BRIEF

Enterprise Value

By Mark Abbott and Tommy Mains

Introduction

Enterprise Value is a commonly used financial metric that represents the total value of a company, taking into account its market capitalization, debt, and cash reserves. Getting the Senior Leadership Team (SLT) to understand the value drivers that determine the company's worth is one of the 9 Core Competencies related to building a great company — one that is focused, aligned, and thriving.

To grow Enterprise Value (EV), company builders need to master a long-term approach that goes beyond **Key Performance Indicators** (KPIs) and winning the quarter. Just like a clear and compelling **Vision** is necessary to align an organization, deep understanding and mastery of this **Core Competency** is essential for sustained growth.

> **"We don't make money because we want to make money; we make money because people value what we do."**
> **—Mark Abbott, Ninety Founder + CEO**

Context

As its name implies, EV is the total value of a company (an enterprise). The most simplified definition is the market value of the organization's equity plus the net cost to pay off its debt (debt minus cash). Calculating the cost to pay off debt is relatively straightforward. What's not as easy is understanding and agreeing on how to measure the value of a company's equity.

In most companies, leaders are incentivized to hit KPIs based on short-term outcomes for improvements in business performance. However, great company builders embrace a different approach to EV creation — one linked to a company playing the long, if not infinite, game. This requires a deeper understanding of value creation, leading to our need to confidently calculate or assess our company's EV.

All of our Stakeholders — especially those with whom we have high-trust relationships — want our company to grow.

- Our **customers**, so they can continue benefiting from their relationship with us.
- Our **team members**, so they can grow their skills and increase the market value of their capabilities.
- Our **Senior Leadership Team**, so they can grow their departments and leverage their leadership strengths.
- Our **vendors**, so they can grow with us to meet their goals and turn their Vision into reality.
- Our **strategic partners**, so their relationship with us proves mutually beneficial and endures.
- Our **investors**, so the value of their investment grows, and the risk/reward becomes more attractive over time.

- Our **society**, so it can employ more of its members and create more stable communities.

Growing EV is not just positive for our investors. The larger, more predictable, and more resilient our EV, the stronger and more attractive our options for raising additional capital, and the better our company's position to get through hard times.

The fact is, clarity on how to measure and grow our organization's EV is foundational to building a great company.

Core Disciplines of Enterprise Value

1. EV is based on someone's perception of a company's future cash flows. Whether we like it or not, several internal and external factors impact our company's EV. This is why the stock market tends to bounce around a lot, even when the fundamental metrics of the associated companies haven't changed. The external factors include interest rates, our competitive environment, the expected rate of change within our industry, the macroeconomic environment, and even the regulatory environment.

External factors aside, the market is essentially applying a discount rate to expected cash flows. In a worst-case scenario, expected cash flow is nothing more than the liquidation value of a company's assets minus its liabilities.

Whether we want to take on some debt, raise equity, or sell our company, the prospective capital provider will want us to provide them with projections demonstrating we understand our business's economics. They will then dig into our forecasts to develop their own predictions. The further they can confidently predict our cash flow, the easier it is for them to value the company. They'll give us more value, all else being equal, when our cash flow is easy to understand and relatively easy to predict. The harder it is to predict, the higher the discount rate they'll apply to our projections.

2. It's important to understand multiples and the evolution of discount rates. Over the years, the marketplace has evolved to convert discount rates into multiples, which are simply inverted discount rates. To simplify this comparison, we can assume constant growth rates of dividends and a constant discount rate to give us a formula of (Multiple) =

1 / (Discount Rate). For example, in the publicly traded stock market, a price/earnings (p/e) multiple of 10 implies a 10% discount rate, and a 20 multiple suggests a 5% discount rate.

3. Many variables influence a company's multiple. Some of the major categories are:

- **The industry.** Some industries, like utilities, generate relatively predictable cash flows. » Total addressable market. A larger market is better since it means more growth opportunities.

- **Revenue.** Revenue can encompass actual dollars, the expected growth rate, the level of predictability, and more.

- **Profits.** This includes gross and operating profits and their margins — with higher margins indicating some form of competitive advantage.

- **Team members.** This includes team member satisfaction and feedback, tenure, retention, and referral.

- **Products and services.** This includes diversification vs. concentration, lifecycle, dependency on suppliers and partners, and expansion opportunities.

- **Barriers to entry.** Patents, unique know-how, etc.

- **Customer base.** For instance, opportunities for expansion, percentage of **Ideal Customers**, and customer satisfaction.

KPIs can capture the data associated with each of these categories. Collectively, their trends and degree of predictability will be the core factors that a potential investor or acquirer will use to determine our multiple. Just as importantly, our ability to capture, understand, and confidently share this information is an "asset" in itself because it demonstrates that we comprehend the core KPIs associated with understanding, growing, and fortifying our EV.

4. Prioritize inputs for long-term value. "We don't make money because we want to make money, we make money because people value what we do." Our founder, Mark Abbott, shares this insight with every one of his coaching colleagues and, on almost a weekly basis, internally with us at Ninety. The big idea is that many leaders invest too much energy in their company's outputs, like revenue. It's crucial for leaders to understand that the inputs of their organization drive their outputs. For example, companies can naturally increase their financial metrics by prioritizing their workforce through encouraging career development, promoting a positive culture, and rewarding achievements. Our people are a primary driver and often the very face of our organization. When we care for them, they can take care of their **roles, accountabilities, and responsibilities**.

Focusing on inputs leads to a preference for leading instead of lagging indicators. Leading indicators help ensure we're focusing on what creates value. While the outputs from lagging indicators show past performance, leading indicators can help guide decisions. Think of a home garden. Our harvested fruits and vegetables are lagging indicators of the efforts we put into the garden. The leading indicators here would be the garden's soil quality, access to sunlight, and watering schedule that help nurture healthy plants and ensure an abundant harvest.

We share this because we deeply believe it's vital that SLTs understand EV and that everyone on the SLT is in alignment on how it's created. That said, we don't want to focus too much on the output that is Enterprise Value. Instead, focus on the inputs and occasionally assess the organization's EV to ensure everything is going as planned.

Takeaway

Understanding the basics of Enterprise Value allows leaders to establish the processes and practices needed for a solid and lasting financial foundation. By operating the levers that influence E-Value, we can attract investors and continue building a company that's focused, aligned, and thriving.

What's next? Visit the **90u Library** or **try Ninety today**.

Tagged with: **Brief**, **Enterprise Value**