Valuation Effects of Excess Cash

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**BALANCE SHEET EXAMPLE**



I. **What is a *non-operating asset*?** *Excess cash* is one form of *non-operating asset*. A non-operating asset is an asset owned by a company that is not needed in the operations of the Company. This can be *excess cash*, as defined later, real estate that is not used in the business, the cash value of a life insurance policy that is not used in the business or a vehicle that is not used by the business.

For valuation purposes, non-operating assets are valued separately from the operating company. That is, the value of the non-operating assets are added to the operating value of the company.

II. **Defining *excess cash***. Excess cash is the value of a non-operating asset that consists of cash that is in excess of what the business needs for its operations.

A. **Ratios**. It is sometimes possible to estimate the amount of the excess cash by the use of a financial ratio.



1. **Current ratio**. This is the current assets divided by the current liabilities. [See above]

In this case, we have a current ratio of 2.48. Whether or not this ratio level is good, bad or adequate is very subjective, but the “textbook” says that a ratio level of 2.0 is expected.

2. **Quick ratio**. This ratio is calculated by dividing the *quick assets* by the current liabilities. The *quick assets* is defined as the cash plus accounts receivable.

In this case, we have a quick ratio of 1.87. Like with the current ratio, the appropriate level is a matter of facts and circumstances, but the “textbook” says that a ratio level of 1.0 is expected.

3. **Debt-to-equity ratio**. This ratio is a measurement of a company’s leverage. In financial analysis, the equity is more often the market value of the equity, but we will use the book value, which is also referred to as a company’s equity value. As shown above [on the slide], we have divided the total debt by the book value (or equity) of the company to yield a debt-to-equity value of 0.67.

These ratios will now help us in the estimation of the amount of excess cash, if any, that a company has.

B. **Company needs**. The question that we must ask here is: “How much in the way of cash, quick assets and/or current assets does a company need in order to maintain the company’s operations with a reasonable degree of safety?” An example of the calculation of the excess cash is shown below:



I will explain the discounts later.

How much is enough is a very subjective measurement to be decided through a careful analysis conducted by the Company’s management, its accountants and other advisors. As a minimum, planners need to consider at least the following:

1. ***Working capital* needs**. *Working capital* is the current assets ($35,845,000 from the balance sheet [REFER TO THE BALANCE SHEET ABOVE]) less current liabilities ($14,454,000 also from the balance sheet). In this case, the working capital is $21,391,000. The amount of working capital that is actually needed depends upon the day-to-day needs of the business as determined by its planners. There is no one answer.

A current ratio of 2.0 would indicate a working capital level equal to the current liabilities.

2. **Dividends**. Undeclared[[1]](#footnote-1) dividends expected to be paid in the next twelve months.

3. **Capital expenditures**. To the extent capital expenditures will not be financed through borrowings or a leasing arrangement, the company will need cash available in order to purchase the needed equipment or other object of the capital expenditure.

The planners will keep in mind that if the purchase is financed through borrowings, payments due within twelve months of the purchase will directly reduce the amount of working capital since those payments will be considered a current liability.

4. **Payment of long-term debt**. Again, principal payment amounts of debt that are due within 12 months are shown on the balance sheet as a current liability. Such payments should be taken into account and planned for by estimating the company’s need for working capital.

If management wishes to prepay long-term debt, that is, debt that is due more than one year in the future, it must plan to satisfy that amount either with cash or the assumption of other debt (or leasing arrangement).

5. **Repurchase Liability**. It is possible that the Company will have to repurchase company stock from terminating ESOP participants during the year. This could be a significant demand on the cash of the Company.

C. **Time period – year-end or monthly average**. Is the cash balance as of the end of the fiscal year a good representation of the cash maintained throughout the year? If executive bonuses and/or S corporation distributions or dividends are paid just before or just after the last day of the fiscal year, the balance sheet balance may not be representative. This, of course, also applies to other items on the balance sheet such as accounts receivable, current liabilities, and specifically, the open balance of the line-of-credit.

It is therefore necessary to the appraiser, the financial officer of the Company and other advisors to review the Company’s financial situation to ensure that the figures that are being used in the calculation of the amount of the excess cash are representative of the Company’s actual financial condition as of the valuation date.

III. **The effects of excess cash on the value of the stock of the Company**.

A. As mentioned previously, the value of all non-operating assets of a sponsoring ESOP company is added to the operating value of the Company. An example of the computation of value is shown below:



As can be seen in this example, the excess cash of $1,570,000 is simply added to the operating value of the Company, which is shown as $39,620,000. The sum of these two yields the total Company value of $41,190,000 as shown.

B. **Repurchase liability**. As discussed previously, the repurchase liability directly affects the amount of the excess cash. If there is excess cash, there is a direct impact on the value of the Company caused by the level of management’s anticipation of the repurchase liability.

1. What is the effect on value of the repurchase liability if there is no excess cash?

a. This liability reduces the Company’s liquidity as measured by the quick ratio and the current ratio. This reduction in liquidity increases the financial risk to which the Company is subject. This may reduce valuation multiples.

b. The repurchase liability could reduce the ability of the Company to make capital expenditures.

This could stifle the Company’s ability to grow and compete with its competitors.

c. The repurchase liability could affect the Company’s ability to borrow from banks.

3. **The cash balance in the ESOT**. A large cash balance in the ESOT that could be used to help the Company out with the repurchase liability by allowing the ESOP to purchase shares of terminating participants could significantly influence the level of excess cash and the risks associated with a low liquidity level.

C. **What effect does prepaying debt have on the value of the company?** An example of the questions that we get from our clients addresses the financing decisions related to the use of available working capital.

If, for example, there is excess cash and some of that excess cash could be used to reduce the Company’s debt level, how would that use affect the value of the Company?

If we use all of the excess cash (before discount adjustments) of $2,132,500 to reduce company debt, that would reduce the value of the Company by $1,570,000 (after discounts). In the application of the debt-free valuation approach, there would be a positive effect on value. Also, a reduction of debt would reduce financial risk and reduce the interest payments to be made by the Company. It would also reduce the interest (or other return) earned by the Company on its excess cash.

The effects that this prepayment of debt has on the value of a company is a complex analysis.

IV. **Control and marketability adjustments**. If the ESOP owns a controlling interest in the stock of the Company and, therefore, has indirect access to the excess cash, then no adjustment should be necessary for a lack of control or lack of marketability.

If, however, the ESOP owns a non-controlling interest in the stock of the Company, then some adjustment is necessary for both control and lack of marketability. This is shown in our example.

1. Declared dividends would appear as a current liability on the balance sheet. [↑](#footnote-ref-1)