Why you use Enterprise Value (EV)?

**COMPANY A**

$10 EBIT

40% tax rate

$6 in Net Income

P/E 10

$60 million Market Cap. or EV = $60

**COMPANY B**

$10 EBIT

-$5 Interest Expense

=$5 million in pre-tax operating

$3 mil. in int. expenses.

$15 mil in market cap + $50 mil in debt = $65 in EV

A is cheaper with a PE of 10 while Company B has a P/E of 5. The price of the EV is lower for A at $60 vs. $65 for B.

I look at EV to sales not P/S. The point of this exercise is that when you show me your comparables and you say the average P/E--every analyst report shows the industry ratios where they say the industry is trading at 13x and this company is trading at 12x so it is cheap--it doesn’t take into account market capitalizations, differences in tax rates and things of that nature. And looking at things through an EV/EBIT basis does.

To make apples to apples comparison we will use EBIT/EV.

The Importance of ROIC vs. ROE

Do I care about the ROE? I care about the return on capital (ROIC).

The first thing I look at ROIC = EBIT/ (NWC + Net Equipment). How good a business is this?

Pre-tax return/Net Tangible Capital. What capital the company needs to use to be in business--NWC + Equipt. Net Working Capital (NWC): Use financial A/R and eliminate the excess cash. Subtract Accounts Payable NIB debt.

Why eliminate goodwill? Because it states historical costs. It doesn’t matter what I paid. You want to know going forward what type of business you are looking at.

EBIT/EV Earnings yield. What price am I paying relative to earnings?

Avoid value traps (low return businesses).

Hotel Capex:

Spend $1,000 for a hotel. Then spend $25 per year for MCX, but then in year 5, I need to refurbish the hotel for $400 to stay competitive. So I would add ($400/5 or $80 per year to the $25 per year and deduct $105 per year in true maint. capex).

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| $25 Capex  +$80 Capex  =$105 Capex | $25 Capex  $80 Capex  =$105 Capex | $25 Capex  $80 Capex  =$105 Capex | $25 Capex  $80 Capex  =$105 Capex | $25 Capex  $80 Capex  =$105 Capex | $400 in fifth year so apportion $80 mil. per year over regular MCX |

**MAGIC FORMULAS**

1. **WHAT YOU PAY:** “Normalized” EBIT/Enterprise Value (What I pay or pre-tax earnings yield). You would value EBIT higher if tax revenues are lower due to a permanent tax change. Take the after-tax yield and see what the differences are. Is EBIT representative of true cash flow. EBIT is a short hand for EBITDA – Maint. Capex. Different capitalization can skew net income. Differences in tax rates. Using EBIT is a way to compare apples to apples.
2. **WHAT YOU EARN:** EBIT/(NWC + NFA) the denominator shows what I need to invest in the business to get that EBIT. Don’t forget to normalize investment capital over the course of a year. What I earn.

I told you about my “magic” formula as my starting point for looking at companies.

***JG:*** You bring up a very important point. These are totally two different things.

This is how much I earn based on what I paid for it (EBIT/EV).

This is what I earn based on what the company paid for the assets that created those earnings (EBIT/IC or (NWC + NFA). Those are two totally separate concepts.

Return on the capital they made on the past. So what? Incremental dollars will make good returns but not as high as they made in the past. I may earn 60% ROIC on the new store versus 70% previously in the old store, but there are no other places to earn as high a return so I will still build that store. But if my pretax returns are between 15% and 20%, it doesn’t take too much to tip the balance.

Use normalized EBIT. Look at the normal environment. **This is the art part.** What I think a normal environment might be. There is nothing special going on in regards to the company or the economy. Obviously it is an assessment now we are into the art part of determining “normalized”.

Here is normalized EBIT over capital invested in the business. This is my best guestimate of what type of business do I have?

When I ran a defense business I had a lot of contact with investment bankers who were pitching acquisitions. They would say, “Well, you can add 20 cents to earnings and make a non-dilutive acquisition by acquiring a business at 9 x EBIT earning 11% pre-tax and that is about flat in growth while borrowing 9.5% partly fixed and partly variable. The spread is 1.5%. Is this worth it for a crappy business? No.

**They slapped on the same multiple we had before even though we would be a lot more levered.** The investment bankers had a 400 page report with a nice cover on it, but when you get down to it, this is the bet you are taking. It looks like a bad bet.

Boil the analysis all down to its essence—**is it a good business at a good price?** Is the bet worth it?

Don’t throw out logic. Ask one simple question. How much do I have to pay? How much am I earning?

If you have to continually make acquisitions to grow, then it is a different animal.

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|  | **Company A** | **Company** |
| **Current Assets** | 3 | 3 |
| **Fixed Assets** | 2 | 7 |
| **Goodwill** | 5 | 0 |
| **Current Liabilities** | 1 | 1 |
| **Book Value** | $9 | $9 |
| **Earnings $2.00 per share in cash** |  |  |
| **Return on Tangible Capital** | 50% | 22% |

You are earning 50% on tangible capital ($2/$4) unless you have to add acquisitions to get future growth. All you have to replace is fixed assets. Your capital spending will be confined to replacing fixed assets. You don’t have to keep replacing Goodwill. Goodwill is a past cost. *(See Warren Buffett’s writing in the 1983 Annual Report of Berkshire Hathaway on amortization and intangible assets).*

This took me a long time to learn, but if I had read Buffett’s letter in 1983, then I would have learned this sooner.

Forget how the company got there. If the company made bad acquisitions so debt is in the EV. Goodwill is a sunk cost in past acquisitions. If management is a serial acquirer that makes bad acquisitions then the future earnings won’t be what they say it will be. Adjust.

I care about what I have to pay today to generate returns today and in the future. EBIT/EV takes into account for what I paid for it.

If they have land where their factory could be moved and the land used for a higher and better use, don’t just take the value of the land without considering the cost of moving the factory. Do the difference between the industrial land and the value of the land.

Why are we taking Net Fixed Assets (NFA)? It is not always right. Say we buy a hotel for $10 and it is going to last 10 years and we write it down over 5 years and now it is at $5. But if this goes down to zero, I might half to invest another $10. This would give me ($5) a skewed return (being too high) because of not considering replacement and reinvestment into the fixed assets.

Say you have 100 hotels and they are all on different cycles, then on average, you will be correct in using NFA. 10% of your hotels will be refurbished each year over a 10 year normal cycle. That is my quick and dirty for an ongoing business.

Do I have to adjust any numbers based on the unique circumstances of the business. Beware of overstating returns on capital.

*Hooke*, author of Security Analysis, said that you don’t control the company so you take the capitalization as is so use P/E. It is the hand you drew. *JG:* I strongly disagree with this—reasonable minds differ—because I have been doing this a long time and EV to EBIT works better than P/E because if management doesn’t optimally use optimal capitalization then someone will come in and do it for you. Using **EV/EBIT** is the way to go.

Acquisition value is not the same as P/E multiple.

If there are big blips in capex then there will be a hybrid between gross and net.

“Roll-ups mean lose money.”

You spent the money on the stores but you don’t receive the EBIT yet, so you must normalize the number for EBIT.

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| **Good Price** | **Good Business** |
| EBIT/EV | EBIT/(NWC + NFA) |

If you are earning 50% to 60% vs. 15% to 20% then we are looking at two different animals. Then what are their growth prospects, what is there growth rate, bargain price, good business?

20% pretax = 12% after tax. The average for business is 12%.

I don’t make money because I am really smart, I make money because I have a big picture in mind for what I am looking to do. The big picture in mind—is the difference between 50% to 60% vs. 15% to 20%.