Valuing Firms under Special Situations

Firms with Temporary Problems

When cash flow is temporarily depressed due to strikes, litigation, warranty claims, employee severance, or other one-time events, it is generally safe to assume that cash flow will recover in the near term. One solution is to base projections on cash flow prior to the one-time event. Alternatively, actual cash flow could be adjusted for the one-time event by adding back the pretax reduction in operating profits of the one-time event and recalculating after-tax profits. If the cost of the one-time event is not displayed on the firm's financial statements, it is necessary to compare each expense item as a percent of sales in the current year with the prior year. Any expense items that look abnormally high should be "normalized" by applying an average ratio from prior years to the current year's sales. Alternatively, the analyst could use the prior year's operating margin to estimate the current year's operating income.

Firms with Longer-Term Problems

Deteriorating cash flow may be symptomatic of a longer-term deterioration in the firm's competitive position due to poor strategic decisions having been made by management. Under such circumstances, the analyst must decide whether the firm is likely to recover and how long it would take to restore the firm's former competitive position. The answer to such questions requires the identification of the cause of the firm's competitive problems. Firms with competitive problems often are less profitable than key competitors or the average firm in the industry. Therefore, the firm's recovery can be included in the forecast of cash flows by allowing its operating profit margin to increase gradually to the industry average or the level of the industry's most competitive firm. The speed of the adjustment depends on the firm's problems. For example, replacing outmoded equipment or back office processing systems may be done more quickly than workforce reductions when the labor force is unionized or if the firm's products are obsolete.

Cyclical Firms

The projected cash flows of firms in highly cyclical industries can be distorted, depending on where the firm is in its business cycle. The most straightforward solution is to project cash flows based on an average historical growth rate during a prior full business cycle for the firm. Alternatively, if the recovery from a recession is expected to be sluggish, the analyst may extend the forecast period to as much as ten years and allow the currently depressed level of cash flow to gradually grow to its more normal historical level.

Using The Enterprise Method to Estimate Equity Value

A firm’s common equity value often is determined by first estimating its enterprise value, adding the value of nonoperating assets, and then deducting the value of debt and other nonequity claims on future cash flows. What follows is a discussion of how to value nonequity claims and nonoperating assets. If these factors already are included in the projections of future cash flows, they should not be deducted from the firm’s enterprise value. This approach is especially useful when a firm’s capital structure (i.e., debt to total capital ratio) is expected to remain stable.

Valuing Nonequity Claims

Nonequity claims commonly include long-term debt, operating leases, deferred taxes, unfunded pension liabilities, preferred stock, employee options, and minority interests. How to value these items is discussed next.