

The Impact of Debt and Leverage on the Valuation of a Business

How Company Vehicles can Influence Business Valuation

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This white paper will help you better understand that a firm's cost of capital plays a critical role in assessing the value of a business. Capital is simply the means by which business assets are financed. For the most part, assets are paid for by cash from owners (either from retained earnings or invested capital) or from lenders (debt). A firm with a higher percentage of debt is considered to have higher financial leverage. Financial leverage affects the cost of capital which is calculated as the expected cost of debt (expressed in terms of an interest rate) and the expected cost of equity (expressed as a percentage return to owners). With everything else being equal, the lower the overall cost of capital, the greater the value of a business. Leasing non-core business assets such as a company's fleet of vehicles can offer a viable opportunity to decrease financial risk and thus lower the cost of capital. This in turn can increase the value of your business.

The purpose of any investment is to increase the value of that investment (e.g., cash deposited in a savings account is expected to compound in value over time). To that end, the purpose of owning or operating a business is to increase its value. The value of a business can be measured in a number of ways, but one of the most common and accepted approaches is to place a value on the business using a discounted cash flow method. In the discounted cash flow valuation (assuming a steady stream of cash flows), a company's future free cash flow is capitalized (or divided) by the cost of capital. The following example illustrates this concept:

A business that is expected to generate \$100,000 in potential free cash flows in the future and has a cost of capital of 10% would yield a business value of \$1 million (\$100,000 divided by 10%). If that same business had a 5% cost of capital, the business value would be \$2 million (\$100,000 divided by 5%).

As shown by the above example, it is unambiguous that firm value increases with decreases in the cost of capital.

Thus, managers should consider ways to reduce the cost of capital. One important element that impacts the cost of capital is the firm's leverage which affects the financial risk of the firm. Financial leverage is measured by the amount of debt on a company's balance sheet as compared to the company's equity. With higher leverage, firms have higher financial risk, which in turn has the potential to increase the cost of capital. This relationship holds because with excessive levels of debt, it is likely interest rates on future debt will increase as lenders become more concerned about default possibilities. In addition, excessive debt may require higher returns on equity because the owner's investment is considered more risky. Logically, it can be reasoned that additional financial risk increases the cost of capital for firms with high leverage.

An important implication of this is that it may be prudent for companies to monitor their leverage and financial risk. They can do this by using their cash from operations and their available bank lines to invest in suitable business investments (those that appreciate in value) or build a healthy balance sheet in the event of economic downturns. Having the availability of cash when these situations arise is a critical factor in determining financial risk and the financial health of a business.

One often overlooked way to lowering financial risk and lowering the cost of capital is the financing of your fleet of vehicles.

In most businesses, the vehicle fleet is not considered the principal business investment; rather the fleet of vehicles is a means by which the business achieves its goals and transacts business. Yet, many businesses own and finance their fleet through cash from operations or by tapping into their bank line of credit. By financing a non-core, depreciating business asset such as vehicles (either with cash from operations or by tapping into bank lines), the company's financial risk can be heightened; and the cost of capital increased.

One approach to free up financial resources and possibly improve your cost of capital is to lease from a fleet management professional. Generally, fleet management companies provide a "cradle-to-grave" program for the management of fleets. Since the fleet management company owns the vehicles (this is the main difference between a lease and a loan), no restrictive debt covenants on other company assets are necessary (the fleet management company considers the vehicles as collateral). In addition, the monthly payments can be structured to reflect the economic use of the vehicle versus financing the entire cost of the vehicle. The following example illustrates this point:

- If a vehicle that costs \$20,000 is expected to sell for \$10,000 after three years of use, the economic depreciation is considered to be \$10,000 (\$20,000 minus \$10,000). The monthly payments within a lease can be structured to reflect the \$10,000 economic depreciation versus the \$20,000 cost of the vehicle.

Because only a portion of the asset is financed, a lease may lower your financial leverage; and because there are no debt covenants on your core business assets, a lease may lower your financial risk.

In summary, the cost of capital is an important factor in assessing the value of a business model. Among other things, the cost of capital is influenced by the level of debt on a company's balance sheet and by the ability of a business to weather an economic downturn. A fleet of vehicles is a depreciating asset and although necessary for transacting business, a fleet of vehicles is normally not the primary business asset. Instead of owning these types of assets, a resourceful approach to improving your firm's cost of capital is to consider a leasing program with a professional fleet management company. Simply stated, leasing provides a low-risk method of financing, which can improve your cost of capital and increase the value of your business.

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