

Updated: Thursday, 5/1/2003 at 9:30 p.m.

## **FAQ on CFROI Spring 2003**

**Market Cap:** Where did the market cap for KMB come from?

*It came from the previous EVA case.*

**Operating Leases:**

- For the present value of operating leases worksheet, what cost of debt do we use?
- In the operating worksheet, we assume that the company is paying \$47,300 after 2006. Why does the right hand of the sheet say that they're paying that amount each year? shouldn't it be \$47,300 divided 14 years? Also, why do we discount back those payments at the real cost of debt?

*Please refer to the "risk factors" worksheet for the cost of debt. For the operating lease per year after year 2006, my reasoning (at the time I made this case) was that the company will take out a new operating lease (roll over the debt) and continue to pay this amount. I had made a similar assumption for the EVA case. With respect to the real cost of debt, why should we?*

**Depreciation and Amortization:** I am a bit confused about the depreciation and amortization assumption. Do we use the Depreciation and Amortization (D&A) from cash flows for all the Depreciation and Amortization numbers? If we were adjusting for net income, why aren't we using the D&A from the income statement?

*The reason that I wrote in the assumptions to use the D&A from the cash flows is because the depreciation and amortization line item in the income statement is equal to goodwill amortization and as such does NOT include depreciation.*

**Plowback Ratio:**

- Is it Depreciation & Amortization that is included in the calculation or only Depreciation?
- Is the Minority Interest number from the Income Statement?
- For Dividends, do we use Dividends and other Distribution from the Statement of Cash Flows?
- To calculate the simple plowback ratio, do we use the market value of minority interest or the book value?

*Both Depreciation & Amortization are included in the calculation. In calculating plowback, where should the Minority Interest number come from the Income Statement or Balance Sheet? Which makes more sense? Sorry for using the Socratic method, but you'll have to think this question through. Ditto for your question on Dividends. Please review your accounting or go to [www.wsrn.com](http://www.wsrn.com) and look at their actual 10K. The question on whether we use the market value of minority interest or book value is really a restatement of whether minority interest is from the income statement. Please think about this.*

### **Adjusted Gross Cash Investments:**

- Do we include "Deposits and other Assets" in Other Long-term assets category?
- Do we or do we not include obligations for employee benefits in KM's debt?

*"Deposits and other Assets" should be included in Other Long-term assets category. Please refer to the WACC template to see whether obligations for employee benefits should be included in KMB's debt.*

### **Gross Receipts:**

- What are operating lease payments?
- Minority Interest Expenses: is it the number from the Income Statement or Balance Sheet?

*Operating lease payments are what you are provided with in the worksheet entitled "Operating Lease". For Minority Interest Expense, which makes more sense... the number from the Income Statement or Balance Sheet? Remember that you are calculating Gross Receipts.*

### **Forecasting Life Cycle:**

How do we impute the CFROI from Management pronouncement as target growth in sales and simple plowback is the same as in calculation for approximate growth in assets? Expected CFROI in 2005 (t+5) turns out to be the same as the past 5-year median CFROI - is it the way it is supposed to be?

What number are we using for CFROI on New Investments for 2001(t+1)?

### **Past 5-Year CFROI:**

Does this number have to be adjusted to real terms?

*No, do not adjust this number.*

**Value of Intangibles:** Is the value of intangibles used in calculating the Adjusted Gross Cash Investment equal to the book value that is listed on the financial statements?

*Yes.*

**CFROI on New Investments:** What is the CFROI on New Investments in 2001 (t+1) and 2005 (t+5)?

*The CFROI on New Investments in 2001(t+1) will be equal to the CFROI on Existing Assets in 2001(t+1). Similarly, the CFROI on New Investments in 2005(t+5) will be equal to the CFROI on Existing Assets in 2005(t+5).*

**Cash Flows on New Projects:** Isn't there a mistake with respect to time subscripts in your formula? (For **Cash Flows on Existing Projects** (Existing(2000) please scroll down this page to **CFROI Valuation**)

*Good catch! The cash flows for the project are  $CF$  for  $Project_T = PMT(Project\ ROI_T, Project\ Life, Expenditures\ for\ New\ Property\ and\ Plant_T, Investment\ Net\ Working\ Capital_T)$*

**So for**

Year	2000	2001	2002		
CFROI on New Investments (Project ROI)		A			
Sustainable Growth Rate					
Expenditures for New Property & Plant		B			
Depreciable Assets					
Investment Net Working Capital (Nondepreciable Assets)		C			
Recaptured Net Working Capital					
Project Cash Flows					
Existing (2000)					
2001			=PMT(A,Project Life,-B,C)		
2002					

**Calculating the Depreciable Assets, Investment Net Working Capital (Nondepreciable Assets) and Expenditures for New Property & Plant:** For the year 2000, where are you obtaining the numbers for Expenditures for New Property & Plant, Depreciable Assets, and Investment Net Working Capital (Nondepreciable Assets)?

*For year 2000, use the "Capital Spending" given in the KMB spreadsheet. Next, using the assumption of Depreciable Assets/Gross Cash Investment of  $x\%$  you would allocate the Capital Spending into Depreciable and Nondepreciable Assets.*

**Recaptured Net Working Capital:** What is the recaptured net working capital in year 2019 and year 2020?

*For year 2019, you are using the Existing Non-depreciable Assets (stated in 2000\$) (see the Assumptions box). For year 2020, you are using the Investment Net Working Capital (Nondepreciable Assets) for year 2000. For year 2021, you are using the Investment Net Working Capital (Nondepreciable Assets) for year 2001. Use a similar logic going forward.*

**Sensitivity Analysis:** Is 2006(t+5) the correct year or a typo?

*It's a typo. It should be 2005(t+5).*

**CFROI Valuation:**

- **Cash Flows on Existing Projects:** For the Existing (2000) project cash flows (cell C27), should this be equal to the number we found on sheet 4 in cell B20, or should we be using the formula given on your FAQ sheet? My justified price per share swings greatly depending on this set of numbers.

*Existing (2000) project cash flows (cell C27), should equal the number you have calculated on sheet 4 in cell B20.*

- To remain consistent with the question I asked earlier, in cell B87, should we use Conventional Debt or Total Debt? The reason I ask is because in calculating the WACC, for cost of equity ( $K_e$ ) we leave out operating leases, whereas in computing cost of debt ( $K_d$ ), we do use them.

*In cell B87, use Total Debt. Note: I made a short cut here to make the case manageable for you so that you didn't have to calculate the PV of Operating leases for each of the comparables. In practice, you would have to do this.*

- Are we to assume again that the value of non-operating assets is 0?

*Yes, you are correct.*