Valuation

Aswath Damodaran
First Principles

- Invest in projects that **yield a return greater than the minimum acceptable hurdle rate.**
  - The hurdle rate should be **higher for riskier projects** and reflect the **financing mix** used - owners’ funds (equity) or borrowed money (debt).
  - Returns on projects should be measured based on **cash flows generated** and the **timing** of these cash flows; they should also consider both **positive and negative side effects** of these projects.

- Choose a **financing mix** that **minimizes the hurdle rate and matches the assets** being financed.

- If there are not enough investments that earn the hurdle rate, **return the cash** to stockholders.
  - The **form of returns** - dividends and stock buybacks - will depend upon the **stockholders’ characteristics**.

**Objective: Maximize the Value of the Firm**
Discounted Cashflow Valuation: Basis for Approach

Value = \sum_{t=1}^{t=n} \frac{CF_t}{(1 + r)^t}

- where,
- n = Life of the asset
- CF_t = Cashflow in period t
- r = Discount rate reflecting the riskiness of the estimated cashflows
Equity Valuation versus Firm Valuation

- value just the equity stake in the business
- value the entire firm, which includes, besides equity, the other claimholders in the firm
I. Equity Valuation

- The value of equity is obtained by discounting expected cashflows to equity, i.e., the residual cashflows after meeting all expenses, tax obligations and interest and principal payments, at the cost of equity, i.e., the rate of return required by equity investors in the firm.

\[
\text{Value of Equity} = \sum_{t=1}^{n} \frac{\text{CF to Equity}_t}{(1 + k_e)^t}
\]

where,
- \( \text{CF to Equity}_t \) = Expected Cashflow to Equity in period \( t \)
- \( k_e \) = Cost of Equity

- The dividend discount model is a specialized case of equity valuation, and the value of a stock is the present value of expected future dividends.
II. Firm Valuation

The value of the firm is obtained by discounting expected cashflows to the firm, i.e., the residual cashflows after meeting all operating expenses and taxes, but prior to debt payments, at the weighted average cost of capital, which is the cost of the different components of financing used by the firm, weighted by their market value proportions.

\[
\text{Value of Firm} = \sum_{t=1}^{n} \frac{\text{CF to Firm}_t}{(1 + \text{WACC})^t}
\]

where,

- \( \text{CF to Firm}_t \) = Expected Cashflow to Firm in period \( t \)
- \( \text{WACC} \) = Weighted Average Cost of Capital
Equity versus Firm Valuation

It is often argued that equity valuation requires more assumptions than firm valuation, because cash flows to equity require explicit assumptions about changes in leverage whereas cash flows to the firm are pre-debt cash flows and do not require assumptions about leverage. Is this true?

- Yes
- No
First Principle of Valuation

- Never mix and match cash flows and discount rates.
- The key error to avoid is mismatching cashflows and discount rates, since discounting cashflows to equity at the weighted average cost of capital will lead to an upwardly biased estimate of the value of equity, while discounting cashflows to the firm at the cost of equity will yield a downward biased estimate of the value of the firm.
Valuation: The Key Inputs

- A publicly traded firm potentially has an infinite life. The value is therefore the present value of cash flows forever.

\[
\text{Value} = \sum_{t=1}^{\infty} \frac{CF_t}{(1+r)^t}
\]

- Since we cannot estimate cash flows forever, we estimate cash flows for a “growth period” and then estimate a terminal value, to capture the value at the end of the period:

\[
\text{Value} = \sum_{t=1}^{N} \frac{CF_t}{(1+r)^t} + \frac{\text{Terminal Value}}{(1+r)^N}
\]
Stable Growth and Terminal Value

- When a firm’s cash flows grow at a “constant” rate forever, the present value of those cash flows can be written as:
  \[ \text{Value} = \frac{\text{Expected Cash Flow Next Period}}{(r - g)} \]
  where,
  \[ r = \text{Discount rate (Cost of Equity or Cost of Capital)} \]
  \[ g = \text{Expected growth rate} \]

- This “constant” growth rate is called a stable growth rate and cannot be higher than the growth rate of the economy in which the firm operates.

- While companies can maintain high growth rates for extended periods, they will all approach “stable growth” at some point in time.

- When they do approach stable growth, the valuation formula above can be used to estimate the “terminal value” of all cash flows beyond.
A key assumption in all discounted cash flow models is the period of high growth, and the pattern of growth during that period. In general, we can make one of three assumptions:

- there is no high growth, in which case the firm is already in stable growth
- there will be high growth for a period, at the end of which the growth rate will drop to the stable growth rate (2-stage)
- there will be high growth for a period, at the end of which the growth rate will decline gradually to a stable growth rate (3-stage)

The assumption of how long high growth will continue will depend upon several factors including:

- the size of the firm (larger firm -> shorter high growth periods)
- current growth rate (if high -> longer high growth period)
- barriers to entry and differential advantages (if high -> longer growth period)
Assume that you are analyzing two firms, both of which are enjoying high growth. The first firm is Earthlink Network, an internet service provider, which operates in an environment with few barriers to entry and extraordinary competition. The second firm is Biogen, a biotechnology firm which is enjoying growth from two drugs to which it owns patents for the next decade. Assuming that both firms are well managed, which of the two firms would you expect to have a longer high growth period?

- Earthlink Network
- Biogen
- Both are well managed and should have the same high growth period
### Choosing a Growth Pattern: Examples

<table>
<thead>
<tr>
<th>Company</th>
<th>Valuation in</th>
<th>Growth Period</th>
<th>Stable Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disney</td>
<td>Nominal U.S. $ Firm</td>
<td>10 years (3-stage)</td>
<td>5% (long term nominal growth rate in the U.S. economy)</td>
</tr>
<tr>
<td>Aracruz</td>
<td>Real BR Equity: FCFE</td>
<td>5 years (2-stage)</td>
<td>5%: based upon expected long term real growth rate for Brazilian economy</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>Nominal DM Equity: Dividends</td>
<td>0 years</td>
<td>5%: set equal to nominal growth rate in the world economy</td>
</tr>
</tbody>
</table>
### The Building Blocks of Valuation

#### Choose a Cash Flow

<table>
<thead>
<tr>
<th>Dividends</th>
<th>Cashflows to Equity</th>
<th>Cashflows to Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected Dividends to Stockholders</td>
<td>Net Income - (1 - ( \delta )) (Capital Exp. - Deprec’n) - (1 - ( \delta )) Change in Work. Capital = Free Cash flow to Equity (FCFE) ([\delta = \text{Debt Ratio}])</td>
<td>EBIT (1 - tax rate) - (Capital Exp. - Deprec’n) - Change in Work. Capital = Free Cash flow to Firm (FCFF)</td>
</tr>
</tbody>
</table>

#### & A Discount Rate

<table>
<thead>
<tr>
<th>Cost of Equity</th>
<th>Cost of Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>• <em>Basis:</em> The riskier the investment, the greater is the cost of equity.</td>
<td>WACC = ( k_e \left( \frac{E}{D+E} \right) ) + ( k_d \left( \frac{D}{D+E} \right) )</td>
</tr>
<tr>
<td>• <em>Models:</em> CAPM: Riskfree Rate + Beta (Risk Premium)</td>
<td>( k_d = \text{Current Borrowing Rate (1-t)} )</td>
</tr>
<tr>
<td>APM: Riskfree Rate + ( \sum ) Beta ( _j ) (Risk Premium): ( n \text{ factors} )</td>
<td>E,D: Mkt Val of Equity and Debt</td>
</tr>
</tbody>
</table>

#### & a growth pattern

<table>
<thead>
<tr>
<th>Stable Growth</th>
<th>Two-Stage Growth</th>
<th>Three-Stage Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>( g )</td>
<td>( g )</td>
<td>( g )</td>
</tr>
<tr>
<td>High Growth</td>
<td>Stable</td>
<td>High Growth Transition Stable</td>
</tr>
</tbody>
</table>
Estimating Inputs: Discount Rates

- **Critical ingredient** in discounted cashflow valuation. Errors in estimating the discount rate or mismatching cashflows and discount rates can lead to serious errors in valuation.
- At an intuitive level, the discount rate used should be consistent with both the **riskiness** and the **type of cashflow** being discounted.
I. Cost of Equity

- The cost of equity is the rate of return that investors require to make an equity investment in a firm. There are two approaches to estimating the cost of equity;
  - a risk and return model
  - a dividend-growth model.

- Using the CAPM, for instance, gives you a cost of equity based upon the beta of the equity in the firm.
Estimating Aracruz’s Bottom Up Beta

- Average Unlevered Beta for Paper and Pulp firms is 0.61
- Aracruz has a cash balance which was 20% of the market value in 1997, which is much higher than the typical cash balance at other paper and pulp firms. The beta of cash is zero.
  
  Unlevered Beta for Aracruz = \((0.8) \times 0.61\) + \(0.2 \times 0\) = 0.488

- Using Aracruz’s gross debt equity ratio of 66.67% and a tax rate of 33%:
  
  Levered Beta for Aracruz = 0.49 \(\times (1+ (1-.33) \times 0.6667)\) = 0.71

- Cost of Equity for Aracruz = Real Riskfree Rate + Beta(Premium)
  
  = 5\% + 0.71 \times (7.5\%) = 10.33\%

Real Riskfree Rate = 5\% (Long term Growth rate in Brazilian economy)
Risk Premium = 7.5\% (U.S. Premium + Brazil Risk (from rating))
Deutsche Bank is in two different segments of business - commercial banking and investment banking.

To estimate its commercial banking beta, we will use the average beta of commercial banks in Germany.

To estimate the investment banking beta, we will use the average beta of investment banks in the U.S and U.K.

### Comparable Firms

<table>
<thead>
<tr>
<th></th>
<th>Average Beta</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Banks in Germany</td>
<td>0.90</td>
<td>90%</td>
</tr>
<tr>
<td>U.K. and U.S. investment banks</td>
<td>1.30</td>
<td>10%</td>
</tr>
</tbody>
</table>

Beta for Deutsche Bank = 0.9 (.90) + 0.1 (1.30) = 0.94

Cost of Equity for Deutsche Bank (in DM) = 7.5% + 0.94 (5.5%)

= 12.67%
II. Cost of Capital

- It will depend upon:
  - (a) the components of financing: Debt, Equity or Preferred stock
  - (b) the cost of each component

- In summary, the cost of capital is the cost of each component weighted by its relative market value.

- \[ WACC = k_e \left( \frac{E}{D+E} \right) + k_d \left( \frac{D}{D+E} \right) \]
### Reviewing Disney’s Costs of Equity & Debt

<table>
<thead>
<tr>
<th>Business</th>
<th>Unlevered D/E Ratio Beta</th>
<th>Levered Beta</th>
<th>Riskfree Rate</th>
<th>Risk Premium</th>
<th>Cost of Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Creative Content</td>
<td>1.25</td>
<td>22.23%</td>
<td>1.43</td>
<td>7.00%</td>
<td>5.50%</td>
</tr>
<tr>
<td>Retailing</td>
<td>1.5</td>
<td>22.23%</td>
<td>1.71</td>
<td>7.00%</td>
<td>5.50%</td>
</tr>
<tr>
<td>Broadcasting</td>
<td>0.9</td>
<td>22.23%</td>
<td>1.03</td>
<td>7.00%</td>
<td>5.50%</td>
</tr>
<tr>
<td>Theme Parks</td>
<td>1.1</td>
<td>22.23%</td>
<td>1.26</td>
<td>7.00%</td>
<td>5.50%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>0.7</td>
<td>22.23%</td>
<td>0.80</td>
<td>7.00%</td>
<td>5.50%</td>
</tr>
<tr>
<td>Disney</td>
<td>1.09</td>
<td>22.23%</td>
<td>1.25</td>
<td>7.00%</td>
<td>5.50%</td>
</tr>
</tbody>
</table>

- Disney’s Cost of Debt (based upon rating) = 7.50%
Estimating Cost of Capital: Disney

- **Equity**
  - Cost of Equity = 13.85%
  - Market Value of Equity = $54.88 Billion
  - Equity/(Debt+Equity) = 82%

- **Debt**
  - After-tax Cost of debt = 7.50% (1-.36) = 4.80%
  - Market Value of Debt = $11.18 Billion
  - Debt/(Debt+Equity) = 18%

- **Cost of Capital** = 13.85%(.82)+4.80%(.18) = 12.22%
Estimating FCFE when Leverage is Stable: Review

Net Income
- \((1 - \delta) \) (Capital Expenditures - Depreciation)
- \((1 - \delta)\) Working Capital Needs
= Free Cash flow to Equity

\(\delta = \text{Debt/Capital Ratio}\)

For this firm,
- Proceeds from new debt issues = Principal Repayments + \(d\) (Capital Expenditures - Depreciation + Working Capital Needs)
Estimating FCFE next year: Aracruz

All inputs are per share numbers:

- Earnings: Since Aracruz’s 1996 earnings are “abnormally” low, I used the average earnings per share from 1992 to 1996.
- Capital Expenditures per share next year = 0.24 BR/share
- Depreciation per share next year = 0.18 BR/share
- Change in Working Capital = 0.03 BR/share
- Debt Ratio = 39%

Earnings = BR 0.222
- (CapEx-Depreciation)*(1-DR) = BR 0.042
- Chg. Working Capital*(1-DR) = BR 0.010

Free Cashflow to Equity = BR 0.170
# Cashflow to Firm

<table>
<thead>
<tr>
<th>Claimholder</th>
<th>Cash flows to claimholder</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Investors</td>
<td>Free Cash flow to Equity</td>
</tr>
<tr>
<td>Debt Holders</td>
<td>Interest Expenses (1 - tax rate) + Principal Repayments - New Debt Issues</td>
</tr>
<tr>
<td>Preferred Stockholders</td>
<td>Preferred Dividends</td>
</tr>
<tr>
<td>Firm</td>
<td>Free Cash flow to Firm =</td>
</tr>
<tr>
<td>Equity Investors</td>
<td>Free Cash flow to Equity</td>
</tr>
<tr>
<td>+ Debt Holders</td>
<td>+ Interest Expenses (1- tax rate)</td>
</tr>
<tr>
<td>+ Preferred Stockholders</td>
<td>+ Principal Repayments</td>
</tr>
<tr>
<td></td>
<td>- New Debt Issues</td>
</tr>
<tr>
<td></td>
<td>+ Preferred Dividends</td>
</tr>
</tbody>
</table>
A Simpler Approach

EBIT (1 - tax rate)
+ Depreciation
- Capital Spending
- Change in Working Capital
= Cash flow to the firm
Estimating FCFF: Disney

- EBIT = $5,559 Million
- Capital spending = $1,746 Million
- Depreciation = $1,145 Million
- Non-cash Working capital Change = $617 Million
- Estimating FCFF

\[
\begin{align*}
\text{EBIT (1-t)} & : \quad $3,558 \\
+ \text{Depreciation} & : \quad $1,134 \\
- \text{Capital Expenditures} & : \quad $1,746 \\
- \text{Change in WC} & : \quad $617 \\
= \text{FCFF} & : \quad $2,329 \text{ Million}
\end{align*}
\]
Expected Growth in EPS

\[
g_{\text{EPS}} = \text{Retained Earnings}_{t-1}/\text{NI}_{t-1} \times \text{ROE}
\]

\[
= \text{Retention Ratio} \times \text{ROE}
\]

\[
= b \times \text{ROE}
\]

• Proposition 1: The expected growth rate in earnings for a company cannot exceed its return on equity in the long term.
Estimating Expected Growth in EPS: Disney, Aracruz and Deutsche Bank

<table>
<thead>
<tr>
<th>Company</th>
<th>ROE</th>
<th>Retention Exp. Ratio</th>
<th>Forecast Retention Growth</th>
<th>Exp ROE</th>
<th>Retention Ratio</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disney</td>
<td>24.95%</td>
<td>77.68%</td>
<td>19.38%</td>
<td>25%</td>
<td>77.68%</td>
<td>19.42%</td>
</tr>
<tr>
<td>Aracruz</td>
<td>2.22%</td>
<td>65.00%</td>
<td>1.44%</td>
<td>13.91%</td>
<td>65.00%</td>
<td>9.04%</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>7.25%</td>
<td>39.81%</td>
<td>2.89%</td>
<td>14.00%</td>
<td>45.00%</td>
<td>6.30%</td>
</tr>
</tbody>
</table>

ROE: Return on Equity for most recent year

Forecasted ROE = Expected ROE for the next 5 years

- For Disney, forecasted ROE is expected to be close to current ROE
- For Aracruz, the average ROE between 1994 and 1996 is used, since 1996 was an abnormally bad year
- For Deutsche Bank, the forecast ROE is set equal to the average ROE for German banks
Growth and ROE

- You attempting to estimate expected growth for The Gap and J.P. Morgan. The Gap has a return on equity of 25% and pays out 30% of its earnings as dividends. J.P. Morgan has a return on equity of 15% and pays out 50% of its earnings as dividends. Estimate the expected growth rate for each of these companies –

  - The Gap’s expected growth =
  - J.P. Morgan’s expected growth =
  - What is the ceiling on the expected growth?
ROE and Leverage

- ROE = ROC + D/E (ROC - i (1-t))
  
  where,
  
  ROC = (Net Income + Interest (1 - tax rate)) / BV of Capital
  
  = EBIT (1- t) / BV of Capital
  
  D/E = BV of Debt/ BV of Equity
  
  i = Interest Expense on Debt / BV of Debt
  
  t = Tax rate on ordinary income

- Note that BV of Assets = BV of Debt + BV of Equity.
Growth and Leverage: An example

Assume that you estimating the effect of a recent restructuring at Rubbermaid on expected growth. Rubbermaid has a return on assets of 18%, has no leverage and pays out 20% of its earnings as dividends. It is planning to sell of low-return assets and increase its return on assets to 20%, increase its debt equity ratio to 25% and pay 30% of its earnings as dividends. The tax rate is 40%, and the pre-tax borrowing rate is 10%. Estimate the growth rate before and after restructuring:

- $E(\text{growth})$ before restructuring =
- $E(\text{growth})$ after restructuring =
- Does the higher growth automatically mean that the value of the stock will increase?
  - Yes
  - No
Decomposing ROE: Disney in 1996

- **Return on Capital**
  \[ \text{Return on Capital} = \frac{\text{EBIT}(1-\text{tax rate})}{\text{BV: Debt + BV: Equity}} \]
  \[ = \frac{5559(1-.36)}{7663+11668} = 18.69\% \]

- **Debt Equity Ratio**
  \[ \text{Debt Equity Ratio} = \frac{\text{Debt}}{\text{Market Value of Equity}} = 45.00\% \]
  \[ = 8.98\% \]

- **Interest Rate on Debt** = 7.50\%

- **Expected Return on Equity** = ROC + D/E (ROC - i(1-t))
  \[ = 18.69\% + .45 (18.69\% - 7.50(1-.36)) = 24.95\% \]
Expected Growth in EBIT And Fundamentals

- Reinvestment Rate and Return on Capital
  \[ g_{\text{EBIT}} = \frac{(\text{Net Capital Expenditures} + \text{Change in WC})}{\text{EBIT}(1-t)} * \text{ROC} \]
  \[ = \text{Reinvestment Rate} * \text{ROC} \]

- Proposition 2: No firm can expect its operating income to grow over time without reinvesting some of the operating income in net capital expenditures and/or working capital.

- Proposition 3: The net capital expenditure needs of a firm, for a given growth rate, should be inversely proportional to the quality of its investments.
Estimating Growth in EBIT: Disney

- Actual reinvestment rate in 1996 = Net Cap Ex/ EBIT (1-t)
  - Net Cap Ex in 1996 = (1745-1134)
  - EBIT (1- tax rate) = 5559(1-.36)
  - Reinvestment Rate = (1745-1134)/(5559*.64)= 7.03%

- Forecasted Reinvestment Rate = 50%

- Real Return on Capital =18.69%

- Expected Growth in EBIT =.5(18.69%) = 9.35%

- The forecasted reinvestment rate is much higher than the actual reinvestment rate in 1996, because it includes projected acquisition. Between 1992 and 1996, adding in the Capital Cities acquisition to all capital expenditures would have yielded a reinvestment rate of roughly 50%.
The No Net Cap Ex Assumption

- Many analysts assume that capital expenditures offset depreciation, when doing valuation. Is it an appropriate assumption to make for a high growth firm?
  - Yes
  - No
- If the net cap ex is zero and there are no working capital requirements, what should the expected growth rate be?
Return on Capital, Profit Margin and Asset Turnover

- **Return on Capital**
  
  \[ \text{Return on Capital} = \frac{\text{EBIT} (1-t)}{\text{Total Assets}} \]
  
  \[ = \frac{\text{EBIT} (1-t)}{\text{Sales}} \times \frac{\text{Sales}}{\text{Total Assets}} \]
  
  \[ = \text{After-tax Operating Margin} \times \text{Asset Turnover} \]

- Thus, a firm can improve its return on capital in one of two ways:
  
  - It can increase its after-tax operating margin
  - It can improve its asset turnover, by selling more of the same asset base

- This is a useful way of thinking about
  
  - choosing between a low-price, high-volume strategy and a high-price, lower-volume strategy
  - the decision of whether to change price levels (decrease or increase) and the resulting effect on volume
## Firm Characteristics as Growth Changes

<table>
<thead>
<tr>
<th>Variable</th>
<th>High Growth Firms tend to</th>
<th>Stable Growth Firms tend to</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk</td>
<td>be above-average risk</td>
<td>be average risk</td>
</tr>
<tr>
<td>Dividend Payout</td>
<td>pay little or no dividends</td>
<td>pay high dividends</td>
</tr>
<tr>
<td>Net Cap Ex</td>
<td>have high net cap ex</td>
<td>have low net cap ex</td>
</tr>
<tr>
<td>Return on Capital</td>
<td>earn high ROC (excess return)</td>
<td>earn ROC closer to WACC</td>
</tr>
<tr>
<td>Leverage</td>
<td>have little or no debt</td>
<td>higher leverage</td>
</tr>
</tbody>
</table>
Estimating Stable Growth Inputs

- Start with the fundamentals:
  - Profitability measures such as return on equity and capital, in stable growth, can be estimated by looking at
    - industry averages for these measures, in which case we assume that this firm in stable growth will look like the average firm in the industry
    - cost of equity and capital, in which case we assume that the firm will stop earning excess returns on its projects as a result of competition.
  - Leverage is a tougher call. While industry averages can be used here as well, it depends upon how entrenched current management is and whether they are stubborn about their policy on leverage (If they are, use current leverage; if they are not; use industry averages)

- Use the relationship between growth and fundamentals to estimate payout and net capital expenditures.
Estimate Stable Period Payout

\[ g_{\text{EPS}} = \frac{\text{Retained Earnings}_{t-1}}{\text{NI}_{t-1}} \times \text{ROE} \]
\[ = \text{Retention Ratio} \times \text{ROE} \]
\[ = b \times \text{ROE} \]

Moving terms around,

Retention Ratio = \[ g_{\text{EPS}} / \text{ROE} \]

Payout Ratio = 1 - Retention Ratio = 1 - \[ g_{\text{EPS}} / \text{ROE} \]
Estimating Stable Period Net Cap Ex

\[ g_{EBIT} = \frac{(\text{Net Capital Expenditures} + \text{Change in WC})}{\text{EBIT}(1-t)} \times \text{ROC} \]
\[ = \text{Reinvestment Rate} \times \text{ROC} \]

- Moving terms around,

Reinvestment Rate = \( g_{EBIT} / \text{Return on Capital} \)

- For instance, assume that Disney in stable growth will grow 5% and that its return on capital in stable growth will be 16%. The reinvestment rate will then be:

Reinvestment Rate for Disney in Stable Growth = \( \frac{5}{16} = 31.25\% \)

- In other words,
  - the net capital expenditures and working capital investment each year during the stable growth period will be 31.25\% of after-tax operating income.
The Importance of Terminal Value

- The bulk of the present value in most discounted cash flow valuations comes from the terminal value. Therefore, it is reasonable to conclude that the assumptions about growth during the high growth period do not affect value as much as assumptions about the terminal price.

- True
- False
- Explain.
Valuation: Deutsche Bank

- Sustainable growth at Deutsche Bank = ROE * Retention Ratio
  \[ = 14\% \times 0.3891 = 6.30\% \]

- Cost of equity = 7.5\% + 0.94 \times 5.5\% = 12.67\%.

- Model Used:
  - Stable Growth (Large firm; Growth is close to stable growth already)
  - Dividend Discount Model (FCFE is tough to estimate)

- Valuation
  - Expected Dividends per Share next year = 4.27 DM \times 1.063 \times 0.6109 = 2.73 DM
  - Value per Share = 2.73 DM / (0.1267 - 0.06) = 42.89 DM

- Deutsche Bank was trading for 119 DM on the day of this analysis.
What does the valuation tell us?

- Stock is tremendously overvalued: This valuation would suggest that Deutsche Bank is significantly overvalued, given our estimates of expected growth and risk.
- Dividends may not reflect the cash flows generated by Deutsche Bank. The FCFE could have been significantly higher than the dividends paid.
- Estimates of growth and risk are wrong: It is also possible that we have underestimated growth or overestimated risk in the model, thus reducing our estimate of value.
Dividend Discount Model: A Visual Perspective

Risk: Beta
1.15

Profitability Measure
ROE
14.30%

Dividend Decisions (Payout)
40.00%

Expected Return = Riskfree Rate + Beta*Risk Premium
12.83% = 6.5% + 1.15(5.5%)

Current Earnings
$6.80

Expected Growth
\[ g = (1 - \text{Payout})(\text{ROA} + \text{D/E}(\text{ROA} - i)) \]
8.59% = (1 - 0.4) (14.30%)

Future Earnings
$6.80 growing at 8.58%

Payout Ratio
40.00%

Value of Stock = Present Value of Dividends
PV = $66.97

\[
\begin{align*}
\text{DPS}_1 & = $2.95 \\
\text{DPS}_2 & = $3.21 \\
\text{DPS}_3 & = $3.48 \\
\text{DPS}_4 & = $3.78 \\
\text{DPS}_5 & = $4.11 \\
\text{...... forever} & \\
\end{align*}
\]

Year 1 Year 2 Year 3 Year 4 Year 5

VALUING J.P. MORGAN: July 1995
The current earnings per share for Aracruz Cellulose is 0.044 BR.

These earnings are abnormally low. To normalize earnings, we use the average earnings per share between 1994 and 1996 of 0.204 BR per share as a measure of the normalized earnings per share.

Model Used:
- Real valuation (since inflation is still in double digits)
- 2-Stage Growth (Firm is still growing in a high growth economy)
- FCFE Discount Model (Dividends are lower than FCFE: See Dividend section)
**Aracruz Cellulose: Inputs for Valuation**

<table>
<thead>
<tr>
<th>High Growth Phase</th>
<th>Stable Growth Phase</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Length</strong></td>
<td>5 years</td>
</tr>
<tr>
<td><strong>Expected Growth</strong></td>
<td>Retention Ratio * ROE</td>
</tr>
<tr>
<td></td>
<td>= 0.65% * 13.91% = 8.18%</td>
</tr>
<tr>
<td><strong>Cost of Equity</strong></td>
<td>5% + 0.72 (7.5%) = 10.40%</td>
</tr>
<tr>
<td></td>
<td>(Beta = 0.72; R_f = 5%)</td>
</tr>
<tr>
<td><strong>Net Capital Expenditures</strong></td>
<td>Net capital ex grows at same rate as earnings. In 1996, the capital ex was 0.24 BR and deprec’n was 0.18 BR.</td>
</tr>
<tr>
<td><strong>Working Capital</strong></td>
<td>32.15% of Revenues; Revenues grow at same rate as earnings in both periods.</td>
</tr>
<tr>
<td><strong>Debt Ratio</strong></td>
<td>39.01% of net capital ex and working capital investments come from debt.</td>
</tr>
</tbody>
</table>
## Aracruz: Estimating FCFE for next 5 years

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>Terminal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings</td>
<td>BR 0.222</td>
<td>BR 0.243</td>
<td>BR 0.264</td>
<td>BR 0.288</td>
<td>BR 0.314</td>
<td>BR 0.330</td>
</tr>
<tr>
<td>- (CapEx-Depreciation)*(1-DR)</td>
<td>BR 0.042</td>
<td>BR 0.046</td>
<td>BR 0.050</td>
<td>BR 0.055</td>
<td>BR 0.060</td>
<td>BR 0.052</td>
</tr>
<tr>
<td>-Chg. Working Capital*(1-DR)</td>
<td>BR 0.010</td>
<td>BR 0.011</td>
<td>BR 0.012</td>
<td>BR 0.013</td>
<td>BR 0.014</td>
<td>BR 0.008</td>
</tr>
<tr>
<td>Free Cashflow to Equity</td>
<td>BR 0.170</td>
<td>BR 0.186</td>
<td>BR 0.202</td>
<td>BR 0.221</td>
<td>BR 0.241</td>
<td>BR 0.269</td>
</tr>
<tr>
<td>Present Value</td>
<td>BR 0.154</td>
<td>BR 0.152</td>
<td>BR 0.150</td>
<td>BR 0.149</td>
<td>BR 0.147</td>
<td></td>
</tr>
</tbody>
</table>

The present value is computed by discounting the FCFE at the current cost of equity of 10.33%.
Aracruz: Estimating Terminal Price and Value per share

- The terminal value at the end of year 5 is estimated using the FCFE in the terminal year.
  - The FCFE in year 6 reflects the drop in net capital expenditures after year 5.
- Terminal Value = $0.269 / (0.125 - 0.05) = 3.59$ BR
- Value per Share = $0.154 + 0.152 + 0.150 + 0.149 + 0.147 + 3.59 / 1.104^5 = 2.94$ BR
- The stock was trading at 2.40 BR in September 1997.
- The value per share is based upon normalized earnings. To the extent that it will take some time to get normalized earnings, discount this value per share back to the present at the cost of equity of 10.33%.
The FCFE Model: A Visual Perspective

THE VALUE OF EQUITY IN NCR

< Uncertainty associated with extraordinary items
Rating Constraint ->

< Int. Rate & Default Risk
Earnings Stability Constraints ->

< Project Risk
Desire for Dividend Stability

Total Risk
Market Risk
Firm-Specific Risk
Cost of Equity
k_e = R_f + β(Risk Premium)
= 9.9% + 1.15*5.5% = 15.33%
Discount Rate

Beta 1.15

Dividend Decisions (Payout=1-b)
Current EPS $5.43

Investment Decisions (ROA)
Expected Growth Rate
g = b (ROA + D/E (ROA - i))

Financing Decisions (D/E)
Current Net CapEx
Extraordinary Items
- Currency Changes
- Interest Rate Changes
- Warrant/Option Exercise
- Pension Liabilities

Extraordinary Gains/Losses

D/(D+E)

Cost of Equity

Discount Rate

Beta=1.00
Growth =6%
CapEx is 120% of Depr

Expected Future Cash Flows

Value Per Share
= PV of DPS + PV of Terminal Price
= PV of FCFE + PV of Terminal Price
$54.50

Terminal Price

Expected Growth Rate
g = b (ROA + D/E (ROA - i))

Current Net CapEx

Year
Expected EPS
Net CapEx
Chg. WC
Extraordinary Gains/Losses
FCFE/share
1
2
3
4
5
TYr

β = 1.00
Growth = 5%
CapEx is 120% of Depr

P_n = $7.63 / (1.145 - .06)
= $89.72

Net CapEx

Trend

Expected Future Cash Flows

Alpha = 0.74
Terminal Price

Value Per Share
= PV of DPS + PV of Terminal Price
= PV of FCFE + PV of Terminal Price
$54.50
Most firms can be valued using FCFE and DDM valuation models. Which of the following statements would you most agree with on the relationship between these two values?

- The FCFE value will always be higher than the DDM value
- The FCFE value will usually be higher than the DDM value
- The DDM value will usually be higher than the FCFE value
- The DDM value will generally be equal to the FCFE value
Disney Valuation

- Model Used:
  - Cash Flow: FCFF (since I think leverage will change over time)
  - Growth Pattern: 3-stage Model (even though growth in operating income is only 10%, there are substantial barriers to entry)
## Disney: Inputs to Valuation

<table>
<thead>
<tr>
<th></th>
<th><strong>High Growth Phase</strong></th>
<th><strong>Transition Phase</strong></th>
<th><strong>Stable Growth Phase</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Length of Period</strong></td>
<td>5 years</td>
<td>5 years</td>
<td>Forever after 10 years</td>
</tr>
<tr>
<td><strong>Revenues</strong></td>
<td>Current Revenues: $18,739; Expected to grow at same rate as operating earnings</td>
<td>Continues to grow at same rate as operating earnings</td>
<td>Grows at stable growth rate</td>
</tr>
<tr>
<td><strong>Pre-tax Operating Margin</strong></td>
<td>29.67% of revenues, based upon 1996 EBIT of $5,559 million.</td>
<td>Increases gradually to 32% of revenues, due to economies of scale.</td>
<td>Stable margin is assumed to be 32%.</td>
</tr>
<tr>
<td><strong>Tax Rate</strong></td>
<td>36%</td>
<td>36%</td>
<td>36%</td>
</tr>
<tr>
<td><strong>Return on Capital</strong></td>
<td>20% (approximately 1996 level)</td>
<td>Declines linearly to 16%</td>
<td>Stable ROC of 16%</td>
</tr>
<tr>
<td><strong>Working Capital</strong></td>
<td>5% of Revenues</td>
<td>5% of Revenues</td>
<td>5% of Revenues</td>
</tr>
<tr>
<td><strong>Reinvestment Rate</strong></td>
<td>50% of after-tax operating income; Depreciation in 1996 is $1,134 million, and is assumed to grow at same rate as earnings</td>
<td>Declines to 31.25% as ROC and growth rates drop; Reinvestment Rate = g/ROC</td>
<td>31.25% of after-tax operating income; this is estimated from the growth rate of 5% Reinvestment rate = g/ROC</td>
</tr>
<tr>
<td><strong>Expected Growth Rate in EBIT</strong></td>
<td>ROC * Reinvestment Rate = 20% * .5 = 10%</td>
<td>Linear decline to Stable Growth Rate</td>
<td>5%, based upon overall nominal economic growth</td>
</tr>
<tr>
<td><strong>Debt/Capital Ratio</strong></td>
<td>18%</td>
<td>Increases linearly to 30%</td>
<td>Stable debt ratio of 30%</td>
</tr>
<tr>
<td><strong>Risk Parameters</strong></td>
<td>Beta = 1.25, k_e = 13.88% Cost of Debt = 7.5% (Long Term Bond Rate = 7%)</td>
<td>Beta decreases linearly to 1.00; Cost of debt stays at 7.5%</td>
<td>Stable beta is 1.00. Cost of debt stays at 7.5%</td>
</tr>
</tbody>
</table>
## Disney: FCFF Estimates

<table>
<thead>
<tr>
<th></th>
<th>Base</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Expected Growth</strong></td>
<td></td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>9%</td>
<td>8%</td>
<td>7%</td>
<td>6%</td>
<td>5%</td>
</tr>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td>$18,739</td>
<td>$20,613</td>
<td>$22,674</td>
<td>$24,942</td>
<td>$30,179</td>
<td>$32,895</td>
<td>$35,527</td>
<td>$38,014</td>
<td>$40,295</td>
<td>$42,310</td>
</tr>
<tr>
<td><strong>Oper. Margin</strong></td>
<td></td>
<td>29.67%</td>
<td>29.67%</td>
<td>29.67%</td>
<td>29.67%</td>
<td>29.67%</td>
<td>30.13%</td>
<td>30.60%</td>
<td>31.07%</td>
<td>31.53%</td>
<td>32.00%</td>
</tr>
<tr>
<td><strong>EBIT</strong></td>
<td></td>
<td>$5,559</td>
<td>$6,115</td>
<td>$6,726</td>
<td>$7,399</td>
<td>$8,139</td>
<td>$8,953</td>
<td>$9,912</td>
<td>$10,871</td>
<td>$11,809</td>
<td>$12,706</td>
</tr>
<tr>
<td><strong>EBIT (1-t)</strong></td>
<td></td>
<td>$3,558</td>
<td>$3,914</td>
<td>$4,305</td>
<td>$4,735</td>
<td>$5,209</td>
<td>$5,730</td>
<td>$6,344</td>
<td>$6,957</td>
<td>$7,558</td>
<td>$8,152</td>
</tr>
<tr>
<td>+ Depreciation</td>
<td></td>
<td>$1,134</td>
<td>$1,247</td>
<td>$1,372</td>
<td>$1,509</td>
<td>$1,660</td>
<td>$1,826</td>
<td>$2,009</td>
<td>$2,210</td>
<td>$2,431</td>
<td>$2,674</td>
</tr>
<tr>
<td>- Capital Exp.</td>
<td></td>
<td>$1,754</td>
<td>$3,101</td>
<td>$3,411</td>
<td>$3,752</td>
<td>$4,128</td>
<td>$4,540</td>
<td>$4,847</td>
<td>$5,103</td>
<td>$5,313</td>
<td>$5,464</td>
</tr>
<tr>
<td>- Change in WC</td>
<td></td>
<td>$94</td>
<td>$94</td>
<td>$103</td>
<td>$113</td>
<td>$125</td>
<td>$137</td>
<td>$136</td>
<td>$132</td>
<td>$124</td>
<td>$114</td>
</tr>
<tr>
<td>= FCFF</td>
<td></td>
<td>$1,779</td>
<td>$1,966</td>
<td>$2,163</td>
<td>$2,379</td>
<td>$2,617</td>
<td>$2,879</td>
<td>$3,370</td>
<td>$3,932</td>
<td>$4,552</td>
<td>$5,228</td>
</tr>
<tr>
<td><strong>ROC</strong></td>
<td></td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>19.2%</td>
<td>18.4%</td>
<td>17.6%</td>
<td>16.8%</td>
<td>16%</td>
</tr>
<tr>
<td><strong>Reinv. Rate</strong></td>
<td></td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
<td>46.875%</td>
<td>43.48%</td>
<td>39.77%</td>
<td>35.71%</td>
<td>31.25%</td>
</tr>
</tbody>
</table>
### Disney: Costs of Capital

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of Equity</td>
<td>13.88%</td>
<td>13.88%</td>
<td>13.88%</td>
<td>13.88%</td>
<td>13.88%</td>
<td>13.60%</td>
<td>13.33%</td>
<td>13.05%</td>
<td>12.78%</td>
<td>12.50%</td>
</tr>
<tr>
<td>Cost of Debt</td>
<td>4.80%</td>
<td>4.80%</td>
<td>4.80%</td>
<td>4.80%</td>
<td>4.80%</td>
<td>4.80%</td>
<td>4.80%</td>
<td>4.80%</td>
<td>4.80%</td>
<td>4.80%</td>
</tr>
<tr>
<td>Debt Ratio</td>
<td>18.00%</td>
<td>18.00%</td>
<td>18.00%</td>
<td>18.00%</td>
<td>18.00%</td>
<td>20.40%</td>
<td>22.80%</td>
<td>25.20%</td>
<td>27.60%</td>
<td>30.00%</td>
</tr>
<tr>
<td>Cost of Capital</td>
<td>12.24%</td>
<td>12.24%</td>
<td>12.24%</td>
<td>12.24%</td>
<td>12.24%</td>
<td>11.80%</td>
<td>11.38%</td>
<td>10.97%</td>
<td>10.57%</td>
<td>10.19%</td>
</tr>
</tbody>
</table>
Disney: Terminal Value

- The terminal value at the end of year 10 is estimated based upon the free cash flows to the firm in year 11 and the cost of capital in year 11.
- \[ FCFF_{11} = EBIT (1-t) - EBIT (1-t) \text{ Reinvestment Rate} \]
  \[ = $13,539 (1.05)(1-.36) + $13,539 (1.05)(1-.36)(.3125) \]
  \[ = $6,255 \text{ million} \]
- Note that the reinvestment rate is estimated from the cost of capital of 16% and the expected growth rate of 5%.
- Cost of Capital in terminal year = 10.19%
- Terminal Value = \[ $6,255/(.1019 -.05) = $120,521 \text{ million} \]
## Disney: Present Value

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>FCFF</td>
<td>$1,966</td>
<td>$2,163</td>
<td>$2,379</td>
<td>$2,617</td>
<td>$2,879</td>
<td>$3,370</td>
<td>$3,932</td>
<td>$4,552</td>
<td>$5,228</td>
<td>$5,957</td>
</tr>
<tr>
<td>Term Value</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>120,521</td>
</tr>
<tr>
<td>Present Value</td>
<td>$1,752</td>
<td>$1,717</td>
<td>$1,682</td>
<td>$1,649</td>
<td>$1,616</td>
<td>$1,692</td>
<td>$1,773</td>
<td>$1,849</td>
<td>$1,920</td>
<td>42,167</td>
</tr>
<tr>
<td>Cost of Capital</td>
<td>12.24%</td>
<td>12.24%</td>
<td>12.24%</td>
<td>12.24%</td>
<td>12.24%</td>
<td>11.80%</td>
<td>11.38%</td>
<td>10.97%</td>
<td>10.57%</td>
<td>10.19%</td>
</tr>
</tbody>
</table>
Present Value Check

- The FCFF and costs of capital are provided for all 10 years. Confirm the present value of the FCFF in year 3.
The FCFF Model: A Visual Perspective

Risk: Beta 0.85

Cost of Equity: 5% + 0.85(7.5%) = 11.38%

Cost of Capital = Cost of Equity (E/(D+E)) + Cost of Debt (D/(D+E))
11.38%(.43)+3.74%(.57)=7.03%

Investment Decisions
Return on Capital 5.43%

Current EBIT(1-t) 488 Mil

Expected Growth
g = (Reinvestment Rate)(ROC)
= 0.6077(5.43%)
= 3.24%

Future EBIT (1-t) 488 mil growing 3.24%

Working Capital Needs: 21.21% of Revenues

Value of Firm = PV of FCFF
8711
Value of Equity = Firm Value - Debt=8711 - 4500 = 4211 mil
Per share: 30.39

Financial Decisions
(Debt Ratio) 57%

Net Capital Expenditures 202 Million

Reinvestment Rate = (NCex+Ch WC)/EBIT(1-t)
=60.77%

Cost of Capital =
Cost of Equity (E/(D+E)) +
Cost of Debt (D/(D+E))
11.38%(.43)+3.74%(.57)=7.03%

Cost of Debt :
Int. rate(1-t) 5.5%(1-.32)=3.74%

Reinvestment Rate = (NCex+Ch WC)/EBIT(1-t)
=60.77%

Financing Decisions

Expected Growth
g = (Reinvestment Rate)(ROC)
= 0.6077(5.43%)
= 3.24%

Future EBIT (1-t) 488 mil growing 3.24%

Working Capital Needs: 21.21% of Revenues

Value of Firm = PV of FCFF
8711
Value of Equity = Firm Value - Debt=8711 - 4500 = 4211 mil
Per share: 30.39

FCFF 1 FCFF 2 FCFF 3 FCFF 4 FCFF 5 ...... forever
262.43 270.93 279.70 288.75 298.10 10631

Year 1 Year 2 Year 3 Year 4 Year 5

VALUING CVRD: FCFF Model
Relative Valuation

In relative valuation, the value of an asset is derived from the pricing of 'comparable' assets, standardized using a common variable such as earnings, cashflows, book value or revenues. Examples include --

- Price/Earnings (P/E) ratios
- and variants (EBIT multiples, EBITDA multiples, Cash Flow multiples)
- Price/Book (P/BV) ratios
- and variants (Tobin's Q)
- Price/Sales ratios
Gordon Growth Model:

\[ P_0 = \frac{DPS}{r - g_n} \]

Dividing both sides by the earnings,

\[ \frac{P_0}{EPS_0} = PE = \frac{\text{Payout Ratio} \ast (1 + g_n)}{r - g_n} \]

Dividing both sides by the book value of equity,

\[ \frac{P_0}{BV_0} = PBV = \frac{\text{ROE} \ast \text{Payout Ratio} \ast (1 + g_n)}{r - g_n} \]

If the return on equity is written in terms of the retention ratio and the expected growth rate

\[ \frac{P_0}{BV_0} = PBV = \frac{\text{ROE} - g_n}{r - g_n} \]

Dividing by the Sales per share,

\[ \frac{P_0}{Sales_0} = PS = \frac{\text{Profit Margin} \ast \text{Payout Ratio} \ast (1 + g_n)}{r - g_n} \]
### Disney: Relative Valuation

<table>
<thead>
<tr>
<th>Company</th>
<th>PE</th>
<th>Expected Growth</th>
<th>PEG</th>
</tr>
</thead>
<tbody>
<tr>
<td>King World Productions</td>
<td>10.4</td>
<td>7.00%</td>
<td>1.49</td>
</tr>
<tr>
<td>Aztar</td>
<td>11.9</td>
<td>12.00%</td>
<td>0.99</td>
</tr>
<tr>
<td>Viacom</td>
<td>12.1</td>
<td>18.00%</td>
<td>0.67</td>
</tr>
<tr>
<td>All American Communications</td>
<td>15.8</td>
<td>20.00%</td>
<td>0.79</td>
</tr>
<tr>
<td>GC Companies</td>
<td>20.2</td>
<td>15.00%</td>
<td>1.35</td>
</tr>
<tr>
<td>Circus Circus Enterprises</td>
<td>20.8</td>
<td>17.00%</td>
<td>1.22</td>
</tr>
<tr>
<td>Polygram NV ADR</td>
<td>22.6</td>
<td>13.00%</td>
<td>1.74</td>
</tr>
<tr>
<td>Regal Cinemas</td>
<td>25.8</td>
<td>23.00%</td>
<td>1.12</td>
</tr>
<tr>
<td>Walt Disney</td>
<td>27.9</td>
<td>18.00%</td>
<td>1.55</td>
</tr>
<tr>
<td>AMC Entertainment</td>
<td>29.5</td>
<td>20.00%</td>
<td>1.48</td>
</tr>
<tr>
<td>Premier Parks</td>
<td>32.9</td>
<td>28.00%</td>
<td>1.18</td>
</tr>
<tr>
<td>Family Golf Centers</td>
<td>33.1</td>
<td>36.00%</td>
<td>0.92</td>
</tr>
<tr>
<td>CINAR Films</td>
<td>48.4</td>
<td>25.00%</td>
<td>1.94</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>27.44</strong></td>
<td><strong>18.56%</strong></td>
<td><strong>1.20</strong></td>
</tr>
</tbody>
</table>
Is Disney fairly valued?

- Based upon the PE ratio, is Disney under, over or correctly valued?
  - Under Valued
  - Over Valued
  - Correctly Valued
- Based upon the PEG ratio, is Disney under valued?
  - Under Valued
  - Over Valued
  - Correctly Valued
- Will this valuation give you a higher or lower valuation than the discounted CF valuation?
  - Higher
  - Lower
Relative Valuation Assumptions

- Assume that you are reading an equity research report where a buy recommendation for a company is being based upon the fact that its PE ratio is lower than the average for the industry. Implicitly, what is the underlying assumption or assumptions being made by this analyst?

- The sector itself is, on average, fairly priced
- The earnings of the firms in the group are being measured consistently
- The firms in the group are all of equivalent risk
- The firms in the group are all at the same stage in the growth cycle
- The firms in the group are of equivalent risk and have similar cash flow patterns
- All of the above
First Principles

- Invest in projects that **yield a return greater** than the **minimum acceptable hurdle rate**.
  - The hurdle rate should be **higher for riskier projects** and reflect the **financing mix** used - owners’ funds (equity) or borrowed money (debt).
  - Returns on projects should be measured based on **cash flows generated** and the **timing** of these cash flows; they should also consider both **positive** and **negative side effects** of these projects.

- Choose a **financing mix** that **minimizes the hurdle rate** and **matches the assets** being financed.

- If there are not enough investments that earn the hurdle rate, **return the cash** to stockholders.
  - The **form of returns** - dividends and stock buybacks - will depend upon the **stockholders’ characteristics**.

**Objective: Maximize the Value of the Firm**