**Enterprise Value**

Investors often use the [**P/E ratio**](http://thismatter.com/money/stocks/valuation/price-earnings-peg-ratios.htm)—stock price divided by net earnings—to compare the different stocks to find the best value. A stock with a lower P/E is often considered a better value, because its price is lower compared to its earnings. However, some companies don’t have net earnings, so they can’t be compared to other companies using the P/E ratio. Sometimes, **earnings before interest and tax** (**EBIT**) is used instead of net earnings. EBIT figures are higher because it includes earnings that will be used to pay interest on debt and to pay taxes. Some companies go further and report **earnings before interest, tax, depreciation, and amortization** (**EBITDA**), which is even higher than EBIT, especially for companies that have a considerable amount of depreciable assets. Depreciation and [amortization](http://thismatter.com/money/tax/amortization.htm) are not current expenses, but bookkeeping entries that reflect the loss of value of tangible and intangible assets. The advantages of using EBIT and EBITDA are that firms with different amounts of debt and assets or that use different [depreciation methods](http://thismatter.com/money/tax/depreciation.htm) can be more directly compared. Because EBITDA shows the highest earnings amount, most companies will have a positive EBITDA, so P/EBITDA ratios can be used to compare most companies. A company with a negative EBITDA would be a risky investment.

However, the P/E, P/EBIT, and P/EBITDA ratios do not account for company debt nor the amount of cash or near-cash equivalents on hand. For instance, if 2 companies—Company A and Company B—have the same P/E ratio and the same cash equivalents, but Company B has significantly more debt, then it will obviously be worth less than Company A. Although EBIT removes the interest payments on the debt, they still have to be paid, and so EBIT does not reflect the true value of the company—EBIT only shows whether the company can cover its interest payments with its earnings. And most assets that are depreciated or amortized are losing real value—many of these assets will eventually have to be replaced. Hence, no financial ratios relating price to earnings can show what a company is truly worth. Enterprise value more accurately reflects the true worth of a company.

**Enterprise value** (**EV**) is how much a company would cost, if it were bought outright — free and clear. The purchase price would have to include the price per share times the number of shares plus the debt would have to be paid and the potential liabilities of the company would have to be assumed — including bonds, preferred stock, capital lease obligations, noncontrolling interests, plus other nonoperating liabilities, such as unallocated pension funds — but cash and marketable securities owned by the company could be subtracted, since it lowers the effective price of the company.

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| **Enterprise Value Formula** | | | | |
| **Enterprise Value** | **=** | **Market Capitalization + Debt + Other Liabilities** | **–** | **(Cash + Cash Equivalents)** |

Another way of looking at enterprise value is that it measures the value of the company's operating assets, so cash is subtracted because it does not earn a return as a result of business operations. Another way to see why debt is added back is because the market capitalization is reduced by the debt, so the market must think that the business is worth the market capitalization plus the net debt. In other words, if the company had no debt, then the market capitalization would be higher, by the amount of the debt. Or consider the private purchase of a business. For instance, you want to buy a business that is selling for $2 million and that has a debt of $1 million, which you will have to assume as the new owner. By paying $2 million and assuming the debt of $1 million, you must think that the business is worth $3 million: this is the value of the business, the enterprise value. If the business had no debt, then the business seller would probably sell it for $3 million. If there were also pending lawsuits against the business or if the business had unfunded pension liabilities, then you would have to consider these potential future liabilities as well.

As a comparison tool, enterprise value is more useful as part of a ratio. Enterprise value can be used like the P/E ratio, but the EV value is substituted for the price per share in the numerator.

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| **Enterprise Value/Earnings Formula** | | |
| **Enterprise Value per Earnings** | **=** | **Enterprise Value**  **Earnings** |

Often, EBITDA is used instead of net earnings for the denominator, because more companies can be compared regardless of capital structure and accounting practices.

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| **Enterprise Value/EBITDA Formula** | | |
| **Enterprise Value per EBITDA** | **=** | **Enterprise Value**  **EBITDA** |

Like the P/E, a lower enterprise value-to-earnings or -EBITDA ratio is usually a better value for your investment money.

This ratio can also be reversed, with the earnings in the numerator and the enterprise value in the denominator to yield the [**return on investment**](http://thismatter.com/money/stocks/valuation/profitability-ratios.htm) (**ROI**). In other words, if you had bought the company outright and retired its debts, your ROI would be the percentage of your investments that would be returned in earned income.

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| **Return on Investment (ROI) Formula** | | |
| **Return on Investment** | **=** | **Earnings**  **Enterprise Value** |

To calculate the enterprise value:

1. From the company’s **income statement**, find the number of fully diluted, outstanding shares, then multiply that number by the current market price—the **market capitalization**.
2. From the **balance sheet**, find the short- and long-term debt, add them together, then add the total to the market capitalization.
3. From the **current assets** section of the balance sheet, subtract the cash and cash equivalents from the total, to arrive at the enterprise value.

The alternative to calculating the enterprise value is to simply look it up. Yahoo Finance, for instance, lists both the enterprise value, **Enterprise Value/Revenue**, and **Enterprise Value/EBITDA** in the *Valuation Measures* section of the *Key Statistics* of any stock. For instance, consider Google ([GOOG](http://www.google.com/finance?q=NASDAQ%3AGOOG)) and Wal-Mart ([WMT](http://www.google.com/finance?q=NYSE%3AWMT)). Believe it or not, Google has surpassed Wal-Mart in market capitalization (October, 2007), even though Wal-Mart is a much bigger company.

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| **Oct. 23, 2007** | **Google** | **Wal-Mart** |
| **Market Capp** | **210.93 B** | 178.72 B |
| **Enterprise Value** | **190.62 B** | 221.04 B |
| **Enterprise Value/Revenue** | **14.19** | 0.61 |
| **Enterprise Value/EBITDA** | **37.222** | 8.207 |

By comparing ratios, you can see that Wal-Mart has better fundamentals, and is a better value, according to almost any ratio. Of course, investors expect Google to continue growing at a phenomenal rate, which is why they priced its stock so high, but, as much as I like Google, it simply cannot last. As with all fast-growing companies, growth will have to slow as the company grows larger—it is the nature of the beast. Investing in Google now would be very risky. As you can see from the above table, the market cap difference between Google and Wal-Mart is $32.21 billion, a very substantial difference. A 32 billion dollar company in itself would be a very big company.

**Update — Enterprise Value in a Bear Market**

At the end of the close on November 20, 2008, the stock market has dropped to new recent lows due to the credit crisis. The S&P 500 Stock index is at a 11-year low, for instance. Let's see how Google and Wal-Mart have faired in this bear market.

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| **Nov. 20, 2008** | **Google** | **Wal-Mart** |
| **Market Cap** | **81.65 B** | 199.14 B |
| **Enterprise Value** | **73.73 B** | 241.63 B |
| **Enterprise Value/Revenue** | **3.52** | 0.60 |
| **Enterprise Value/EBITDA** | **9.674** | 7.991 |

As you can see by comparing tables, Google has lost 61% of its market value in a little more than 1 year, its stock price sliding from a high of $677.60 per share to $259.56, while Wal-Mart has increased its market value by 11% over the same time period, its stock price rising from $43.93 per share to $50.66; thus, Google's enterprise value has decreased significantly while Wal-Mart's enterprise value has increased, even in what is turning out to be one of the worst market declines in history. Note, also, that Google's enterprise value per revenue has declined 75%, and its enterprise value per EBITDA has declined 74%! By contrast, Wal-Mart's enterprise value per revenue declined only 1.6% while its enterprise value per EBITDA declined only 2.6%! Hence, it is easy to see that Wal-Mart has weathered the financial meltdown much better than Google, so, in fact, there was much less risk in owning Wal-Mart than owning Google as predicted by Wal-Mart's much lower enterprise value ratios. Google does have a much higher profit margin than Wal-Mart, and will, no doubt, rise significantly again. And as you can see from Google's much lower enterprise value ratios in November, 2008 compared to October, 2007, Google is a much better buy now, with considerably less risk than in the prior year.

