## Avoiding A Common Valuation Mistake:
## The Importance of Matching Cash Flows and Rates of Return

### FIGURES 1, 2 & 3

| Figure 1<br>DATA TO COMPUTE EQUITY NET CASH FLOWS AND<br>INVESTED CAPITAL NET CASH FLOWS | |
|---|---|
| EBITDA | $1,083 |
| EBIT | 933 |
| Net Income After Taxes | 500 |
| Depreciation Expense | 150 |
| Interest Expense | 100 |
| Forecasted Increase in Net Working Capital | 50 |
| Forecasted Capital Expenditures | 180 |
| Forecasted Increase in Long-Term Debt | 25 |
| Income Tax Rate | 40% |

Based on this data, Figure 2, below, computes **Invested Capital Net Cash Flows**, which considers the company's internal needs for capital expenditures and working capital and demonstrates why EBITDA and EBIT are so popular with sellers.

| Figure 2<br>COMPUTATION OF INVESTED CAPITAL NET CASH FLOW | | |
|---|---|---|
| . | Net Income After Taxes | $500 |
| + | Tax Adjusted Interest Expense ($100 X (1-40%)) | 60 |
| + | Non-Cash Expenses | 150 |
| - | Capital Expenditures | (160) |
| +/- | Change in Working Capital | (50) |
| = | **INVESTED CAPITAL NET CASH FLOW** | **500** |

For the sake of clarity, note the computation of **Equity Net Cash Flows**, illustrated in Figure 3 below, and how it differs from **Invested Capital Net Cash Flows** from Figure 2.

| **Figure 3**<br>**COMPUTATION OF EQUITY NET CASH FLOW** | | |
|---|---|---|
| | Net Income After Taxes | $500 |
| + | Non-Cash Expenses | 150 |
| - | Capital Expenditures | (160) |
| +/- | Change in Working Capital | (50) |
| +/- | Change in Long-Term Debt | *25* |
| = | **EQUITY NET CASH FLOW** | **$465** |

This cash flow is considered to be the proxy for dividends and capital appreciation to common stockholders.