Path to Business Value & EMVA

The Value Equation

÷

Current Pre-Tax Return Expected By Investors

=

Equity Valuation Multiple

+

Equity Invested At Cost

=

Equity Value

+

OPM

=

Business Value

Equity Valuation Multiple - 1

×

Equity Invested At Cost

=

Equity Market Value Added
(EMVA)

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With the simple six variable Value Equation solved to compute current pre-tax equity returns, you are just three steps away from determining business value. You are also just three steps away from determining Equity Market Value Added (EMVA), or the amount by which your equity is worth more then it cost. EMVA creation is a common characteristic of the world's most successful companies and central to the fortunes of the world's richest.

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Path to Growth & Returns

The Value Equation*

×

(1 – Income Tax Rate)

=

Base Business Current After-Tax Annual Return

×

(1 – % Paid Out In Shareholder Dividends)

=

Sustainable Growth Rate

Delivering Added Growth Through Compounding

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If your pre-tax current rate of return exceeds the return sought by investors in businesses having similar risks and growth prospects (the hurdle rate), then your total expected after-tax rate of return will exceed your current after-tax return. If the hurdle rate equals your rate of current return, then your business will be worth what it cost, inclusive of the reinvested equity after dividends and taxes. Businesses become worth less than what they cost to create when the hurdle rate exceeds their current pre-tax rate of return.

*For this form of the equation, use the OPM payment constant rather than the OPM interest/lease rate.

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Path to Growth & Returns

With the simple six variable Value Equation solved to compute current pre-tax equity returns, you are on your way to estimating your business growth potential.

The first step is to compute the Value Equation on an after-tax basis to arrive at the maximum amount you can reinvest into your business. The after-tax current equity return equals your sustainable growth rate, which is the amount the business can grow (all Value Equation variables equal) by reinvesting your after-tax cash flow.

The second step is to multiply your after-tax return by the percentage of cash flows retained after shareholder dividends, arriving at an ultimate sustainable growth rate.

Growth can come from the original base business or from the after-tax cash flow reinvestment into new business investment. Either way, your ability to grow without raising new equity is going to be capped at your sustainable growth rate after dividends unless Value Equation variables change. One such change might be limited business investment needed for added sales. This is called operating leverage and is a characteristic of many fine businesses, raising their sustainable growth rates. Scalability, which is the ability achieve sales growth with modest cost increases, elevating operating profit margins, can also boost your sustainable growth rate and returns.

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