, sales, and other measures to enterprise value can offer better basis to understand company's true valuation.

## Importance

Investors, particularly those who follow value philosophy in investments, look for companies that are generating a lot of cash flow in relation to enterprise value. Companies that fall into this category require little additional reinvestment; instead, the owners can take the profit out of the business and put it into other investments.

This dimension of equity valuation gives better insight when used in relation to other variables such as earnings before interest tax depreciation and amortization (EBITDA), free cash flows (FCF), sales and production. These ratios offer much more stable and greater predictive value. These comparative ratios demonstrate nicely how this dimension works, with least chances of getting manipulated, better than market capitalization for assessing companies with differing capital structures and cash levels.

**Table-1**  
**Equity Valuation Price-earnings vs. Enterprise value Steel Authority of India (SAIL) Limited**

Variable / Ratio	Financial Year				
	2011-12	2010-11	2009-10	2008-09	2007-08
Market Capitalisation (Rs. In crores)	296571.70	378468.64	104313.28	39837.72	76536.33
Enterprise Value (Rs. In crores)	306252.81	381154.87	98385.53	29147.98	65822.13
EV/PBITA	39.94	43.03	8.52	2.60	5.14
EV/OCF	261.83	176.79	20.49	4.76	7.86
EV per Share	741.44	922.80	238.20	70.57	159.36
Price -to-Earnings	66.98	78.18	15.45	6.45	10.15
EV-to-Earnings	69.16	78.74	14.57	4.72	8.73
Reported EPS (Rs)	10.72	11.72	16.35	14.95	18.25
Market Capitalisation / FCF	-26.80	-76.31	24.99	8.91	18.44
E V/ FCF	-27.68	-76.85	23.57	6.52	15.86
FCF Yield (M Cap Approach)	-3.73	-1.31	4.00	11.22	5.42
FCF Yield (EV Approach)	-3.61	-1.30	4.24	15.33	6.30

Source: Data adapted from <http://money.rediff.com>

**Table-2**  
**Equity Valuation Price-earnings vs. Enterprise value JSW Steel Limited**

Variable / Ratio	Financial Year				
	2011-12	2010-11	2009-10	2008-09	2007-08
Market Capitalisation (Rs. In crores)	16019.80	20522.30	23096.81	4355.44	15324.92
Enterprise Value (Rs. In crores)	27995.39	32325.80	34696.13	15540.39	22853.56
EV/PBITA	4.84	6.73	8.00	5.10	6.45
EV/OCF	13.09	15.82	10.52	3.83	6.43
Market Capitalisation / OCF	7.49	10.05	7.00	1.07	4.31
EV per Share	1254.74	1448.83	1854.92	830.82	1221.80
Price -to-Earnings	13.23	16.64	11.58	10.14	9.02
EV-to-Earnings	23.12	26.21	17.40	36.19	13.45
Reported EPS (Rs)	54.28	55.28	106.59	22.96	90.84
Market Capitalisation / FCF	-8.96	-4.01	154.00	-2.45	-7.35
E V/ FCF	-15.65	-6.32	231.34	-8.74	-10.97
FCF Yield (M Cap Approach)	-11.17	-24.94	0.65	-40.84	-13.60
FCF Yield (EV Approach)	-6.39	-15.83	0.43	-11.45	-9.12

Source: Data adapted from <http://money.rediff.com>

## Findings

With a view to explain this new dimension in equity valuation practically, the financial data for the last five financial years of two companies from steel industry i.e., Steel Authority of India (SAIL) Limited and JSW Steel Limited, have been taken. The different variables and ratios as discussed in the earlier section of the paper have been computed to present the difference in inferences from price-earnings philosophy and the concept of enterprise value.

The tables reveal that the two companies are distinctly differs in terms of their enterprise values. The later company has higher enterprise value in relation to its market capitalization, which is due to large size debts and relatively less cash reserves. This situation has made the stock expensive to buy in terms of actual cost of acquisition. While the first company's enterprise value is very slightly high as compared to its market capitalization,

which converts its share lucrative in terms of its actual acquisition cost. This is due to possibly less debts and / or good cash reserves.

This fact is also evident from the relative study of market capitalization and enterprise value to free cash flows. The EV/FCF is almost equal to MC/FCF in case of first company whereas it is many times in case of second company under study. This may also be interpreted that the market price of the stock in case of first company is almost correct representation of its actual cost of acquisition whereas the actual cost of acquisition of stock in second company is very much higher as compared to its market price.

Relative study of price to earnings and enterprise value to earnings, and free cash flow yield by market capitalization and enterprise value also depicts the same picture.

## Conclusion

The price to earnings concept to value the stock has many flaws as discussed earlier. Apart this, it has some limitations such as some companies do not have net earnings, so they can't be compared to other companies using this ratio. Moreover, the P/E, P/EBIT, and P/EBITDA ratios neither consider the amount of debt of a company nor its liquidity status. Use of enterprise value instead of market capitalization for valuation provides significant value, because it rewards the companies with good liquidity, which is the touch stone for the short term solvency, and penalizes the companies with large size of debts. These high-liquid and low-debt companies maintain better degree of flexibility that ensures easy survival in economic downturn and business problems, and in rewarding shareholders. High liquidity and little debt enable company to pursue growth through new business lines or new acquisitions. This also helps in buying back more shares and paying higher dividends.

On the other hand, companies with large size debts and poor liquidity suffer the loss of operating profits through interest payments, and are also at solvency risk in instance of business going down as they can no longer afford to cover interest obligations. At the same time, most of the assets depreciated or amortized lose their real value and many of these assets will eventually have to be replaced in normal course of business. Hence, no financial ratio that relates price to earnings can show the company's is true worth. Enterprise value more accurately reflects the true worth of a company for investment decisions.

However, enterprise value itself is not miraculous. The use of enterprise value as a tool for comparing companies' valuation is restrictive as using this tool for the companies with different products and productions capacities may not give correct valuation. Similarly, it may not give correct inference if it is used to compare the conglomerates. Furthermore, companies with subsidiaries or with a sizable unquoted investment cannot easily be valued by its enterprise value. The enterprise value in such cases may not reflect economic or financial realities.

However, while comparing different stocks of common belongings, this new dimension in equity valuation offers better basis to evaluate the stocks from different facets of analysis for investment decisions. The enterprise value enables the potential investors to more accurately understand whether or not a company is truly undervalued.

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