Debt free cash free

Financial Training Associates explains the use of debt free cash free values in the purchase and sale of businesses

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A letter written by a buyer offering to purchase a business commonly contains the words: 'This offer is made on a debt free cash free basis.' Alternatively a seller, after providing information about the business, might ask for offers 'on a debt free cash free basis'. In this article, we:

- explain what debt free cash free offers are;
- provide some suggestions as to why they are used;
- explain how debt free cash free offers are determined; and
- compare debt free cash free with another term commonly used in finance: enterprise value.

What is debt free cash?

Imagine a typical business, which had some amount of net debt, let's say £30m, in a situation where net debt equals debt less cash. Imagine too, that we had a magnificent benefactor or a fairy godmother who could work a wonder for the business and magic away that £30m of net debt. Without those net liabilities, the business's value would be higher.

That's what the debt free cash free value is: the value of the business if it didn't have any net debt.

Debt free cash free versus shares consideration

Let's imagine a business with shares valued at £70m. That's the value shown on the right hand side of the chart below. Let's imagine that the business had debt less cash, or net debt, of £30m. In this scenario, the debt free cash free valuation would be £100m; that's the value on the left hand side.

For a business that has net debt (in other words, where its debt is greater than its cash), the debt free cash free value is higher than the value of the shares in the business. You can see that from the chart: the £100m on the left is greater than the £70m on the right.

Working from left to right, if the owner of a business had received a debt free cash free offer of £100m and net debt was £30m, the owner would expect to receive £70m consideration for the shares in the business.

Why is debt free cash free used?

Given that debt free cash free valuation differs from shares consideration, it's easy for confusion to result. For example, the buyer's letter might contain a debt free cash free offer of £100m but, as shown above, that's going to differ from the £70m the seller expects to receive for the shares.

So why is the debt free cash free valuation used at all? Here are some possible explanations:

- Comparability. Debt free cash free provides a common basis for comparing offers. Debt levels in a business will likely fluctuate up until the day that the business is sold. By focusing on the debt free cash free value we have a consistent way of measuring the value of the business, irrespective of how debt levels fluctuate up until the sale of the business is completed.
- It takes the purchaser's perspective. The buyer of the business in the chart on the previous page is going to have to purchase the shares (for £70m, say) and also make sure that banks are prepared to lend £30m. The purchaser is responsible for making sure a total of £100m of financing is in place. Debt free cash free takes the purchaser's perspective: the £100m of

funding the buyer is responsible for. It doesn't take the perspective of the seller, who expects to receive £70m for the shares.

- Deal inflation. People working on deals may prefer to talk about higher rather than lower numbers. For example, an adviser might prefer to tell another potential client that they have just been working on a £100m deal rather than a £70m one. And after the deal is done, the former business owner might prefer to tell fellow golf club members that they have just sold off the business in a £100m deal.
- The adviser's fee. An adviser working to sell an owner's business might be expecting a fee that is calculated as a small percentage of the deal. The bigger the deal, the bigger the fee. Here we're seeing how at least one party to negotiations might be interested in making sure that people are seeing the deal size as £100m not £70m.
- It's a convention. We have already seen how the debt free cash free value reconciles to shares value, with the bridge between the two being net debt. Because we can reconcile between the two, it doesn't really matter where we start. Convention means that the debt free cash free value is often used.

Debt free cash free and legal agreements for sale

Debt free cash free is really just a convention. Wherever you start, left or right on the chart, £100m or £70m, the two reconcile. There might be some people around the table who would rather talk about a big deal. Perhaps the adviser whose fee is a percentage of the deal size would rather talk about a £100m deal. Perhaps the business owner would rather say the business has just been sold for £100m.

But in the actual legal agreement used for the deal, having a smaller deal size might help. A lower number such as £70m might be useful when it comes to calculating transaction taxes such as stamp duty or capital gains tax. So while offers are often presented on a debt free cash free basis, the actual legal agreement often contains a lower value.

Determining the debt free cash free value

This CPD article does not focus on business valuation, but the highest possible level answer to how the debt free cash free value is determined depends on the realisation that businesses are often valued by multiplying up earnings. A buyer might take a business's earnings and multiply those to calculate the debt free cash free (DFCF) value used in the offer letter.

- EBITDA x multiple = DFCF value. Debt free cash free is the value of a business assuming its banks' claims were magically removed. Debt free cash free is the value of a business before we take account of the net liabilities owed to banks. To be consistent, when valuing a business by multiplying earnings, our valuation needs to utilise an earnings figure that also excludes banks' claims, such as earnings before interest, tax, depreciation and amortisation (EBITDA, which is a pre-interest measure of earnings). The consistency here is that applying an appropriate multiple to pre-finance earnings provides a valuation prior to banks' claims on the business: the debt free cash free value.
- DFCF value minus net debt = shares value. In our table we saw a route from debt free cash free to shares value, which is what the seller expects to receive. We could subtract net debt to get from debt free cash free value to shares value.
- Alternatively, we could take a slightly different route straight to shares value by taking a post-finance earnings figure like net profit after tax (NPAT) and applying an appropriate multiple. NPAT x multiple = shares value would provide us with a valuation after banks' claims on the business.

This is not a detailed explanation of valuations but the very essentials are laid out above. The most important point is that EBITDA x a multiple = debt free cash free valuation. A buyer could conduct some research into values that other businesses had sold at or values other businesses were trading at in the stock market, obtaining a multiple for comparable companies.

The buyer might then apply that multiple to EBITDA earnings for the comparable business and use that to help them decide what the debt free cash free offer should be.

The bridge between debt free cash free and shares value is net debt (see the second bullet point above), although there is another way to get there too, as outlined in the third bullet point above.

Enterprise value

Those who have studied finance before will recognise the similarity between debt free cash free value and enterprise value. Both measures value a business by excluding some of its liabilities. This makes the two measures of value very similar.

The difference is that some valuation practitioners would include a few more liabilities in their calculation of enterprise value, such as items that may not bear interest but still have to be financed (a pension liability, say)

Summary

To summarise, debt free cash free value:

- represents the value of a business with net debt removed (remember the fairy godmother waving her wand over the business, magically removing those liabilities, increasing the value of the business);
- is greater than shares value/ consideration for a business that has net debt (remember the £100m against the £70m);
- is often used in letters offering to buy a business; and
- is very similar to another term used in finance: enterprise value.