THE FAT LADY IS SINGING: SPRING 2021

Aswath Damodaran

Ponderous Thoughts, or maybe not

1. There are few facts and lots of opinions.
   a. Even the givens (cash & risk free rate) are not.
   b. With accounting and market numbers, all bets are off.
2. The real world is a messy place.
   a. Money making firms can become money losers
   b. Companies can be restructured/ given facelifts
3. Models don't compute values and optimal paths. You do.
4. Change is the only constant. Everything changes all the time.

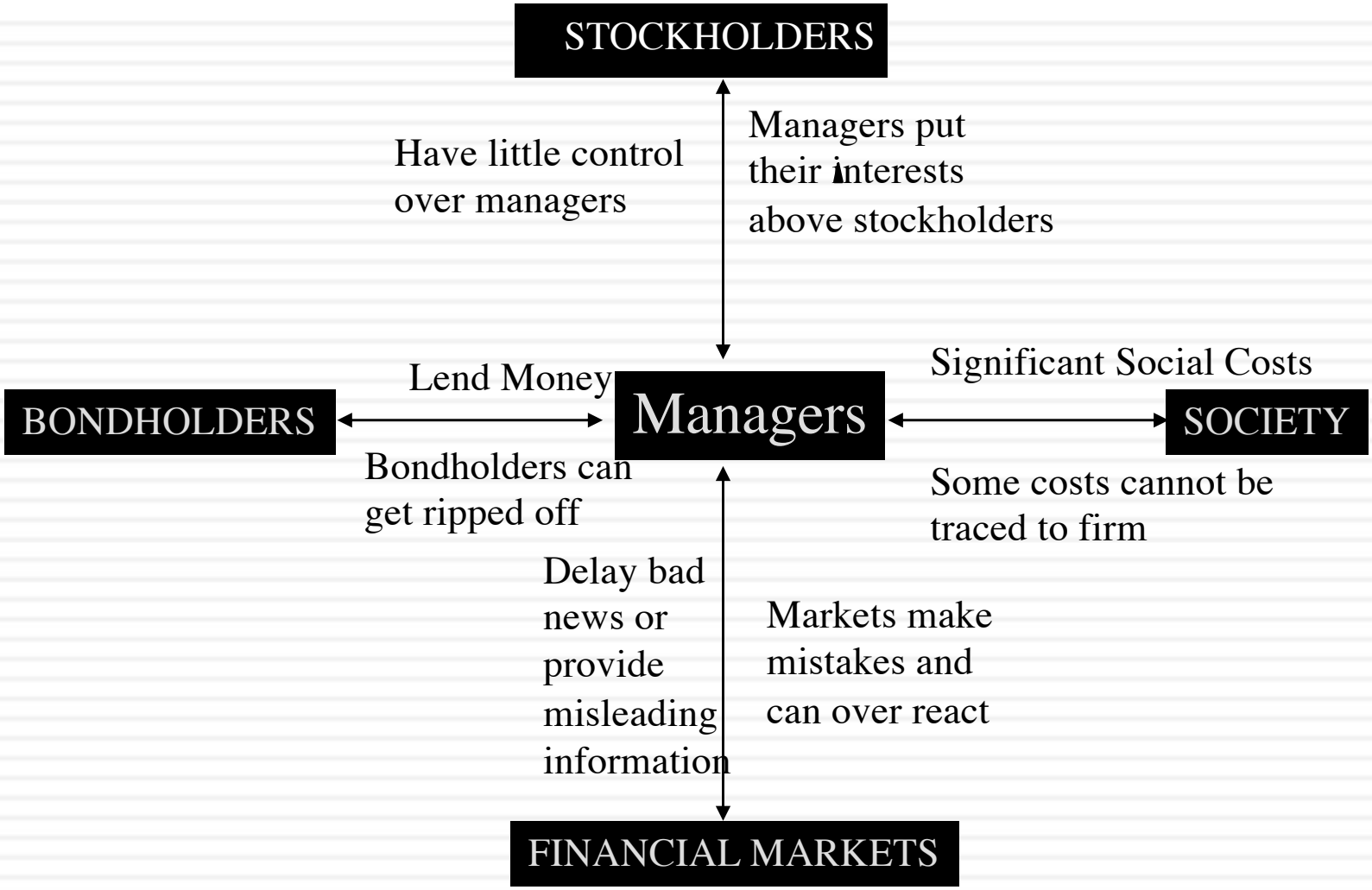
The most analyzed companies this semester were..

Company	Number of analyses
Netflix	6
Lululemon	5
Peloton	5
Square	5
IBM	3
Amazon	3
Costco, Shopify	3
Zoom	3

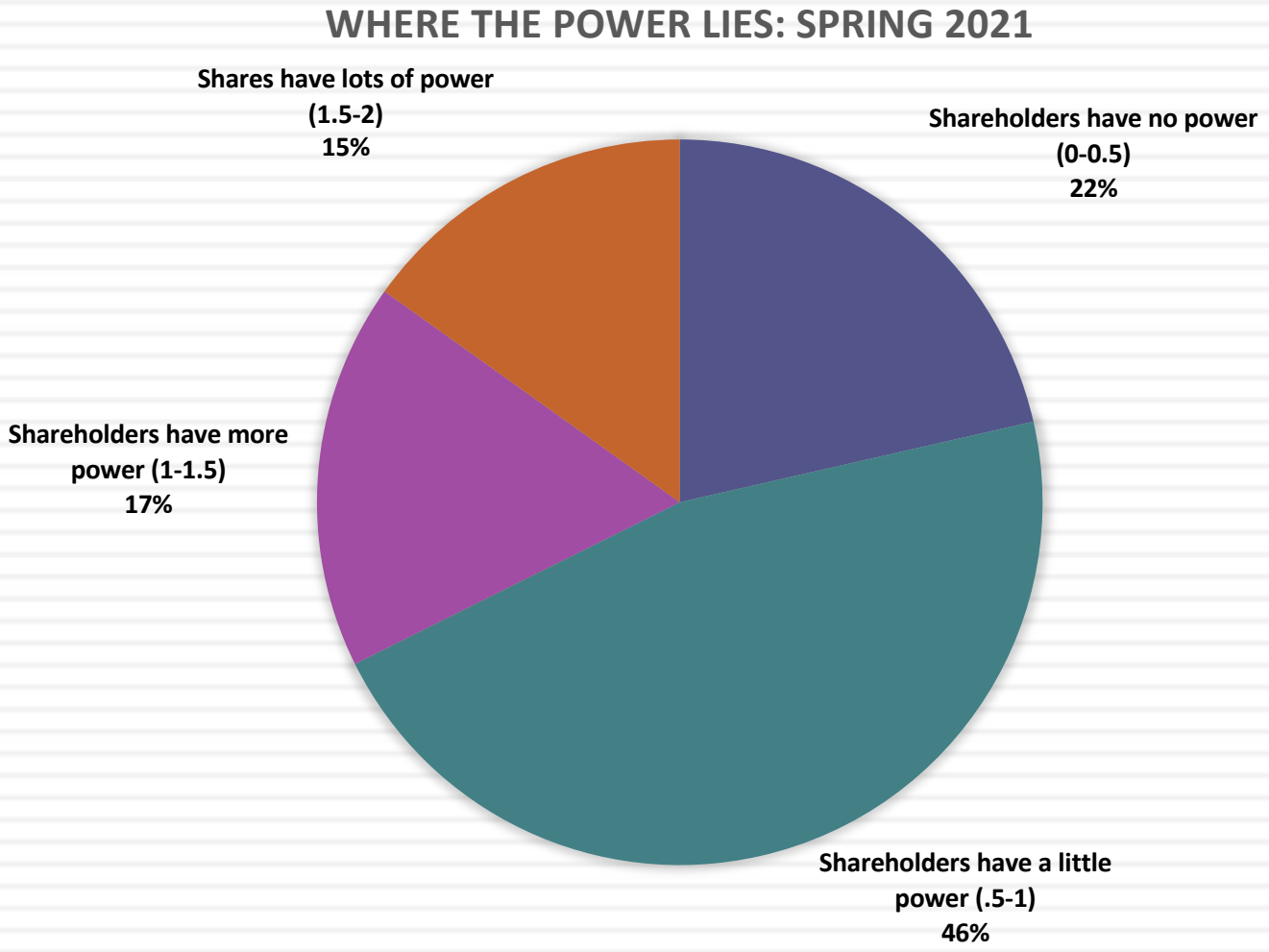
And here's why you can do the same company..

Company picked for project	Corporate Governance Measure (0-2)	Regression Beta	Jensen's Alpha (% annualized)	R Squared (%)	Bottom up Levered Beta (%)	Equity Risk Premium	Cost of equity (%)	Debt to Capital Ratio	Cost of debt (pre-tax) (%)	Cost of Capital (%)
Netflix	1	0.64	13.08%	17.50%	0.96	6.98%	8.37%	4.50%	4.40%	8.11
Netflix (NFLX)	1	0.78	34.90%	11%	0.88	5.96%	6.82%	8.50%	3.89%	6.50%
Netflix (NFLX)	1	0.82	24.65%	29.80%	1.39	5.80%	9.64%	7.42%	2.87%	9.08%
Netflix (NFLX)	1	0.75	30.81%	10.40%	1.1	5.76%	7.95%	7.65%	3.90%	7.57%
Netflix (NFLX)	1	0.77	14.48%	18.10%	1.15	5.80%	5.08%	6.85%	2.19%	10.90%
Netflix (NFLX)	1	0.75	24.86%	10.40%	1.18	5.80%	8.4342	8.06%	3.94%	8.15%

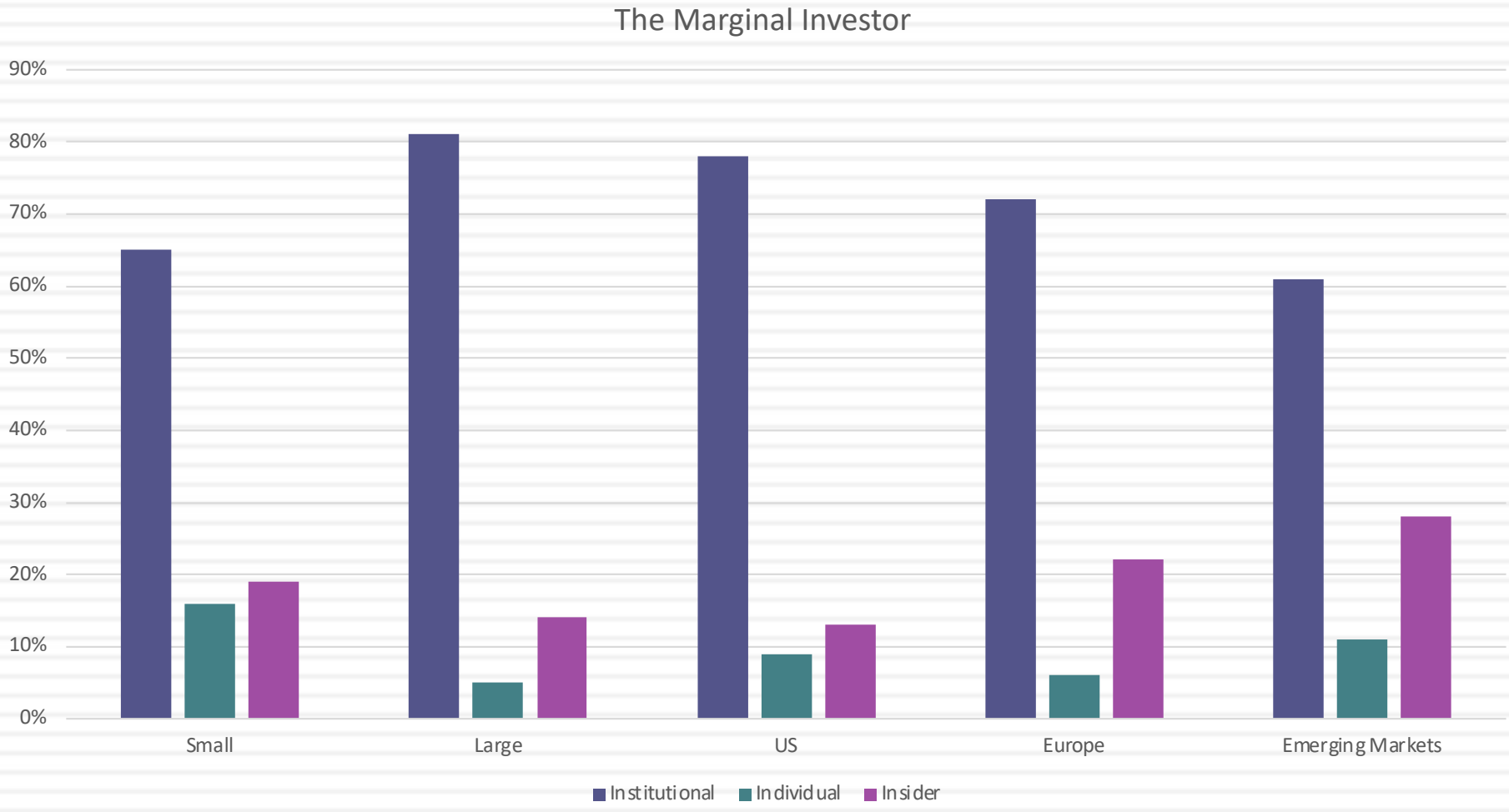
The Breakdown in the Classical Objective Function



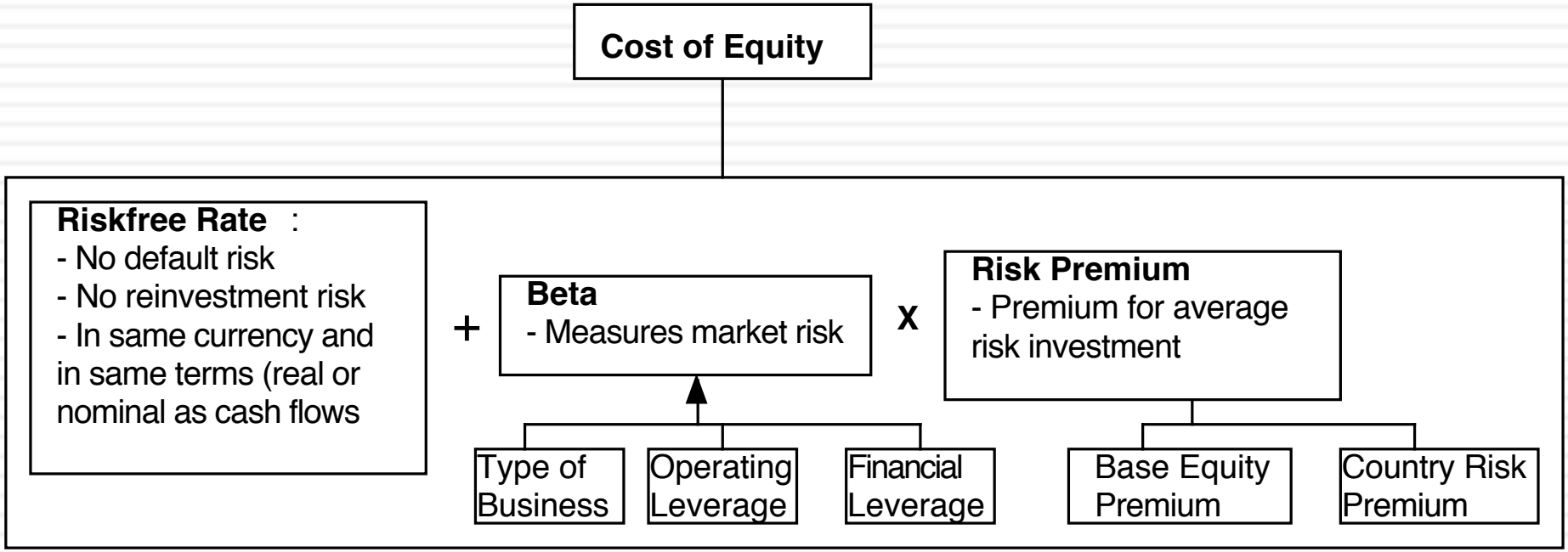
I. Where does the power lie?



II. Who is your marginal investor? From Spring 2020

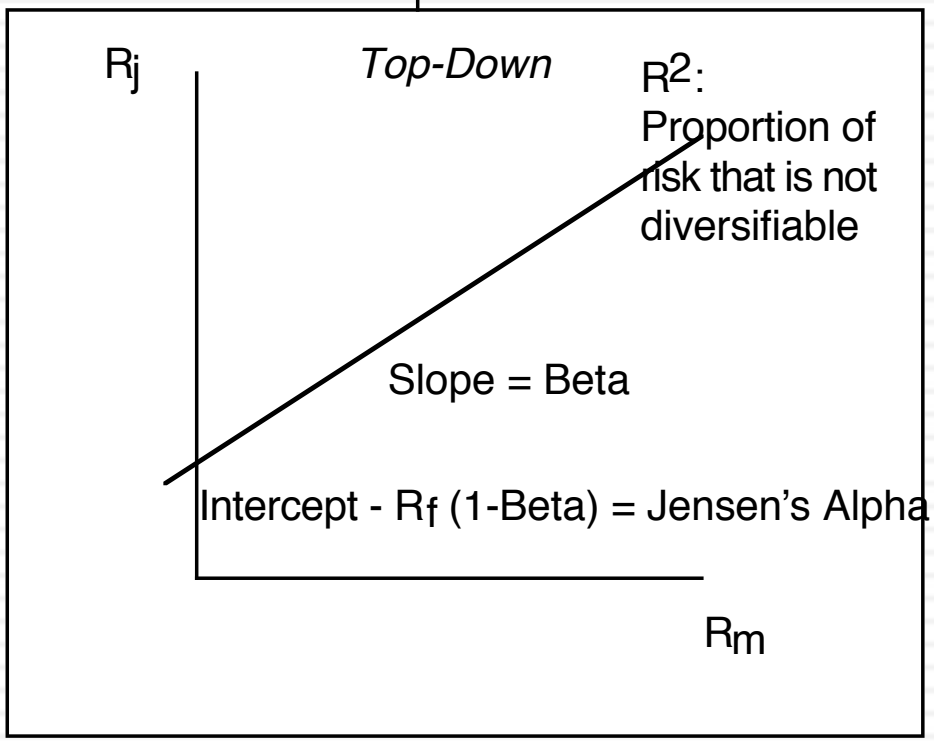


III. Risk Profiles and Costs of Equity



Beta: The Standard Approach

Beta of Equity

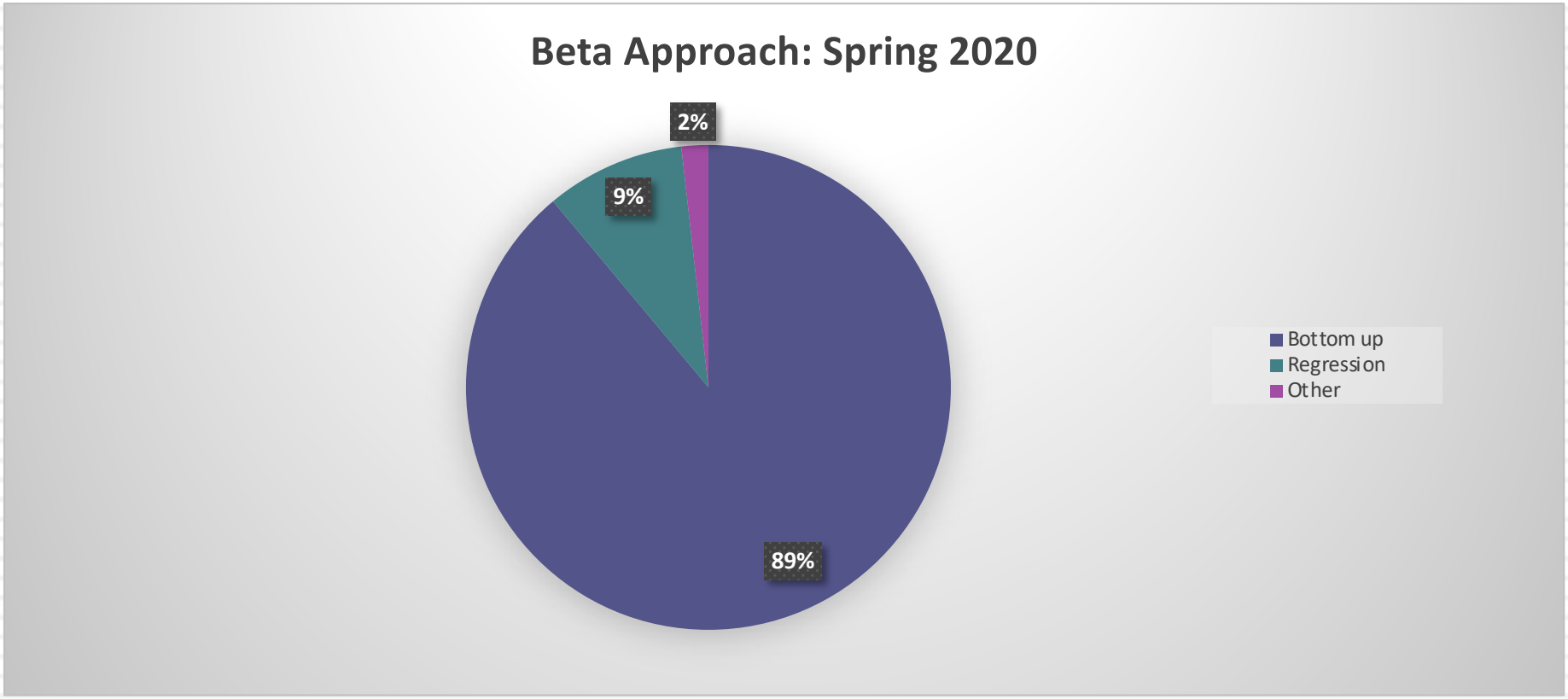


Bottom-up

1. Identify businesses that firm is in.
2. Take weighted average of the unlevered betas of other firms in the business
3. Compute the levered beta using the firm's current debt to equity ratio:

$$\beta_l = \beta_u [1 + (1\text{-tax rate}) (\text{Debt/Equity})]$$

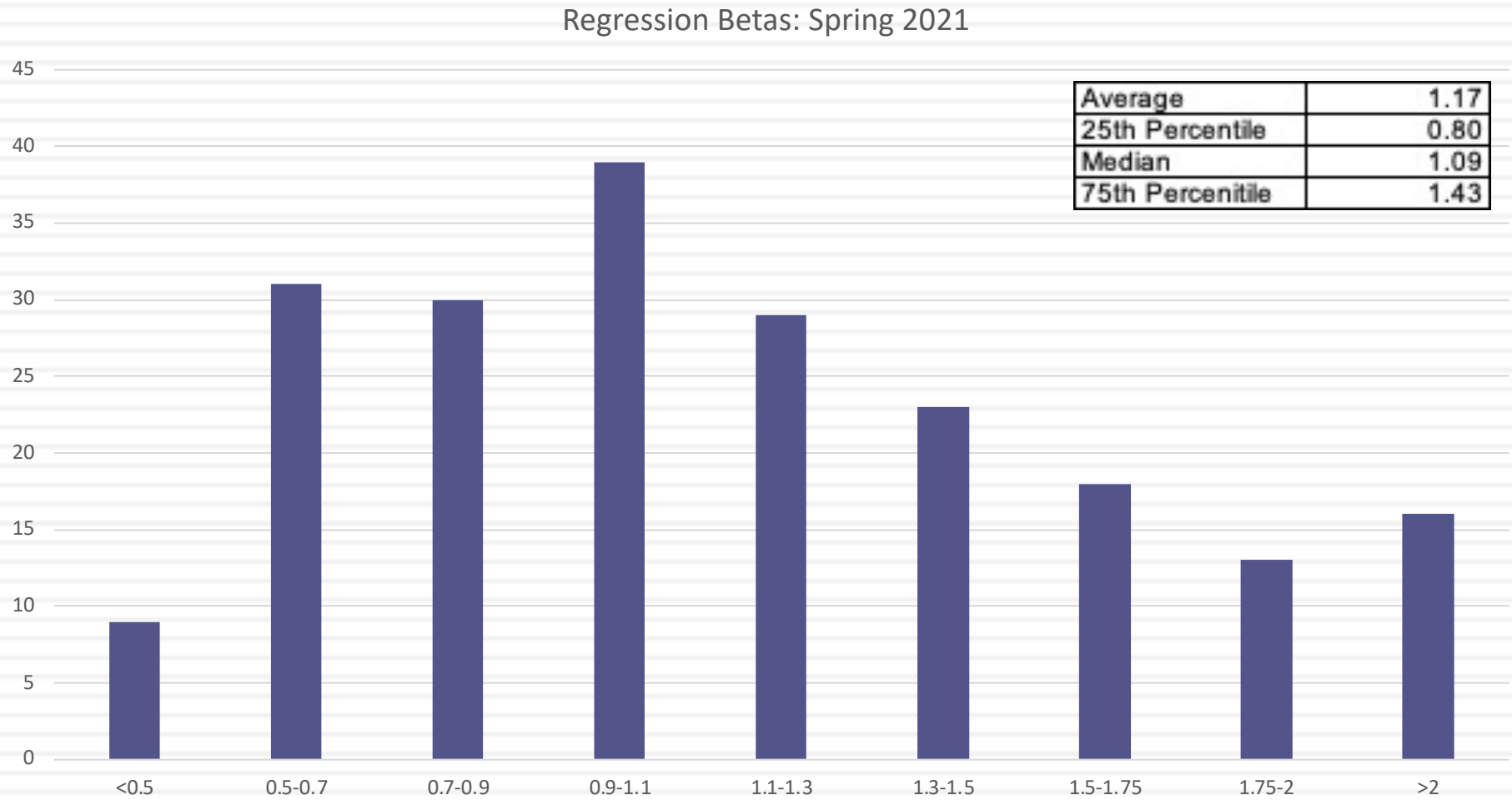
Your choice on beta approach



Typical reasons

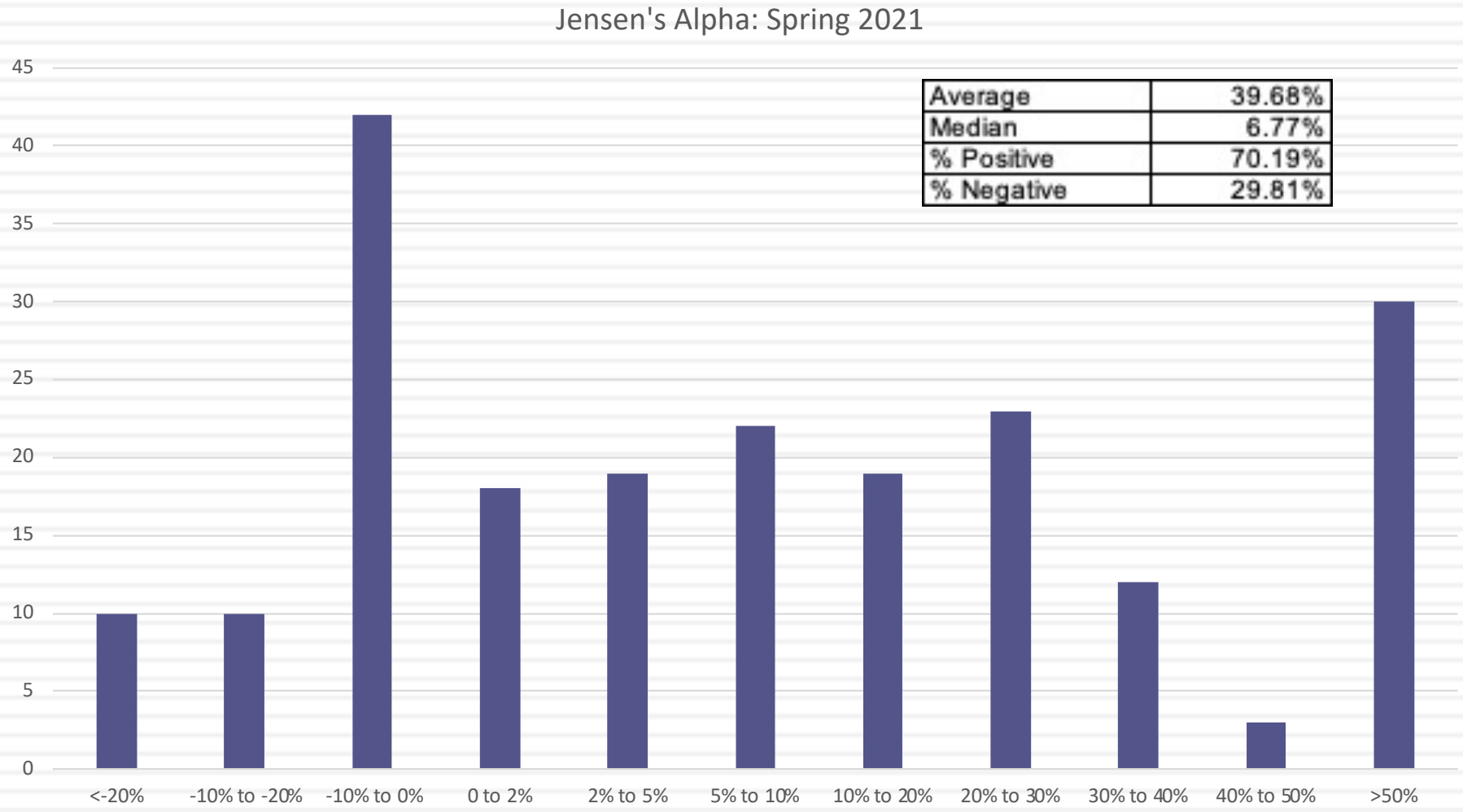
1. My company is unique. I cannot find comparable firms.
2. My company is in only one line of business
3. My bottom-up beta is too different from my regression beta

Beta Distribution

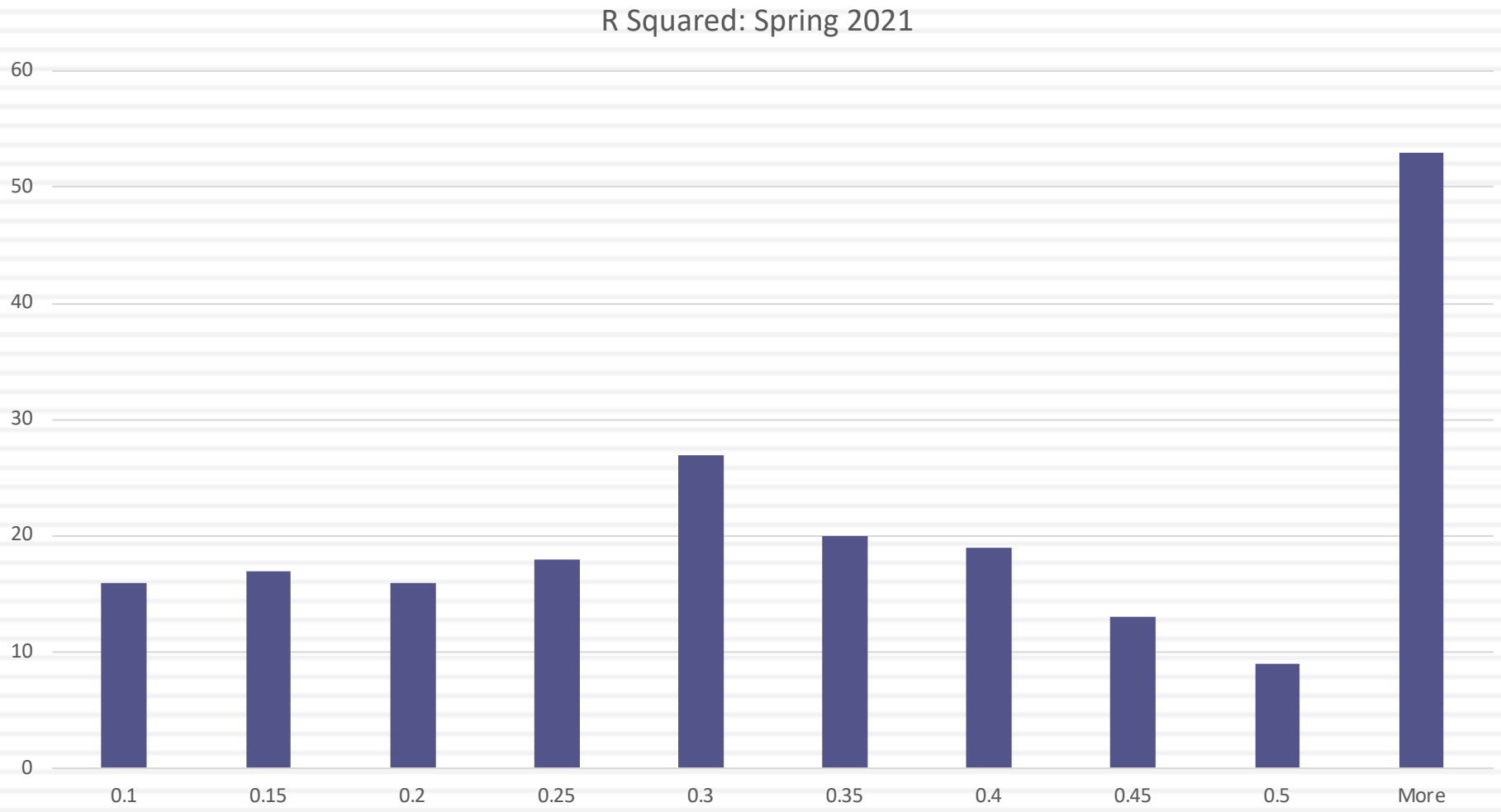


Average	1.17
25th Percentile	0.80
Median	1.09
75th Percenitile	1.43

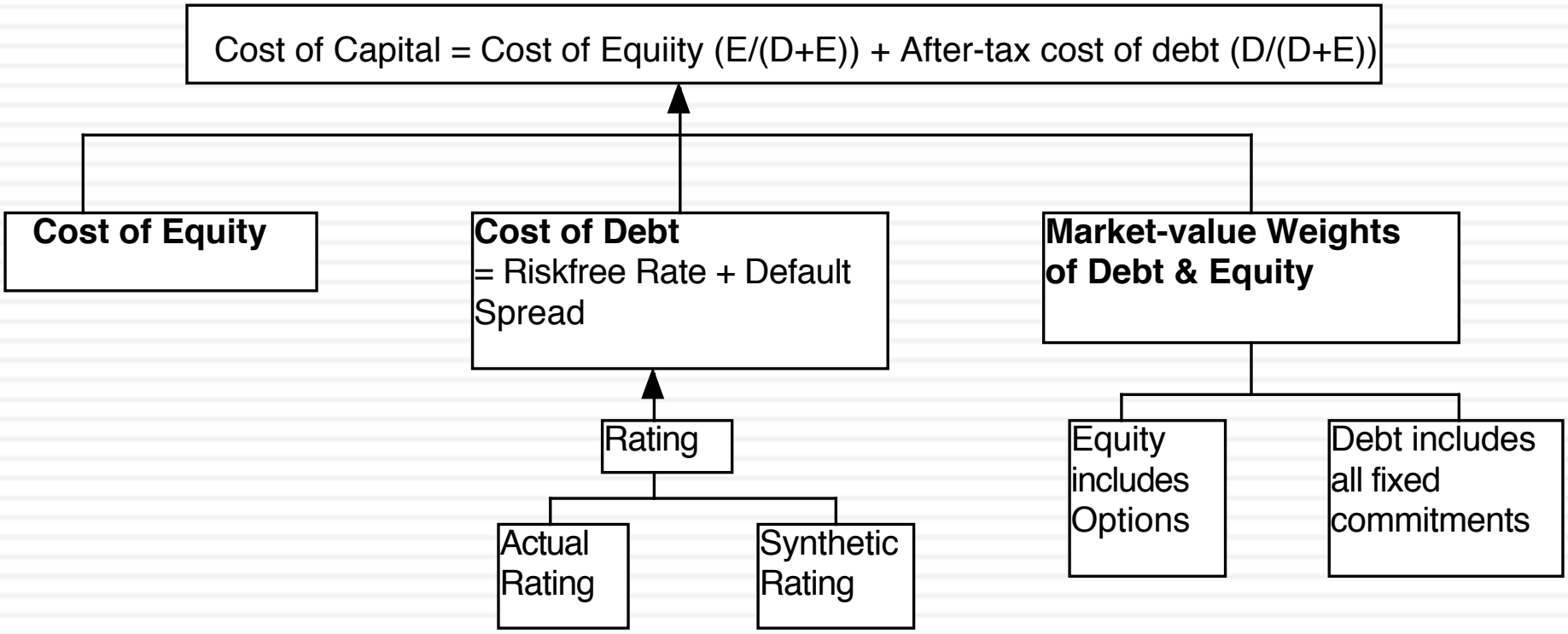
Jensen’s Alpha Distribution



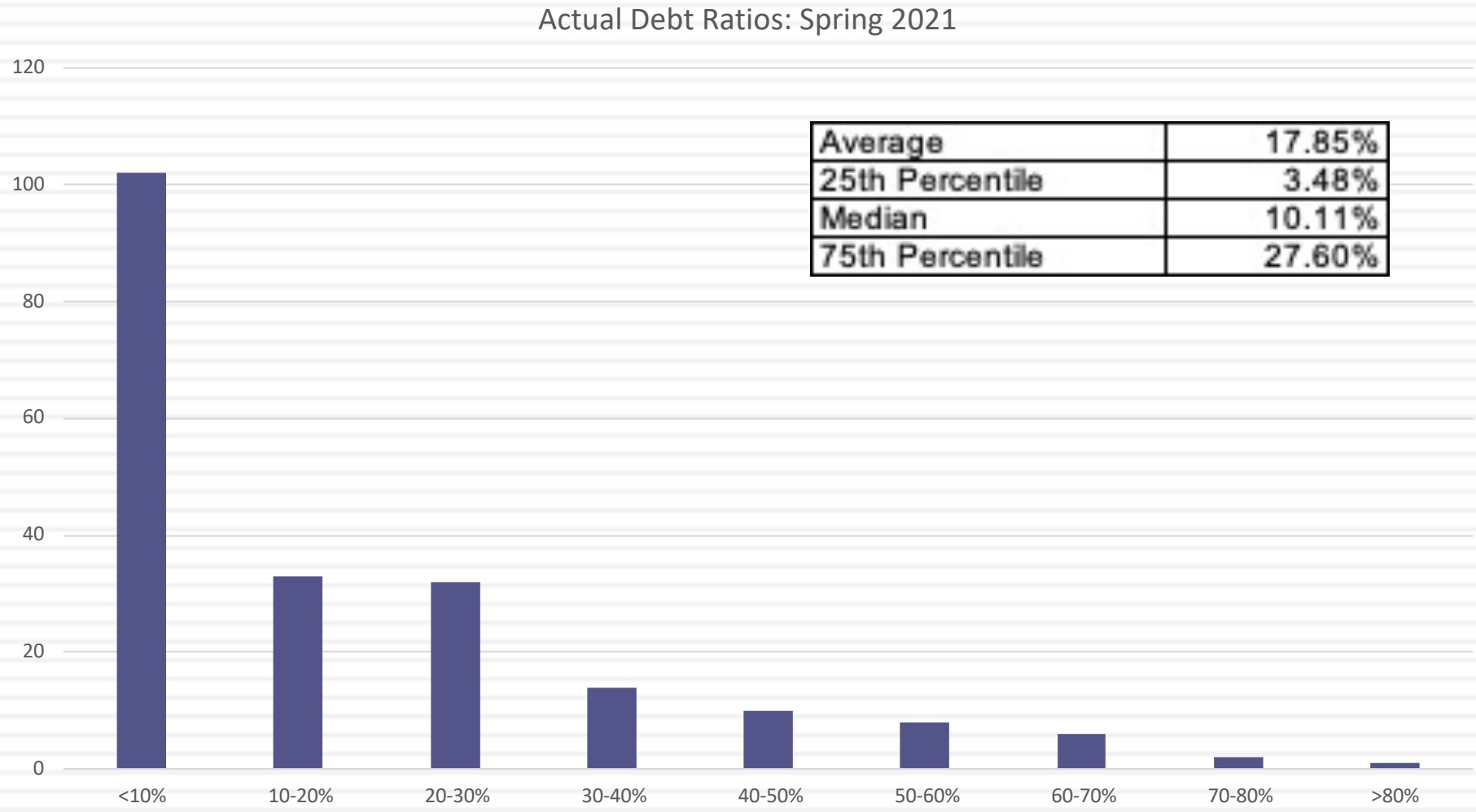
R Squared


R Squared: Spring 2021
60
50
40
30
20
10
0
0.1
0.15
0.2
0.25
0.3
0.35
0.4
0.45
0.5
More

Cost of Capital

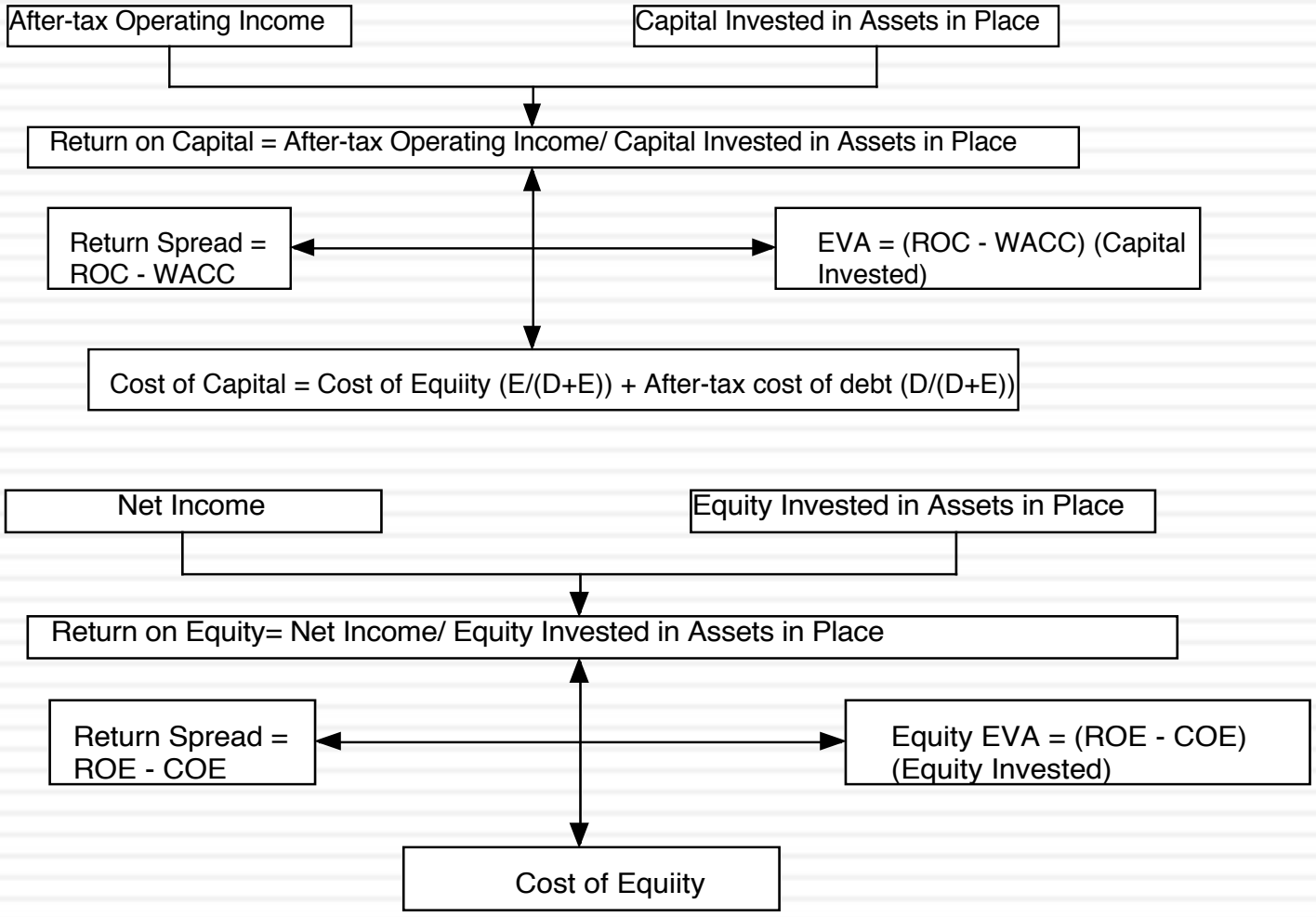


Distribution of Current Market Value Debt Ratios

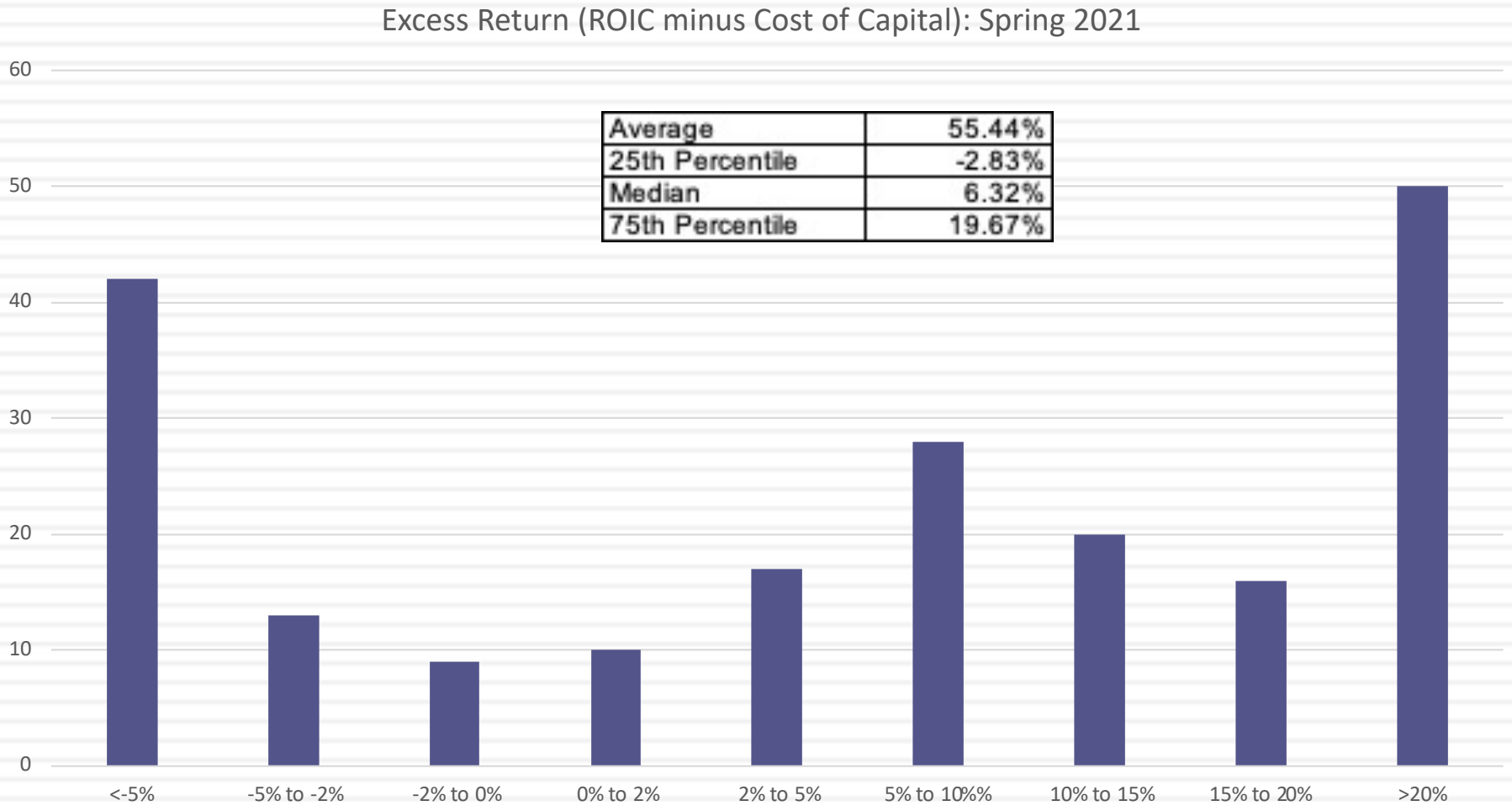


Average	17.85%
25th Percentile	3.48%
Median	10.11%
75th Percentile	27.60%

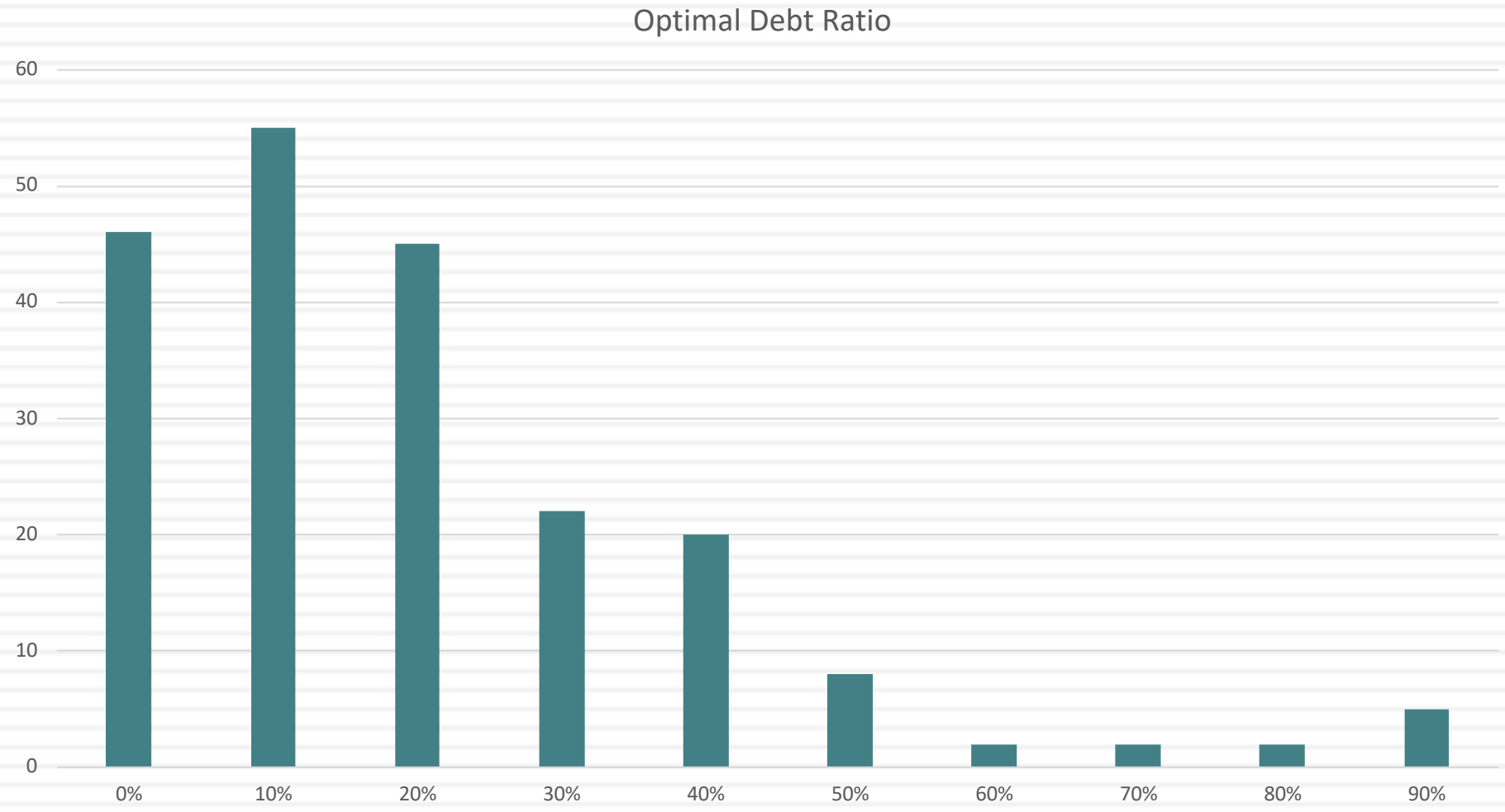
IV. The Quality of Investments: The Firm View



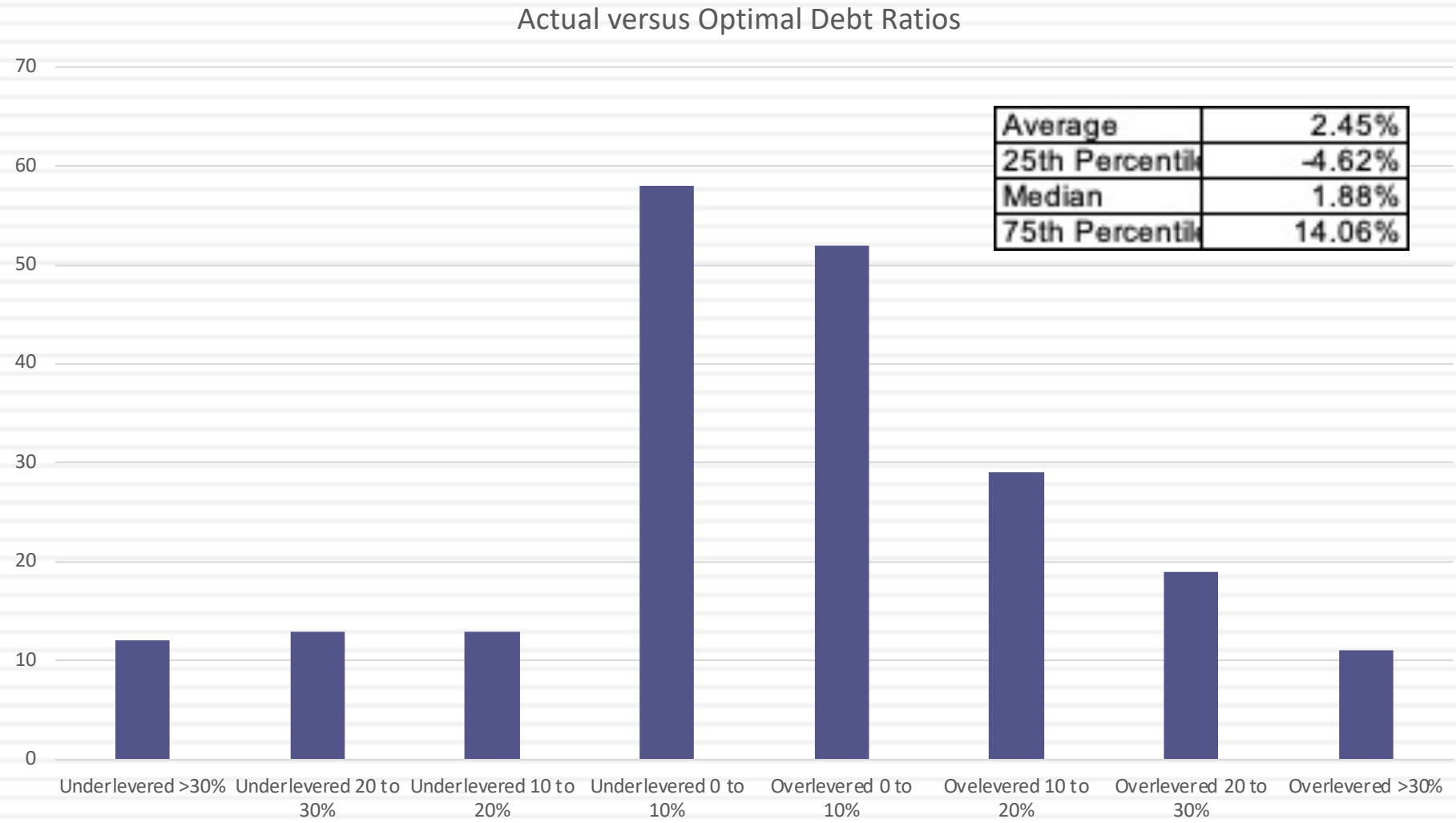
Return Spreads



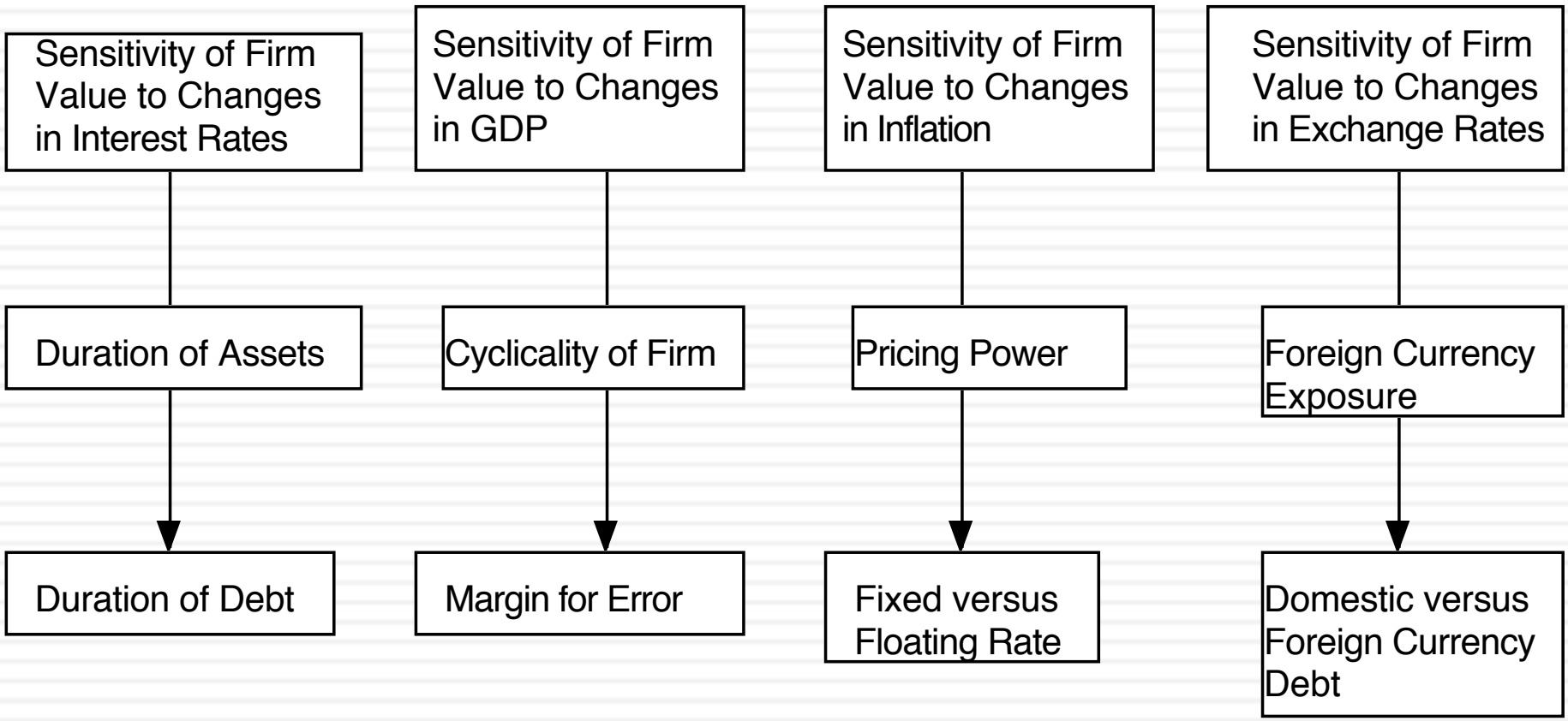
VI. The Optimal Financing Mix



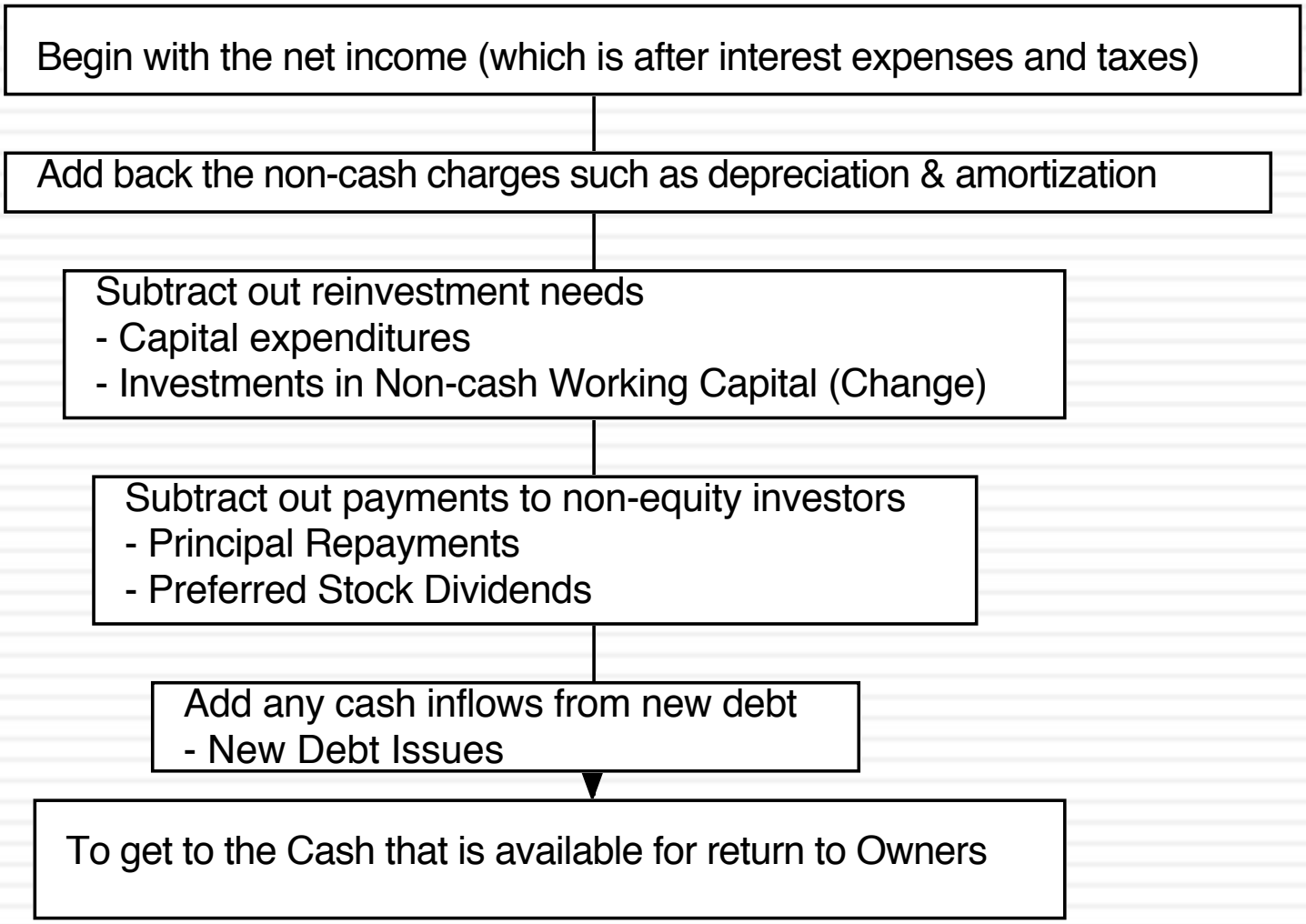
Under versus Over Levered Firms



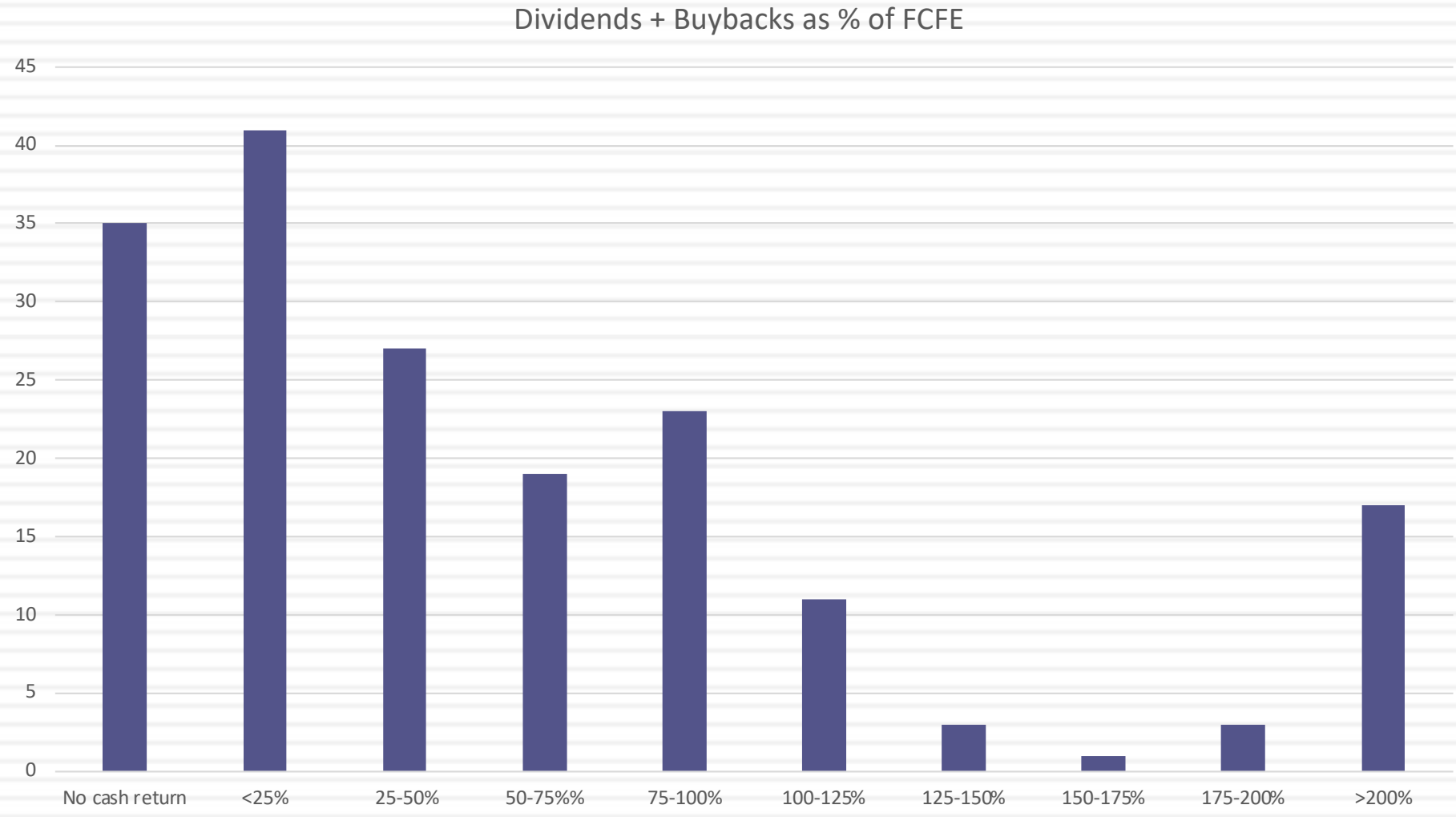
VIII. The Right Kind of Financing



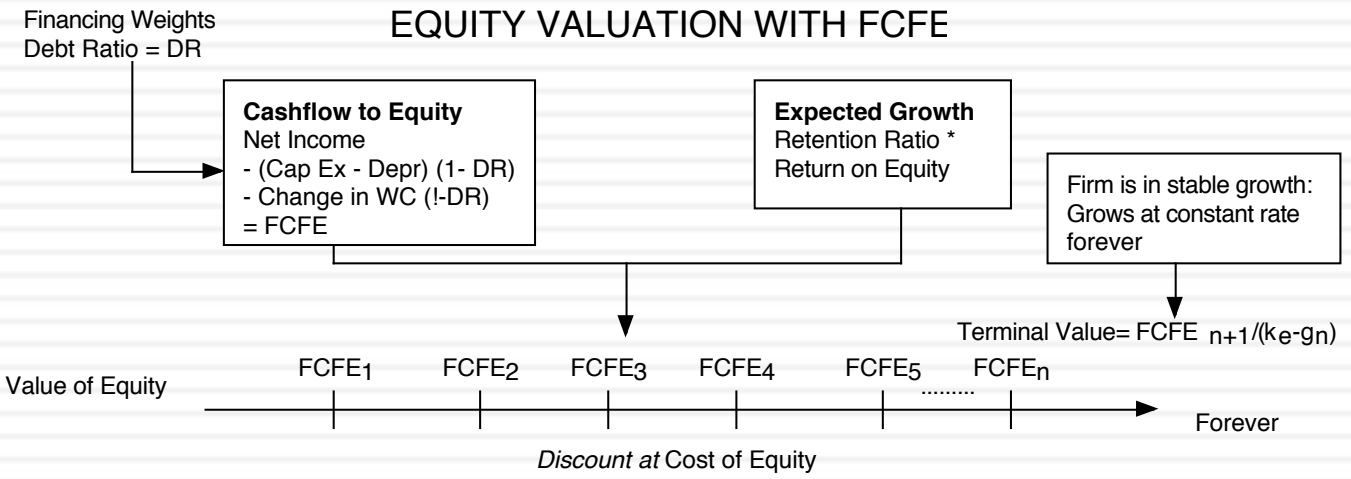
IX. Measuring Potential Dividends

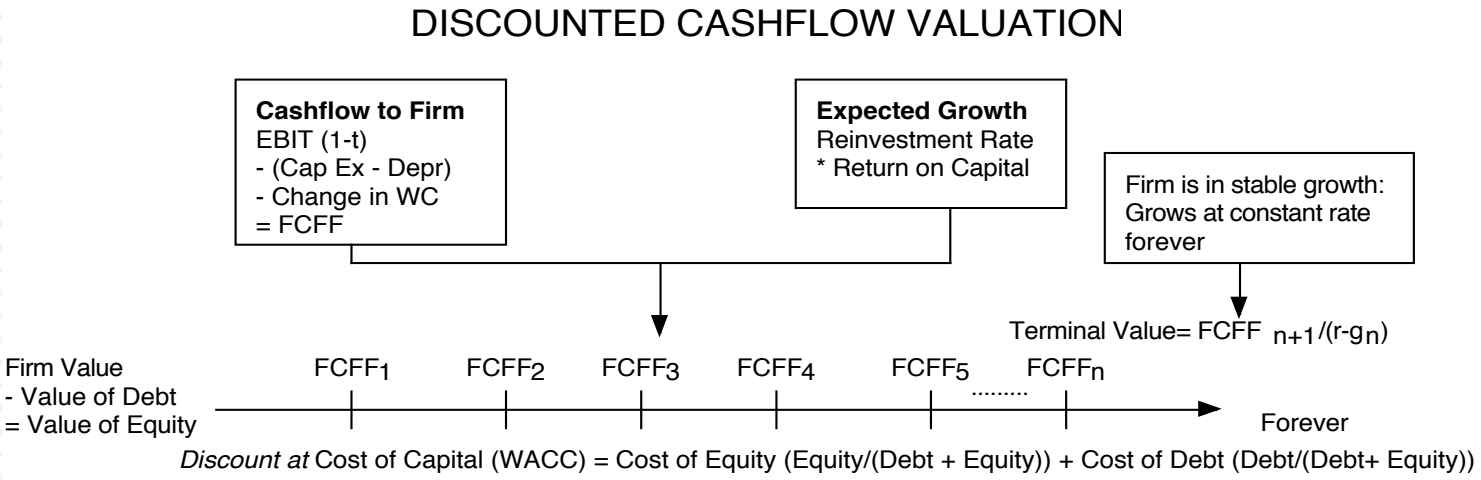


Dividends versus FCFE



X. Valuation:
Match up cashflows and discount rates…





From firm value to equity value per share

Approach used	To get to equity value per share
Discount dividends per share at the cost of equity	Present value is value of equity per share
Discount aggregate FCFE at the cost of equity	Present value is value of aggregate equity. Subtract the value of equity options given to managers and divide by number of shares.
Discount aggregate FCFF at the cost of capital	PV = Value of operating assets + Cash & Near Cash investments + Value of minority cross holdings -Debt outstanding = Value of equity -Value of equity options =Value of equity in common stock / Number of shares

Valuing Deutsche Bank in early 2008

- To value Deutsche Bank, we started with the normalized income over the previous five years (3,954 million Euros) and the dividends in 2008 (2,146 million Euros). We assumed that the payout ratio and ROE, based on these numbers will continue for the next 5 years:
  - Payout ratio = 2,146/3954 = 54.28%
  - Expected growth rate = (1-.5428) * .1181 = 0.054 or 5.4%
  - Cost of equity = 9.23%

Year	*Net Income*	*Payout Ratio*	*Dividends*	*PV @ 9.23%*
2008	4,167 €	54.28%	2,262 €	2,071 €
2009	4,392 €	54.28%	2,384 €	1,998 €
2010	4,629 €	54.28%	2,513 €	1,928 €
2011	4,879 €	54.28%	2,648 €	1,861 €
2012	5,143 €	54.28%	2,791 €	1,795 €
				9,653 €

Deutsche Bank in stable growth

- At the end of year 5, the firm is in stable growth. We assume that the cost of equity drops to 8.5% (as the beta moves to 1) and that the return on equity also drops to 8.5 (to equal the cost of equity).

  Stable Period Payout Ratio = 1 – g/ROE = 1 – 0.03/0.085 = 0.6471 or 64.71%

  Expected Dividends in Year 6 = Expected Net Income$_5$ *(1+g_{Stable})* Stable Payout Ratio
  = €5,143 (1.03) * 0.6471 = €3,427 million

  Terminal Value = $$\frac{\text{Expected Dividends}_6}{(\text{Cost of Equity-g})} = \frac{3{,}247}{(.085-.03)} = 62{,}318 \text{ million Euros}$$

  PV of Terminal Value = $$\frac{\text{Terminal Value}_n}{(1+\text{Cost of Equity}_{\text{High growth}})^n} = \frac{62{,}318}{(1.0923)^5} = 40{,}079 \text{ mil Euros}$$

- Value of equity = €9,653+ €40,079 = €49,732 million Euros
- Value of equity per share= $$\frac{\text{Value of Equity}}{\text{\# Shares}} = \frac{49{,}732}{474.2} = 104.88 \text{ Euros/share}$$

  Stock was trading at 89 Euros per share at the time of the analysis.

Disney: Inputs to Valuation

	High Growth Phase	*Transition Phase*	*Stable Growth Phase*
Length of Period	5 years	5 years	Forever after 10 years
Tax Rate	31.02% (Effective) 36.1% (Marginal)	31.02% (Effective) 36.1% (Marginal)	31.02% (Effective) 36.1% (Marginal)
Return on Capital	12.61%	Declines linearly to 10%	Stable ROC of 10%
Reinvestment Rate	53.93% (based on normalized acquisition costs)	Declines gradually to 25% as ROC and growth rates drop:	25% of after-tax operating income. Reinvestment rate = g/ ROC = 2.5/10=25%
Expected Growth Rate in EBIT	ROC * Reinvestment Rate = 0.1261*.5393 = .068 or 6.8%	Linear decline to Stable Growth Rate of 2.5%	2.5%
Debt/Capital Ratio	11.5%	Rises linearly to 20.0%	20%
Risk Parameters	Beta = 1.0013, k_e = 8.52%% Pre-tax Cost of Debt = 3.75% Cost of capital = 7.81%	Beta changes to 1.00; Cost of debt stays at 3.75% Cost of capital declines gradually to 7.29%	Beta = 1.00; k_e = 8.51% Cost of debt stays at 3.75% Cost of capital = 7.29%

Disney - November 2013

Current Cashflow to Firm
EBIT(1-t)= 10,032(1-.31)= 6,920
- (Cap Ex - Deprecn) 3,629
- Chg Working capital 103
= FCFF 3,188
Reinvestment Rate = 3,732/6920 =53.93%
Return on capital = 12.61%

Reinvestment Rate 53.93%

Return on Capital 12.61%

Expected Growth
.5393*.1261=.068 or 6.8%

Stable Growth
g = 2.75%; Beta = 1.00;
Debt %= 20%; k(debt)=3.75
Cost of capital =7.29%
Tax rate=36.1%; ROC= 10%;
Reinvestment Rate=2.5/10=25%

Terminal Value$_{10}$= 7,980/(.0729-.025) = 165,323

Term Yr
10,639
2,660
7,980

First 5 years

Growth declines gradually to 2.75%

	1	2	3	4	5	6	7	8	9	10
EBIT * (1 - tax rate)	$7,391	$7,893	$8,430	$9,003	$9,615	$10,187	$10,704	$11,156	$11,531	$11,819
- Reinvestment	$3,985	$4,256	$4,546	$4,855	$5,185	$4,904	$4,534	$4,080	$3,550	$2,955
FCFF	$3,405	$3,637	$3,884	$4,148	$4,430	$5,283	$6,170	$7,076	$7,981	$8,864

Op. Assets 125,477
+ Cash: 3,931
+ Non op inv 2,849
- Debt 15,961
- Minority Int 2,721
=Equity 113,575
-Options 972
Value/Share $ 62.56

Cost of capital declines gradually to 7.29%

Cost of Capital (WACC) = 8.52% (0.885) + 2.40% (0.115) = 7.81%

Cost of Equity
8.52%

Cost of Debt
(2.75%+1.00%)(1-.361)
= 2.40%
Based on actual A rating

Weights
E = 88.5% D = 11.5%

In November 2013, Disney was trading at $67.71/share

Riskfree Rate:
Riskfree rate = 2.75%

+

Beta
1.0013

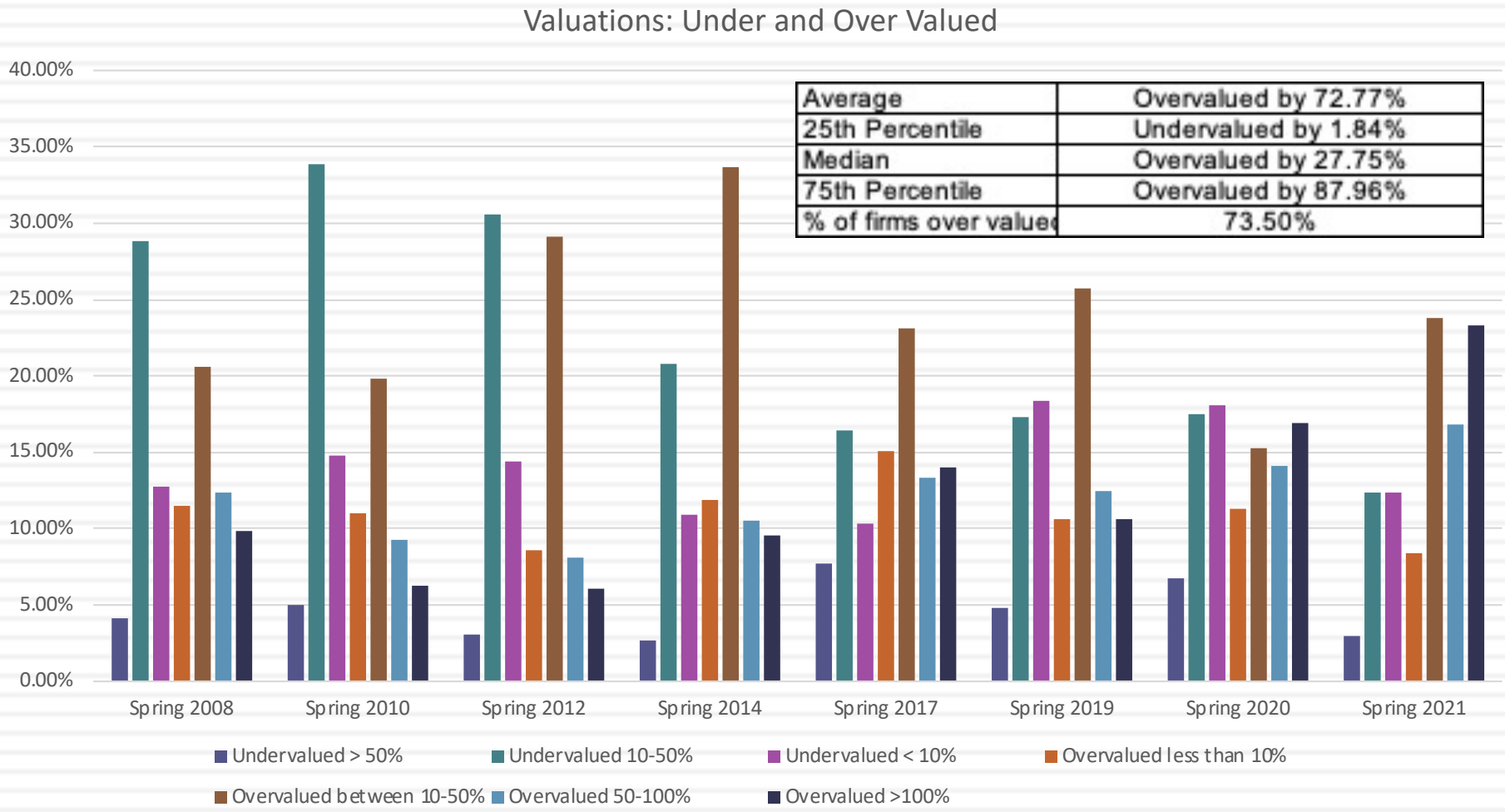
Unlevered Beta for Sectors: 0.9239

D/E=13.10%

X

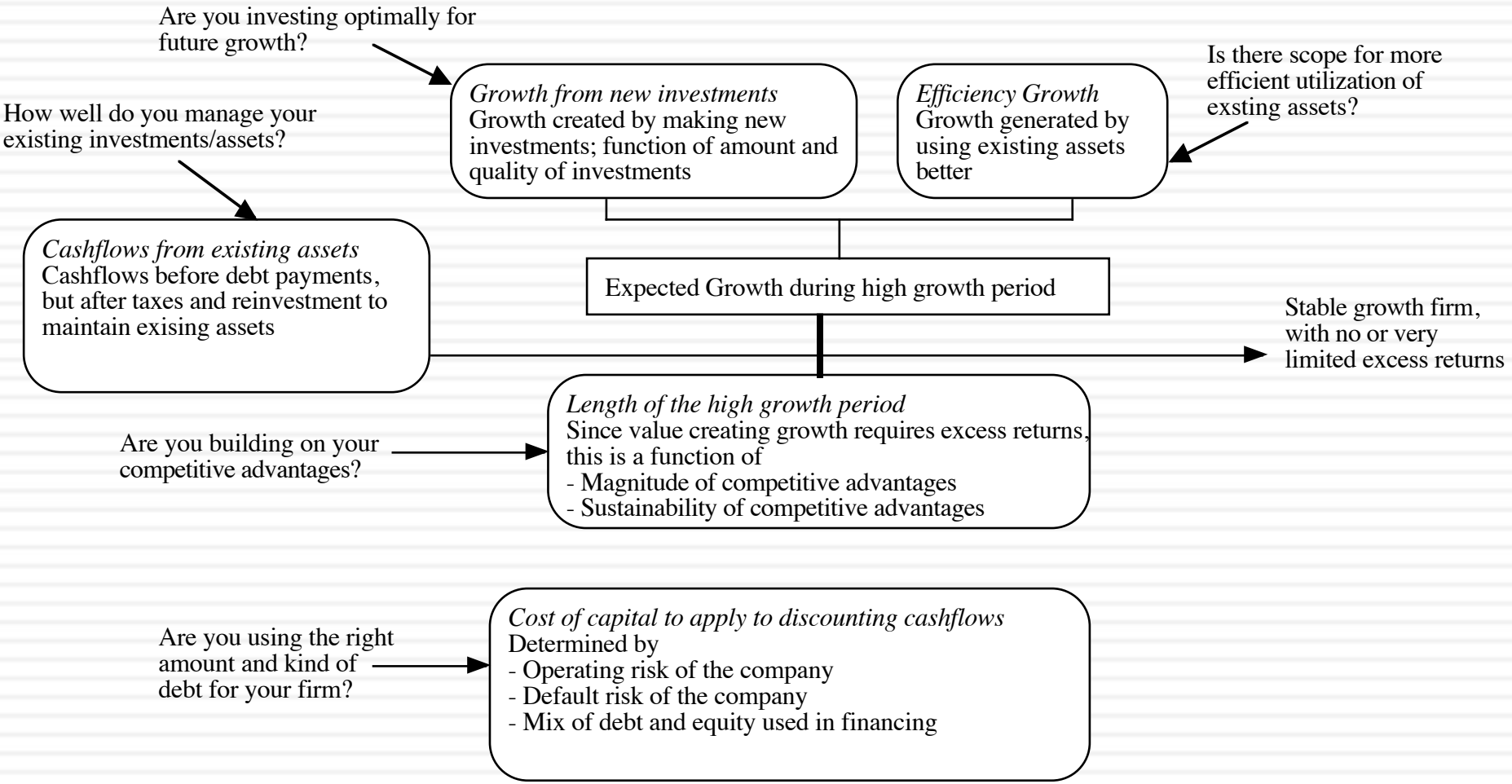
ERP for operations
5.76%

Value versus Price



Average	Overvalued by 72.77%
25th Percentile	Undervalued by 1.84%
Median	Overvalued by 27.75%
75th Percentile	Overvalued by 87.96%
% of firms over value	73.50%

Ways of changing value…



Disney (Restructured)- November 2013

Current Cashflow to Firm
EBIT(1-t)= 10,032(1-.31)= 6,920
- (Cap Ex - Deprecn) 3,629
- Chg Working capital 103
= FCFF 3,188
Reinvestment Rate = 3,732/6920 =53.93%
Return on capital = 12.61%

Reinvestment Rate 50.00%

More selective acquisitions & payoff from gaming

Return on Capital 14.00%

Expected Growth
.50* .14 = .07 or 7%

Stable Growth
g = 2.75%; Beta = 1.20;
Debt %= 40%; k(debt)=3.75%
Cost of capital =6.76%
Tax rate=36.1%; ROC= 10%;
Reinvestment Rate=2.5/10=25%

Terminal Value$_{10}$= 9,206/(.0676-.025) = 216,262

First 5 years

Growth declines gradually to 2.75%

	1	2	3	4	5	6	7	8	9	10
EBIT * (1 - tax rate)	$7,404	$7,923	$8,477	$9,071	$9,706	$10,298	$10,833	$11,299	$11,683	$11,975
- Reinvestment	$3,702	$3,961	$4,239	$4,535	$4,853	$4,634	$4,333	$3,955	$3,505	$2,994
Free Cashflow to Firm	$3,702	$3,961	$4,239	$4,535	$4,853	$5,664	$6,500	$7,344	$8,178	$8,981

Term Yr
12,275
3,069
9,206

Op. Assets 147,704
+ Cash: 3,931
+ Non op inv 2,849
- Debt 15,961
- Minority Int 2,721
=Equity 135,802
-Options 972
Value/Share $ 74.91

Cost of capital declines gradually to 6.76%

Cost of Capital (WACC) = 8.52% (0.60) + 2.40%(0.40) = 7.16%

Cost of Equity
10.34%

Cost of Debt
(2.75%+1.00%)(1-.361)
= 2.40%
Based on synthetic A rating

Weights
E = 60% D = 40%

In November 2013, Disney was trading at $67.71/share

Move to optimal debt ratio, with higher beta.

Riskfree Rate:
Riskfree rate = 2.75%

+

Beta
1.3175

Unlevered Beta for Sectors: 0.9239

D/E=66.67%

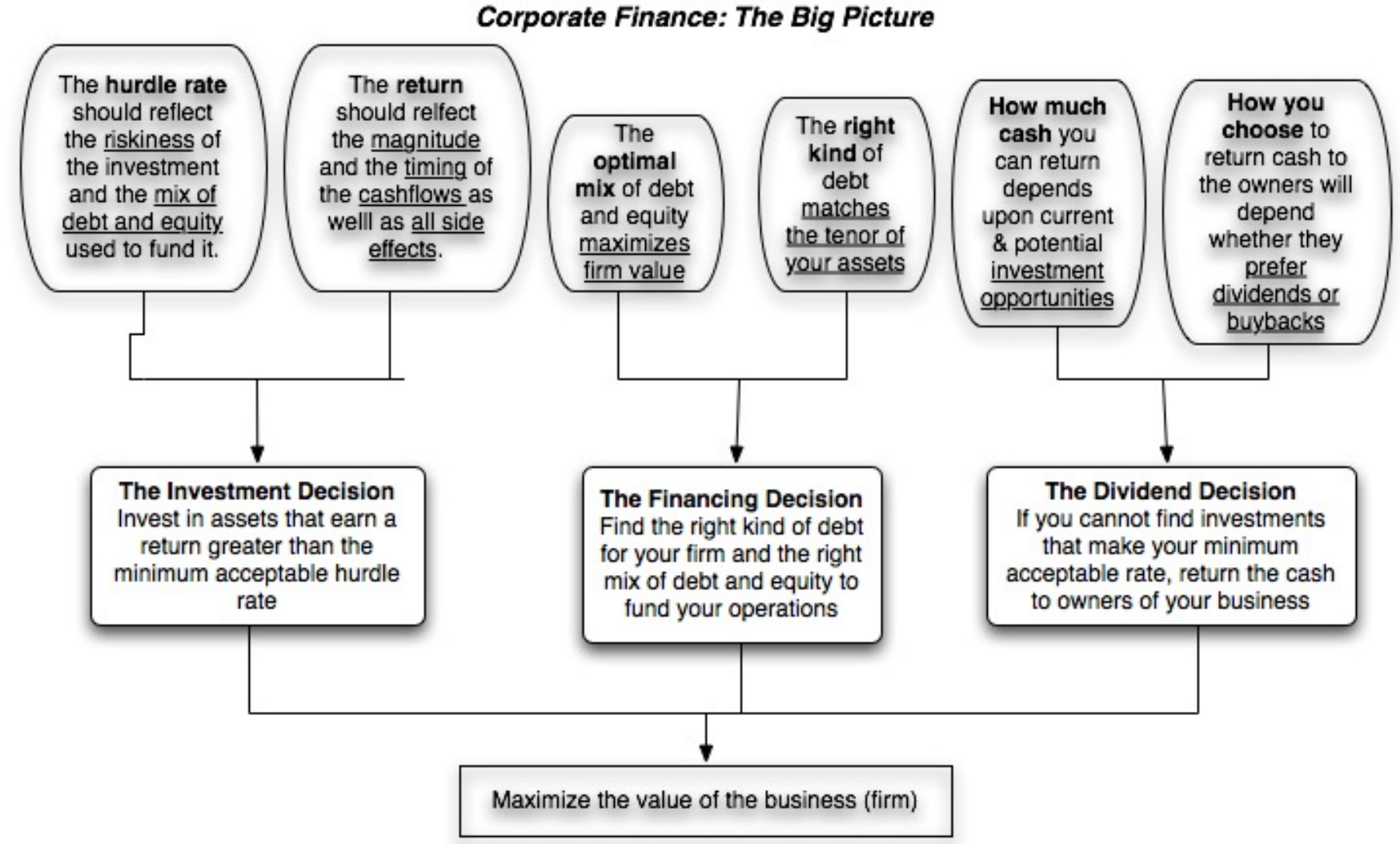
X

ERP for operations
5.76%

The Triple Whammy: Under levered, Cash Build-up and Under valued by at least 10%?

Company picked for project	Corporate Governance Measure (0-2)	Return on Equity (%)	Return on Capital	Optimal Debt Ratio (%)	Change in Value (in % terms)	Dividends in most recent periods (Total $)	Buybacks in most recent periods (Total $)	FCFE in most recent periods (Total $)	Price per share ($)	Value per share ($)
Danone S.A. (ENXTPA:BN)	0.5	12.46%	5.41%	0.00%	4.49%	€ 1,016.67	€ 0	€ 2,795.67	€ 58.63	€ 68.84
Tivity Health (TVTY)	1.5	50.02%	8.99%	0.00%	18.66%	0	$6,300,000	$790,000,000	$21.21	$29.57
Tyson Foods	0.5	14.57%	8.91%	0%	0.05%	$2,575,000,000	$6,365,000,000	$28,294,000,000	73.57	148.18
IBM	1	4.97%	2.29%	10%	41.10%	$5,795,000,000.00	$0.00	$10,805,000,000.00	125.88	132.97
ULTA	1	8.79%	3.40%	0.00%	0.00%	$0.00	$118,200,000	$780,300,000	$147.55	$322.74
Comcast Corporation	0.5	76.43%	10.82%	20.00%	-14.00%	19148	24320	56708	56.41	61.39
Fiserv (FISV)	2	2.87%	9.90%	10.00%	-11.01%	0	$1,826,000,000.00	$3,636,400,000.00	$120.12	$144.86

First Principles



Objectives of this class

- If you get the big picture, the details will come (sooner or later)
- Tools are useful but only in the larger context of answering bigger questions.
- Corporate finance is not so bad !!!