



Earnings Stream

Net Cash Flow to Invested Capital

Net Cash Flow to Invested Capital differs from Net Cash Flow to Equity in that it accounts for **all** of the invested capital. Invested capital for our purposes includes not only equity but debt. After all, if the business did not have the debt that allows them to operate, it would have to issue more stock.

Below is the formula for Net Cash Flow to Invested Capital:

$$\begin{array}{rcl} & & \text{Normalized net income} \\ + & & \text{Interest expense (net of taxes)} \\ + & & \underline{\text{Normalized noncash charges (depreciation, amortization, ect.)}} \\ = & & \text{Gross cash flow} \\ - & & \text{Anticipated capital expenditures} \\ - \text{ or } + & & \underline{\text{Working capital necessary to support growth}} \\ = & & \text{Net Cash Flow} \end{array}$$

Now, if you will compare last months education piece, when we talked about net cash flow to equity, and compare the two. You will see the difference immediately. The above net cash flow deducts interest expense and does not account for changes in debt. Net cash flow to invested capital is based on the assumption that the resulting appraisal is estimating the debt-free value.

Notice the interest in this formula is net of taxes. It has been tax-effected to represent the fact that interest lowers the taxes owed. To tax-effect the interest, you in essence have reduced the amount of interest paid since there is less tax paid. The tax-effecting of interest, is a standard practice in business appraisal.

Tax-effecting the net cash flow is a big controversy in the business appraisal field when valuing non-tax paying entities such as S corporations. One side says that non-tax paying entities are already tax-effected. The other side says that all non-tax paying entities should be tax-effected because the willing buyer may not be eligible to continue the tax election of the seller.

We will cover tax-effecting in a later issue. What we wanted to do at this time is bring the issue to your attention so you are aware. Whether the cash flow is tax-effected or not, it is important that the correct discount or capitalization rate is used. Example: do not use a pretax capitalization rate on after-tax earnings stream.

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