CORPORATE FINANCE
LECTURE NOTE PACKET 2
CAPITAL STRUCTURE, DIVIDEND POLICY AND VALUATION

B40.2302
Aswath Damodaran
CAPITAL STRUCTURE: THE CHOICES AND THE TRADE OFF

“Neither a borrower nor a lender be”
Someone who obviously hated this part of corporate finance
First principles

Maximize the value of the business (firm)

The Investment Decision
Invest in assets that earn a return greater than the minimum acceptable hurdle rate

The Financing Decision
Find the right kind of debt for your firm and the right mix of debt and equity to fund your operations

The Dividend Decision
If you cannot find investments that make your minimum acceptable rate, return the cash to owners of your business

The hurdle rate should reflect the riskiness of the investment and the mix of debt and equity used to fund it.

The return should reflect the magnitude and the timing of the cash flows as well as all side effects.

The optimal mix of debt and equity maximizes firm value.

The right kind of debt matches the tenor of your assets.

How much cash you can return depends upon current & potential investment opportunities.

How you choose to return cash to the owners will depend whether they prefer dividends or buybacks.

Aswath Damodaran
The Choices in Financing

- There are only two ways in which a business can raise money.
  - The first is debt. The essence of debt is that you promise to make fixed payments in the future (interest payments and repaying principal). If you fail to make those payments, you lose control of your business.
  - The other is equity. With equity, you do get whatever cash flows are left over after you have made debt payments.

Figure 7.1: Debt versus Equity

<table>
<thead>
<tr>
<th>Debt</th>
<th>Hybrid Securities</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Debt</td>
<td>Convertible Debt</td>
<td>Owner’s Equity</td>
</tr>
<tr>
<td>Commercial Paper</td>
<td>Preferred Stock</td>
<td>Venture Capital</td>
</tr>
<tr>
<td>Corporate Bonds</td>
<td>Option-linked Bonds</td>
<td>Common Stock</td>
</tr>
</tbody>
</table>

Aswath Damodaran
Global Patterns in Financing...

Figure 7.4: Financing Patterns for G-7 Countries – 1984-91
And a much greater dependence on bank loans outside the US...

Figure 7.5: Bonds versus Bank Loans - 1990-96
### Assessing the existing financing choices: Disney, Vale, Tata Motors, Baidu & Bookscape

<table>
<thead>
<tr>
<th></th>
<th>Disney</th>
<th>Vale</th>
<th>Tata Motors</th>
<th>Baidu</th>
</tr>
</thead>
<tbody>
<tr>
<td>BV of Interest bearing Debt</td>
<td>$14,288</td>
<td>$48,469</td>
<td>535,914¥</td>
<td>¥17,844</td>
</tr>
<tr>
<td>MV of Interest bearing Debt</td>
<td>$13,028</td>
<td>$41,143</td>
<td>477,268¥</td>
<td>¥15,403</td>
</tr>
<tr>
<td>Lease Debt</td>
<td>$2,933</td>
<td>$1,248</td>
<td>0.00¥</td>
<td>¥3,051</td>
</tr>
<tr>
<td><strong>Type of Debt</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank Debt</td>
<td>7.93%</td>
<td>59.97%</td>
<td>62.26%</td>
<td>100.00%</td>
</tr>
<tr>
<td>Bonds/Notes</td>
<td>92.07%</td>
<td>40.03%</td>
<td>37.74%</td>
<td>0.00%</td>
</tr>
<tr>
<td><strong>Debt Maturity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&lt;1 year</td>
<td>13.04%</td>
<td>6.08%</td>
<td>0.78%</td>
<td>1.98%</td>
</tr>
<tr>
<td>1-5 years</td>
<td>48.93%</td>
<td>23.12%</td>
<td>30.24%</td>
<td>68.62%</td>
</tr>
<tr>
<td>5-10 years</td>
<td>20.31%</td>
<td>29.44%</td>
<td>57.90%</td>
<td>29.41%</td>
</tr>
<tr>
<td>10-20 years</td>
<td>4.49%</td>
<td>3.00%</td>
<td>10.18%</td>
<td>0.00%</td>
</tr>
<tr>
<td>&gt;20 years</td>
<td>13.24%</td>
<td>38.37%</td>
<td>0.90%</td>
<td>0.00%</td>
</tr>
<tr>
<td><strong>Currency for debt</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt in domestic currency</td>
<td>94.51%</td>
<td>34.52%</td>
<td>70.56%</td>
<td>17.90%</td>
</tr>
<tr>
<td>Debt in foreign currency</td>
<td>5.49%</td>
<td>65.48%</td>
<td>29.44%</td>
<td>82.10%</td>
</tr>
<tr>
<td><strong>Fixed versus Floating rate debt</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed rate debt</td>
<td>94.33%</td>
<td>100.00%</td>
<td>100.00%</td>
<td>94.63%</td>
</tr>
<tr>
<td>Floating rate debt</td>
<td>5.67%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>5.37%</td>
</tr>
</tbody>
</table>
### Financing Choices across the life cycle

**External funding needs**
- Stage 1 (Start-up): High, but constrained by infrastructure.
- Stage 2 (Rapid Expansion): High, relative to firm value.
- Stage 3 (High Growth): Moderate, relative to firm value.
- Stage 4 (Mature Growth): Declining, as a percent of firm value.
- Stage 5 (Decline): Low, as projects dry up.

**Internal financing**
- Stage 1 (Start-up): Negative or low.
- Stage 2 (Rapid Expansion): Negative or low.
- Stage 3 (High Growth): Low, relative to funding needs.
- Stage 4 (Mature Growth): High, relative to funding needs.
- Stage 5 (Decline): More than funding needs.

**External Financing**
- Stage 1 (Start-up): Owner’s Equity, Bank Debt.
- Stage 2 (Rapid Expansion): Venture Capital, Common Stock.
- Stage 3 (High Growth): Common stock, Warrants, Convertibles.
- Stage 4 (Mature Growth): Debt.
- Stage 5 (Decline): Retire debt, Repurchase stock.

**Growth stage**
- Stage 1 (Start-up).
- Stage 2 (Rapid Expansion).
- Stage 3 (High Growth).
- Stage 4 (Mature Growth).
- Stage 5 (Decline).

**Financing Transitions**
- Accessing private equity.
- Initial Public offering.
- Seasoned equity issue.
- Bond issues.
The Transitional Phases..

- The transitions that we see at firms – from fully owned private businesses to venture capital, from private to public and subsequent seasoned offerings are all motivated primarily by the need for capital.

- In each transition, though, there are costs incurred by the existing owners:
  - When venture capitalists enter the firm, they will demand their fair share and more of the ownership of the firm to provide equity.
  - When a firm decides to go public, it has to trade off the greater access to capital markets against the increased disclosure requirements (that emanate from being publicly lists), loss of control and the transactions costs of going public.
  - When making seasoned offerings, firms have to consider issuance costs while managing their relations with equity research analysts and rat
The simplest measure of how much debt and equity a firm is using currently is to look at the proportion of debt in the total financing. This ratio is called the debt to capital ratio:

Debt to Capital Ratio = Debt / (Debt + Equity)

Debt includes all interest bearing liabilities, short term as well as long term. It should also include other commitments that meet the criteria for debt: contractually pre-set payments that have to be made, no matter what the firm’s financial standing.

Equity can be defined either in accounting terms (as book value of equity) or in market value terms (based upon the current price). The resulting debt ratios can be very different.
The Financing Mix Question

- In deciding to raise financing for a business, is there an optimal mix of debt and equity?
  - If yes, what is the trade off that lets us determine this optimal mix?
    - What are the benefits of using debt instead of equity?
    - What are the costs of using debt instead of equity?
  - If not, why not?
Costs and Benefits of Debt

- **Benefits of Debt**
  - Tax Benefits
  - Adds discipline to management

- **Costs of Debt**
  - Bankruptcy Costs
  - Agency Costs
  - Loss of Future Flexibility
Tax Benefits of Debt

- When you borrow money, you are allowed to deduct interest expenses from your income to arrive at taxable income. This reduces your taxes. When you use equity, you are not allowed to deduct payments to equity (such as dividends) to arrive at taxable income.

- The dollar tax benefit from the interest payment in any year is a function of your tax rate and the interest payment:
  - Tax benefit each year = Tax Rate * Interest Payment

- *Proposition 1*: Other things being equal, the higher the marginal tax rate of a business, the more debt it will have in its capital structure.
The Effects of Taxes

You are comparing the debt ratios of real estate corporations, which pay the corporate tax rate, and real estate investment trusts, which are not taxed, but are required to pay 95% of their earnings as dividends to their stockholders. Which of these two groups would you expect to have the higher debt ratios?

a. The real estate corporations
b. The real estate investment trusts
c. Cannot tell, without more information
Debt adds discipline to management

- If you are managers of a firm with no debt, and you generate high income and cash flows each year, you tend to become complacent. The complacency can lead to inefficiency and investing in poor projects. There is little or no cost borne by the managers.

- Forcing such a firm to borrow money can be an antidote to the complacency. The managers now have to ensure that the investments they make will earn at least enough return to cover the interest expenses. The cost of not doing so is bankruptcy and the loss of such a job.
Debt and Discipline

Assume that you buy into this argument that debt adds discipline to management. Which of the following types of companies will most benefit from debt adding this discipline?

a. Conservatively financed (very little debt), privately owned businesses.

b. Conservatively financed, publicly traded companies, with stocks held by millions of investors, none of whom hold a large percent of the stock.

c. Conservatively financed, publicly traded companies, with an activist and primarily institutional holding.
Bankruptcy Cost

- The expected bankruptcy cost is a function of two variables--
  - the probability of bankruptcy, which will depend upon how uncertain you are about future cash flows
  - the cost of going bankrupt
    - direct costs: Legal and other Deadweight Costs
    - indirect costs: Costs arising because people perceive you to be in financial trouble

- Proposition 2: Firms with more volatile earnings and cash flows will have higher probabilities of bankruptcy at any given level of debt and for any given level of earnings.

- Proposition 3: Other things being equal, the greater the indirect bankruptcy cost, the less debt the firm can afford to use for any given level of debt.
Rank the following companies on the magnitude of bankruptcy costs from most to least, taking into account both explicit and implicit costs:

a. A Grocery Store
b. An Airplane Manufacturer
c. High Technology company
An agency cost arises whenever you hire someone else to do something for you. It arises because your interests (as the principal) may deviate from those of the person you hired (as the agent).

When you lend money to a business, you are allowing the stockholders to use that money in the course of running that business. Stockholders interests are different from your interests, because

- You (as lender) are interested in getting your money back
- Stockholders are interested in maximizing their wealth

In some cases, the clash of interests can lead to stockholders

- Investing in riskier projects than you would want them to
- Paying themselves large dividends when you would rather have them keep the cash in the business.

Proposition 4: Other things being equal, the greater the agency problems associated with lending to a firm, the less debt the firm can afford to use.
Debt and Agency Costs

- Assume that you are a bank. Which of the following businesses would you perceive the greatest agency costs?
  a. A Large Technology firm
  b. A Large Regulated Electric Utility
- Why?
Loss of future financing flexibility

- When a firm borrows up to its capacity, it loses the flexibility of financing future projects with debt.

- Proposition 5: Other things remaining equal, the more uncertain a firm is about its future financing requirements and projects, the less debt the firm will use for financing current projects.
What managers consider important in deciding on how much debt to carry...

- A survey of Chief Financial Officers of large U.S. companies provided the following ranking (from most important to least important) for the factors that they considered important in the financing decisions.

<table>
<thead>
<tr>
<th>Factor</th>
<th>Ranking (0-5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Maintain financial flexibility</td>
<td>4.55</td>
</tr>
<tr>
<td>2. Ensure long-term survival</td>
<td>4.55</td>
</tr>
<tr>
<td>3. Maintain Predictable Source of Funds</td>
<td>4.05</td>
</tr>
<tr>
<td>5. Maintain financial independence</td>
<td>3.88</td>
</tr>
<tr>
<td>6. Maintain high debt rating</td>
<td>3.56</td>
</tr>
<tr>
<td>7. Maintain comparability with peer group</td>
<td>2.47</td>
</tr>
</tbody>
</table>
## Debt: Summarizing the trade off

<table>
<thead>
<tr>
<th>Advantages of Debt</th>
<th>Disadvantages of debt</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Tax Benefit</strong>: Interest expenses on debt are tax deductible but cash flows to equity are generally not. <strong>Implication</strong>: The higher the marginal tax rate, the greater the benefits of debt.</td>
<td><strong>1. Expected Bankruptcy Cost</strong>: The expected cost of going bankrupt is a product of the probability of going bankrupt and the cost of going bankrupt. The latter includes both direct and indirect costs. The probability of going bankrupt will be higher in businesses with more volatile earnings and the cost of bankruptcy will also vary across businesses. <strong>Implication</strong>: 1. Firms with more stable earnings should borrow more, for any given level of earnings. 2. Firms with lower bankruptcy costs should borrow more, for any given level of earnings.</td>
</tr>
<tr>
<td><strong>2. Added Discipline</strong>: Borrowing money may force managers to think about the consequences of the investment decisions a little more carefully and reduce bad investments. <strong>Implication</strong>: As the separation between managers and stockholders increases, the benefits to using debt will go up.</td>
<td><strong>2. Agency Costs</strong>: Actions that benefit equity investors may hurt lenders. The greater the potential for this conflict of interest, the greater the cost borne by the borrower (as higher interest rates or more covenants). <strong>Implication</strong>: Firms where lenders can monitor/control how their money is being used should be able to borrow more than firms where this is difficult to do.</td>
</tr>
<tr>
<td><strong>3. Loss of flexibility</strong>: Using up available debt capacity today will mean that you cannot draw on it in the future. This loss of flexibility can be disastrous if funds are needed and access to capital is shut off. <strong>Implication</strong>: 1. Firms that can forecast future funding needs better should be able to borrow more. 2. Firms with better access to capital markets should be more willing to borrow more today.</td>
<td></td>
</tr>
</tbody>
</table>
# The Trade off for Disney, Vale, Tata Motors and Baidu

<table>
<thead>
<tr>
<th>Debt trade off</th>
<th>Discussion of relative benefits/costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax benefits</td>
<td>Marginal tax rates of 40% in US (Disney &amp; Bookscape), 32.5% in India (Tata Motors), 25% in China (Baidu) and 34% in Brazil (Vale), but there is an offsetting tax benefit for equity in Brazil (interest on equity capital is deductible).</td>
</tr>
<tr>
<td>Added Discipline</td>
<td>The benefits should be highest at Disney, where there is a clear separation of ownership and management and smaller at the remaining firms.</td>
</tr>
<tr>
<td>Expected Bankruptcy Costs</td>
<td>Volatility in earnings: Higher at Baidu (young firm in technology), Tata Motors (cyclicality) and Vale (commodity prices) and lower at Disney (diversified across entertainment companies).</td>
</tr>
<tr>
<td></td>
<td>Indirect bankruptcy costs likely to be highest at Tata Motors, since it’s products (automobiles) have long lives and require service and lower at Disney and Baidu.</td>
</tr>
<tr>
<td>Agency Costs</td>
<td>Highest at Baidu, largely because it’s assets are intangible and it sells services and lowest at Vale (where investments are in mines, highly visible and easily monitored) and Tata Motors (tangible assets, family group backing). At Disney, the agency costs will vary across its business, higher in the movie and broadcasting businesses and lower at theme parks.</td>
</tr>
<tr>
<td>Flexibility needs</td>
<td>Baidu will value flexibility more than the other firms, because technology is a shifting and unpredictable business, where future investment needs are difficult to forecast. The flexibility needs should be lower at Disney and Tata Motors, since they are mature companies with well-established investment needs. At Vale, the need for investment funds may vary with commodity prices, since the firm grows by acquiring both reserves and smaller companies. At Bookscape, the difficulty of accessing external capital will make flexibility more necessary.</td>
</tr>
</tbody>
</table>
Application Test: Would you expect your firm to gain or lose from using a lot of debt?

- Considering, for your firm,
  - The potential tax benefits of borrowing
  - The benefits of using debt as a disciplinary mechanism
  - The potential for expected bankruptcy costs
  - The potential for agency costs
  - The need for financial flexibility

- Would you expect your firm to have a high debt ratio or a low debt ratio?

- Does the firm’s current debt ratio meet your expectations?
A Hypothetical Scenario

Assume that you live in a world where

(a) There are no taxes
(b) Managers have stockholder interests at heart and do what’s best for stockholders.
(c) No firm ever goes bankrupt
(d) Equity investors are honest with lenders; there is no subterfuge or attempt to find loopholes in loan agreements.
(e) Firms know their future financing needs with certainty

☐ What happens to the trade off between debt and equity? How much should a firm borrow?
The Miller-Modigliani Theorem

- In an environment, where there are no taxes, default risk or agency costs, capital structure is irrelevant.

- If the Miller Modigliani theorem holds:
  - A firm's value will be determined the quality of its investments and not by its financing mix.
  - The cost of capital of the firm will not change with leverage. As a firm increases its leverage, the cost of equity will increase just enough to offset any gains to the leverage.

Figure 7.9: Cost of Capital in the MM World
What do firms look at in financing?

- There are some who argue that firms follow a financing hierarchy, with retained earnings being the most preferred choice for financing, followed by debt and that new equity is the least preferred choice. In particular,
  - Managers value flexibility. Managers value being able to use capital (on new investments or assets) without restrictions on that use or having to explain its use to others.
  - Managers value control. Managers like being able to maintain control of their businesses.

- With flexibility and control being key factors:
  - Would you rather use internal financing (retained earnings) or external financing?
  - With external financing, would you rather use debt or equity?
## Preference rankings long-term finance: Results of a survey

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Source</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Retained Earnings</td>
<td>5.61</td>
</tr>
<tr>
<td>2</td>
<td>Straight Debt</td>
<td>4.88</td>
</tr>
<tr>
<td>3</td>
<td>Convertible Debt</td>
<td>3.02</td>
</tr>
<tr>
<td>4</td>
<td>External Common Equity</td>
<td>2.42</td>
</tr>
<tr>
<td>5</td>
<td>Straight Preferred Stock</td>
<td>2.22</td>
</tr>
<tr>
<td>6</td>
<td>Convertible Preferred</td>
<td>1.72</td>
</tr>
</tbody>
</table>
And the unsurprising consequences..

Figure 7.3: External and Internal Financing at US Firms
Financing Choices

□ You are reading the Wall Street Journal and notice a tombstone ad for a company, offering to sell convertible preferred stock. What would you hypothesize about the health of the company issuing these securities?

a. Nothing
b. Healthier than the average firm
c. In much more financial trouble than the average firm
CAPITAL STRUCTURE:
FINDING THE RIGHT FINANCING MIX

You can have too much debt... or too little...
The Big Picture..

Maximize the value of the business (firm)

**The Investment Decision**
Invest in assets that earn a return greater than the minimum acceptable hurdle rate

- The **hurdle rate** should reflect the riskiness of the investment and the mix of debt and equity used to fund it.

**The Financing Decision**
Find the right kind of debt for your firm and the right mix of debt and equity to fund your operations

- The **return** should reflect the magnitude and the timing of the cashflows as well as all side effects.

- The **optimal mix** of debt and equity maximizes firm value.

- The **right kind** of debt matches the tenor of your assets.

**The Dividend Decision**
If you cannot find investments that make your minimum acceptable rate, return the cash to owners of your business

- How much **cash** you can return depends upon current & potential investment opportunities.

- How you choose to return cash to the owners will depend whether they prefer dividends or buybacks.

Aswath Damodaran
Pathways to the Optimal

1. **The Cost of Capital Approach**: The optimal debt ratio is the one that minimizes the cost of capital for a firm.

2. **The Enhanced Cost of Capital approach**: The optimal debt ratio is the one that generates the best combination of (low) cost of capital and (high) operating income.

3. **The Adjusted Present Value Approach**: The optimal debt ratio is the one that maximizes the overall value of the firm.

4. **The Sector Approach**: The optimal debt ratio is the one that brings the firm closes to its peer group in terms of financing mix.

5. **The Life Cycle Approach**: The optimal debt ratio is the one that best suits where the firm is in its life cycle.
I. The Cost of Capital Approach

- Value of a Firm = Present Value of Cash Flows to the Firm, discounted back at the cost of capital.
- If the cash flows to the firm are held constant, and the cost of capital is minimized, the value of the firm will be maximized.
Recapping our discussion of cost of capital:

- The cost of debt is the market interest rate that the firm has to pay on its long term borrowing today, net of tax benefits. It will be a function of:
  
  a) The long-term riskfree rate
  
  b) The default spread for the company, reflecting its credit risk
  
  c) The firm’s marginal tax rate

- The cost of equity reflects the expected return demanded by marginal equity investors. If they are diversified, only the portion of the equity risk that cannot be diversified away (beta or betas) will be priced into the cost of equity.

- The cost of capital is the cost of each component weighted by its relative market value.

Cost of capital = Cost of equity \( \frac{E}{D+E} \) + After-tax cost of debt \( \frac{D}{D+E} \)
An article in an Asian business magazine argued that equity was cheaper than debt, because dividend yields are much lower than interest rates on debt. Do you agree with this statement?

a. Yes
b. No

Can equity ever be cheaper than debt?

a. Yes
b. No
Applying Cost of Capital Approach: The Textbook Example

Assume the firm has $200 million in cash flows, expected to grow 3% a year forever.

<table>
<thead>
<tr>
<th>D/(D+E)</th>
<th>Cost of Equity</th>
<th>After-tax Cost of Debt</th>
<th>Cost of Capital</th>
<th>Firm Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>10.50%</td>
<td>4.80%</td>
<td>10.50%</td>
<td>$2,747</td>
</tr>
<tr>
<td>10%</td>
<td>11.00%</td>
<td>5.10%</td>
<td>10.41%</td>
<td>$2,780</td>
</tr>
<tr>
<td>20%</td>
<td>11.60%</td>
<td>5.40%</td>
<td>10.36%</td>
<td>$2,799</td>
</tr>
<tr>
<td>30%</td>
<td>12.30%</td>
<td>5.52%</td>
<td>10.27%</td>
<td>$2,835</td>
</tr>
<tr>
<td>40%</td>
<td>13.10%</td>
<td>5.70%</td>
<td>10.14%</td>
<td>$2,885</td>
</tr>
<tr>
<td>50%</td>
<td>14.50%</td>
<td>6.10%</td>
<td>10.30%</td>
<td>$2,822</td>
</tr>
<tr>
<td>60%</td>
<td>15.00%</td>
<td>7.20%</td>
<td>10.32%</td>
<td>$2,814</td>
</tr>
<tr>
<td>70%</td>
<td>16.10%</td>
<td>8.10%</td>
<td>10.50%</td>
<td>$2,747</td>
</tr>
<tr>
<td>80%</td>
<td>17.20%</td>
<td>9.00%</td>
<td>10.64%</td>
<td>$2,696</td>
</tr>
<tr>
<td>90%</td>
<td>18.40%</td>
<td>10.20%</td>
<td>11.02%</td>
<td>$2,569</td>
</tr>
<tr>
<td>100%</td>
<td>19.70%</td>
<td>11.40%</td>
<td>11.40%</td>
<td>$2,452</td>
</tr>
</tbody>
</table>

Value = \( \frac{\text{Expected Cash flow to firm next year}}{(\text{Cost of capital} - g)} \)

Value = \( \frac{200(1.03)}{(\text{Cost of capital} - 0.03)} \)
The U-shaped Cost of Capital Graph...
Current Cost of Capital: Disney

- The beta for Disney’s stock in November 2013 was 1.0013. The T. bond rate at that time was 2.75%. Using an estimated equity risk premium of 5.76%, we estimated the cost of equity for Disney to be 8.52%:

  \[
  \text{Cost of Equity} = 2.75\% + 1.0013(5.76\%) = 8.52\%
  \]

- Disney’s bond rating in May 2009 was A, and based on this rating, the estimated pretax cost of debt for Disney is 3.75%. Using a marginal tax rate of 36.1, the after-tax cost of debt for Disney is 2.40%.

  \[
  \text{After-Tax Cost of Debt} = 3.75\% (1 – 0.361) = 2.40\%
  \]

- The cost of capital was calculated using these costs and the weights based on market values of equity (121,878) and debt (15,961):

  \[
  \text{Cost of capital} = \frac{8.52\%}{(15,961+121,878)} + \frac{2.40\%}{15,961+121,878} = 7.81\%
  \]
Mechanics of Cost of Capital Estimation

1. Estimate the Cost of Equity at different levels of debt:
   - Equity will become riskier -> Beta will increase -> Cost of Equity will increase.
   - Estimation will use levered beta calculation

2. Estimate the Cost of Debt at different levels of debt:
   - Default risk will go up and bond ratings will go down as debt goes up -> Cost of Debt will increase.
   - To estimating bond ratings, we will use the interest coverage ratio (EBIT/Interest expense)

3. Estimate the Cost of Capital at different levels of debt

4. Calculate the effect on Firm Value and Stock Price.
Laying the groundwork:
1. Estimate the unlevered beta for the firm

- **The Regression Beta**: One approach is to use the regression beta (1.25) and then unlever, using the average debt to equity ratio (19.44%) during the period of the regression to arrive at an unlevered beta.

  Unlevered beta = \( \frac{1.25}{1 + (1 - 0.361)(0.1944)} \) = 1.1119

- **The Bottom up Beta**: Alternatively, we can back to the source and estimate it from the betas of the businesses.

<table>
<thead>
<tr>
<th>Business</th>
<th>Revenues</th>
<th>EV/Sales</th>
<th>Value of Business</th>
<th>Proportion of Disney</th>
<th>Unlevered beta</th>
<th>Value</th>
<th>Proportion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Media Networks</td>
<td>$20,356</td>
<td>3.27</td>
<td>$66,580</td>
<td>49.27%</td>
<td>1.03</td>
<td>$66,579.81</td>
<td>49.27%</td>
</tr>
<tr>
<td>Parks &amp; Resorts</td>
<td>$14,087</td>
<td>3.24</td>
<td>$45,683</td>
<td>33.81%</td>
<td>0.70</td>
<td>$45,682.80</td>
<td>33.81%</td>
</tr>
<tr>
<td>Studio Entertainment</td>
<td>$5,979</td>
<td>3.05</td>
<td>$18,234</td>
<td>13.49%</td>
<td>1.10</td>
<td>$18,234.27</td>
<td>13.49%</td>
</tr>
<tr>
<td>Consumer Products</td>
<td>$3,555</td>
<td>0.83</td>
<td>$2,952</td>
<td>2.18%</td>
<td>0.68</td>
<td>$2,951.50</td>
<td>2.18%</td>
</tr>
<tr>
<td>Interactive</td>
<td>$1,064</td>
<td>1.58</td>
<td>$1,684</td>
<td>1.25%</td>
<td>1.22</td>
<td>$1,683.72</td>
<td>1.25%</td>
</tr>
<tr>
<td><strong>Disney Operations</strong></td>
<td><strong>$45,041</strong></td>
<td></td>
<td><strong>$135,132</strong></td>
<td><strong>100.00%</strong></td>
<td><strong>0.9239</strong></td>
<td><strong>$135,132.11</strong></td>
<td><strong>100.00%</strong></td>
</tr>
</tbody>
</table>
2. Get Disney’s current financials...

<table>
<thead>
<tr>
<th></th>
<th>Most recent fiscal year (2012-13)</th>
<th>Prior year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$45,041</td>
<td>$42,278</td>
</tr>
<tr>
<td>EBITDA</td>
<td>$10,642</td>
<td>$10,850</td>
</tr>
<tr>
<td>Depreciation &amp; Amortization</td>
<td>$2,192</td>
<td>$1,987</td>
</tr>
<tr>
<td>EBIT</td>
<td>$9,450</td>
<td>$8,863</td>
</tr>
<tr>
<td>Interest Expenses</td>
<td>$349</td>
<td>$564</td>
</tr>
<tr>
<td>EBITDA (adjusted for leases)</td>
<td>$12,517</td>
<td>$11,168</td>
</tr>
<tr>
<td>Depreciation (adjusted for leases)</td>
<td>$2,485</td>
<td>$2,239</td>
</tr>
<tr>
<td>EBIT (adjusted for leases)</td>
<td>$10,032</td>
<td>$8,929</td>
</tr>
<tr>
<td>Interest Expenses (adjusted for leases)</td>
<td>$459</td>
<td>$630</td>
</tr>
</tbody>
</table>
I. Cost of Equity

<table>
<thead>
<tr>
<th>Debt to Capital Ratio</th>
<th>D/E Ratio</th>
<th>Levered Beta</th>
<th>Cost of Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>0.00%</td>
<td>0.9239</td>
<td>8.07%</td>
</tr>
<tr>
<td>10%</td>
<td>11.11%</td>
<td>0.9895</td>
<td>8.45%</td>
</tr>
<tr>
<td>20%</td>
<td>25.00%</td>
<td>1.0715</td>
<td>8.92%</td>
</tr>
<tr>
<td>30%</td>
<td>42.86%</td>
<td>1.1770</td>
<td>9.53%</td>
</tr>
<tr>
<td>40%</td>
<td>66.67%</td>
<td>1.3175</td>
<td>10.34%</td>
</tr>
<tr>
<td>50%</td>
<td>100.00%</td>
<td>1.5143</td>
<td>11.48%</td>
</tr>
<tr>
<td>60%</td>
<td>150.00%</td>
<td>1.8095</td>
<td>13.18%</td>
</tr>
<tr>
<td>70%</td>
<td>233.33%</td>
<td>2.3016</td>
<td>16.01%</td>
</tr>
<tr>
<td>80%</td>
<td>400.00%</td>
<td>3.2856</td>
<td>21.68%</td>
</tr>
<tr>
<td>90%</td>
<td>900.00%</td>
<td>6.2376</td>
<td>38.69%</td>
</tr>
</tbody>
</table>

Levered Beta = 0.9239 \( (1 + (1 - .361) \text{ (D/E)}) \)

Cost of equity = 2.75% + Levered beta * 5.76%

Aswath Damodaran
Estimating Cost of Debt

Start with the market value of the firm = $121,878 + $15,961 = $137,839 million

<table>
<thead>
<tr>
<th>D/(D+E)</th>
<th>0.00%</th>
<th>10.00%</th>
<th>Debt to capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>D/E</td>
<td>0.00%</td>
<td>11.11%</td>
<td>D/E = 10/90 = .1111</td>
</tr>
<tr>
<td>$ Debt</td>
<td>$0</td>
<td>$13,784</td>
<td>10% of $137,839</td>
</tr>
</tbody>
</table>

EBITDA $12,517 $12,517 Same as 0% debt
Depreciation $2,485 $2,485 Same as 0% debt
EBIT $10,032 $10,032 Same as 0% debt
Interest $0 $434 Pre-tax cost of debt * $ Debt

Pre-tax Int. cov ∞ 23.10 EBIT/ Interest Expenses
Likely Rating AAA AAA From Ratings table
Pre-tax cost of debt 3.15% 3.15% Riskless Rate + Spread

Aswath Damodaran
### The Ratings Table

<table>
<thead>
<tr>
<th>Interest coverage ratio is</th>
<th>Rating is</th>
<th>Spread is</th>
<th>Interest rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt; 8.50</td>
<td>Aaa/AAA</td>
<td>0.40%</td>
<td>3.15%</td>
</tr>
<tr>
<td>6.5 – 8.5</td>
<td>Aa2/AA</td>
<td>0.70%</td>
<td>3.45%</td>
</tr>
<tr>
<td>5.5 – 6.5</td>
<td>A1/A+</td>
<td>0.85%</td>
<td>3.60%</td>
</tr>
<tr>
<td>4.25 – 5.5</td>
<td>A2/A</td>
<td>1.00%</td>
<td>3.75%</td>
</tr>
<tr>
<td>3 – 4.25</td>
<td>A3/A-</td>
<td>1.30%</td>
<td>4.05%</td>
</tr>
<tr>
<td>2.5 – 3</td>
<td>Baa2/BBB</td>
<td>2.00%</td>
<td>4.75%</td>
</tr>
<tr>
<td>2.25 – 2.5</td>
<td>Ba1/BB+</td>
<td>3.00%</td>
<td>5.75%</td>
</tr>
<tr>
<td>2 – 2.25</td>
<td>Ba2/BB</td>
<td>4.00%</td>
<td>6.75%</td>
</tr>
<tr>
<td>1.75 – 2</td>
<td>B1/B+</td>
<td>5.50%</td>
<td>8.25%</td>
</tr>
<tr>
<td>1.5 – 1.75</td>
<td>B2/B</td>
<td>6.50%</td>
<td>9.25%</td>
</tr>
<tr>
<td>1.25 – 1.5</td>
<td>B3/B-</td>
<td>7.25%</td>
<td>10.00%</td>
</tr>
<tr>
<td>0.8 – 1.25</td>
<td>Caa/CCC</td>
<td>8.75%</td>
<td>11.50%</td>
</tr>
<tr>
<td>0.65 – 0.8</td>
<td>Ca2/CC</td>
<td>9.50%</td>
<td>12.25%</td>
</tr>
<tr>
<td>0.2 – 0.65</td>
<td>C2/C</td>
<td>10.50%</td>
<td>13.25%</td>
</tr>
<tr>
<td>&lt;0.2</td>
<td>D2/D</td>
<td>12.00%</td>
<td>14.75%</td>
</tr>
</tbody>
</table>

T.Bond rate =2.75%
A Test: Can you do the 30% level?

<table>
<thead>
<tr>
<th></th>
<th>Iteration 1 (Debt @AAA rate)</th>
<th>Iteration 2 (Debt @AA rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$D/(D + E)$</td>
<td>20.00%</td>
<td>30.00%</td>
</tr>
<tr>
<td>$D/E$</td>
<td>25.00%</td>
<td></td>
</tr>
<tr>
<td>$ Debt</td>
<td>$27,568</td>
<td></td>
</tr>
<tr>
<td>EBITDA</td>
<td>$12,517</td>
<td></td>
</tr>
<tr>
<td>$ Depreciation</td>
<td>$2,485</td>
<td></td>
</tr>
<tr>
<td>EBIT</td>
<td>$10,032</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>$868</td>
<td></td>
</tr>
<tr>
<td>Interest coverage ratio</td>
<td>11.55</td>
<td></td>
</tr>
<tr>
<td>Likely rating</td>
<td>AAA</td>
<td></td>
</tr>
<tr>
<td>Pretax cost of debt</td>
<td>3.15%</td>
<td></td>
</tr>
</tbody>
</table>
## Bond Ratings, Cost of Debt and Debt Ratios

<table>
<thead>
<tr>
<th>Debt Ratio</th>
<th>$ Debt</th>
<th>Interest Expense</th>
<th>Interest Coverage Ratio</th>
<th>Bond Rating</th>
<th>Pre-tax cost of debt</th>
<th>Tax rate</th>
<th>After-tax cost of debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>$0</td>
<td>$0</td>
<td>$\infty$</td>
<td>Aaa/AAA</td>
<td>3.15%</td>
<td>36.10%</td>
<td>2.01%</td>
</tr>
<tr>
<td>10%</td>
<td>$13,784</td>
<td>$434</td>
<td>23.10</td>
<td>Aaa/AAA</td>
<td>3.15%</td>
<td>36.10%</td>
<td>2.01%</td>
</tr>
<tr>
<td>20%</td>
<td>$27,568</td>
<td>$868</td>
<td>11.55</td>
<td>Aaa/AAA</td>
<td>3.15%</td>
<td>36.10%</td>
<td>2.01%</td>
</tr>
<tr>
<td>30%</td>
<td>$41,352</td>
<td>$1,427</td>
<td>7.03</td>
<td>Aa2/AA</td>
<td>3.45%</td>
<td>36.10%</td>
<td>2.20%</td>
</tr>
<tr>
<td>40%</td>
<td>$55,136</td>
<td>$2,068</td>
<td>4.85</td>
<td>A2/A</td>
<td>3.75%</td>
<td>36.10%</td>
<td>2.40%</td>
</tr>
<tr>
<td>50%</td>
<td>$68,919</td>
<td>$6,892</td>
<td>1.46</td>
<td>B3/B-</td>
<td>10.00%</td>
<td>36.10%</td>
<td>6.39%</td>
</tr>
<tr>
<td>60%</td>
<td>$82,703</td>
<td>$9,511</td>
<td>1.05</td>
<td>Caa/CCC</td>
<td>11.50%</td>
<td>36.10%</td>
<td>7.35%</td>
</tr>
<tr>
<td>70%</td>
<td>$96,487</td>
<td>$11,096</td>
<td>0.90</td>
<td>Caa/CCC</td>
<td>11.50%</td>
<td>32.64%</td>
<td>7.75%</td>
</tr>
<tr>
<td>80%</td>
<td>$110,271</td>
<td>$13,508</td>
<td>0.74</td>
<td>Ca2/CC</td>
<td>12.25%</td>
<td>26.81%</td>
<td>8.97%</td>
</tr>
<tr>
<td>90%</td>
<td>$124,055</td>
<td>$16,437</td>
<td>0.61</td>
<td>C2/C</td>
<td>13.25%</td>
<td>22.03%</td>
<td>10.33%</td>
</tr>
</tbody>
</table>
You need taxable income for interest to provide a tax savings. Note that the EBIT at Disney is $10,032 million. As long as interest expenses are less than $10,032 million, interest expenses remain fully tax-deductible and earn the 36.1% tax benefit. At an 60% debt ratio, the interest expenses are $9,511 million and the tax benefit is therefore 36.1% of this amount.

At a 70% debt ratio, however, the interest expenses balloon to $11,096 million, which is greater than the EBIT of $10,032 million. We consider the tax benefit on the interest expenses up to this amount:

- Maximum Tax Benefit = EBIT * Marginal Tax Rate = $10,032 million * 0.361 = $3,622 million
- Adjusted Marginal Tax Rate = Maximum Tax Benefit/Interest Expenses = $3,622/$11,096 = 32.64%
Disney’s cost of capital schedule...

<table>
<thead>
<tr>
<th>Debt Ratio</th>
<th>Beta</th>
<th>Cost of Equity</th>
<th>Cost of Debt (after-tax)</th>
<th>WACC</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>0.9239</td>
<td>8.07%</td>
<td>2.01%</td>
<td>8.07%</td>
</tr>
<tr>
<td>10%</td>
<td>0.9895</td>
<td>8.45%</td>
<td>2.01%</td>
<td>7.81%</td>
</tr>
<tr>
<td>20%</td>
<td>1.0715</td>
<td>8.92%</td>
<td>2.01%</td>
<td>7.54%</td>
</tr>
<tr>
<td>30%</td>
<td>1.1770</td>
<td>9.53%</td>
<td>2.20%</td>
<td>7.33%</td>
</tr>
<tr>
<td>40%</td>
<td>1.3175</td>
<td>10.34%</td>
<td>2.40%</td>
<td>7.16%</td>
</tr>
<tr>
<td>50%</td>
<td>1.5143</td>
<td>11.48%</td>
<td>6.39%</td>
<td>8.93%</td>
</tr>
<tr>
<td>60%</td>
<td>1.8095</td>
<td>13.18%</td>
<td>7.35%</td>
<td>9.68%</td>
</tr>
<tr>
<td>70%</td>
<td>2.3762</td>
<td>16.44%</td>
<td>7.75%</td>
<td>10.35%</td>
</tr>
<tr>
<td>80%</td>
<td>3.6289</td>
<td>23.66%</td>
<td>8.97%</td>
<td>11.90%</td>
</tr>
<tr>
<td>90%</td>
<td>7.4074</td>
<td>45.43%</td>
<td>10.33%</td>
<td>13.84%</td>
</tr>
</tbody>
</table>

Aswath Damodaran
Disney: Cost of Capital Chart
Disney: Cost of Capital Chart: 1997

Note the kink in the cost of capital graph at 60% debt. What is causing it?
The cost of capital approach suggests that Disney should do the following...

- Disney currently has $15.96 billion in debt. The optimal dollar debt (at 40%) is roughly $55.1 billion. Disney has excess debt capacity of 39.14 billion.

- To move to its optimal and gain the increase in value, Disney should borrow $39.14 billion and buy back stock.

- Given the magnitude of this decision, you should expect to answer three questions:
  - Why should we do it?
  - What if something goes wrong?
  - What if we don’t want (or cannot) buy back stock and want to make investments with the additional debt capacity?
Why should we do it?

Effect on Firm Value – Full Valuation

Step 1: Estimate the cash flows to Disney as a firm

\[
\text{EBIT} (1 - \text{Tax Rate}) = 10,032 (1 - 0.361) = \$6,410 \\
+ \text{Depreciation and amortization} = \$2,485 \\
- \text{Capital expenditures} = \$5,239 \\
- \text{Change in noncash working capital} = \$0 \\
\text{Free cash flow to the firm} = \$3,657
\]

Step 2: Back out the implied growth rate in the current market value

\[
\text{Current enterprise value} = \$121,878 + 15,961 - 3,931 = 133,908
\]

\[
\text{Value of firm} = \$133,908 = \frac{\text{FCFF}_0 (1 + g)}{(\text{Cost of Capital} - g)} = \frac{3,657(1+g)}{(0.0781 - g)}
\]

\[
\text{Growth rate} = \frac{\text{Firm Value} \times \text{Cost of Capital} - \text{CF to Firm}}{\text{Firm Value} + \text{CF to Firm}}
\]

\[
= (133,908 \times 0.0781 - 3,657)/(133,908 + 3,657) = 0.0494 \text{ or } 4.94\%
\]

Step 3: Revalue the firm with the new cost of capital

\[
\text{Firm value} = \frac{\text{FCFF}_0 (1 + g)}{(\text{Cost of Capital} - g)} = \frac{3,657(1.0494)}{(0.0716 - 0.0484)} = \$172,935 \text{ million}
\]

\[
\text{Increase in firm value} = \$172,935 - \$133,908 = \$39,027 \text{ million}
\]
Effect on Value: Incremental approach

- In this approach, we start with the current market value and isolate the effect of changing the capital structure on the cash flow and the resulting value.

Enterprise Value before the change = $133,908 million

Cost of financing Disney at existing debt ratio = $133,908 * 0.0781 = $10,458 million

Cost of financing Disney at optimal debt ratio = $133,908 * 0.0716 = $9,592 million

Annual savings in cost of financing = $10,458 million – $9,592 million = $866 million

Increase in Value = \( \frac{\text{Annual Savings next year}}{\text{(Cost of Capital - g)}} \) = \( \frac{$866}{(0.0716 - 0.0275)} \) = $19,623 million

Enterprise value after recapitalization

= Existing enterprise value + PV of Savings = $133,908 + $19,623 = $153,531 million
From firm value to value per share: The Rational Investor Solution

- Because the increase in value accrues entirely to stockholders, we can estimate the increase in value per share by dividing by the total number of shares outstanding (1,800 million).
  - Increase in Value per Share = $19,623/1800 = $10.90
  - New Stock Price = $67.71 + $10.90 = $78.61

- Implicit in this computation is the assumption that the increase in firm value will be spread evenly across both the stockholders who sell their stock back to the firm and those who do not and that is why we term this the “rational” solution, since it leaves investors indifferent between selling back their shares and holding on to them.

Aswath Damodaran
The more general solution, given a buyback price

- Start with the buyback price and compute the number of shares outstanding after the buyback:
  - Increase in Debt = Debt at optimal – Current Debt
  - # Shares after buyback = # Shares before – \( \frac{\text{Increase in Debt}}{\text{Share Price}} \)

- Then compute the equity value after the recapitalization, starting with the enterprise value at the optimal, adding back cash and subtracting out the debt at the optimal:
  - Equity value after buyback = Optimal Enterprise value + Cash – Debt

- Divide the equity value after the buyback by the post-buyback number of shares.
  - Value per share after buyback = Equity value after buyback/ Number of shares after buyback
Let’s try a price: What if can buy shares back at the old price ($67.71)?

- Start with the buyback price and compute the number of shares outstanding after the buyback
  - Debt issued = $ 55,136 - $15,961 = $39,175 million
  - # Shares after buyback = 1800 - $39,175/$67.71 = 1221.43 m

- Then compute the equity value after the recapitalization, starting with the enterprise value at the optimal, adding back cash and subtracting out the debt at the optimal:
  - Optimal Enterprise Value = $153,531
  - Equity value after buyback = $153,531 + $3,931 – $55,136 = $102,326

- Divide the equity value after the buyback by the post-buyback number of shares.
  - Value per share after buyback = $102,326/1221.43 = $83.78
Back to the rational price ($78.61): Here is the proof

- Start with the buyback price and compute the number of shares outstanding after the buyback
  - # Shares after buyback = 1800 - $39,175/$78.61 = 1301.65 m

- Then compute the equity value after the recapitalization, starting with the enterprise value at the optimal, adding back cash and subtracting out the debt at the optimal:
  - Optimal Enterprise Value = $153,531
  - Equity value after buyback = $153,531 + $3,931– $55,136 = $102,326

- Divide the equity value after the buyback by the post-buyback number of shares.
  - Value per share after buyback = $102,326/1301.65 = $78.61
2. What if something goes wrong?
The Downside Risk

- Sensitivity to Assumptions
  A. “What if” analysis
    The optimal debt ratio is a function of our inputs on operating income, tax rates and macro variables. We could focus on one or two key variables – operating income is an obvious choice – and look at history for guidance on volatility in that number and ask what if questions.
  B. “Economic Scenario” Approach
    We can develop possible scenarios, based upon macro variables, and examine the optimal debt ratio under each one. For instance, we could look at the optimal debt ratio for a cyclical firm under a boom economy, a regular economy and an economy in recession.

- Constraint on Bond Ratings/ Book Debt Ratios
  Alternatively, we can put constraints on the optimal debt ratio to reduce exposure to downside risk. Thus, we could require the firm to have a minimum rating, at the optimal debt ratio or to have a book debt ratio that is less than a “specified” value.
# Disney’s Operating Income: History

<table>
<thead>
<tr>
<th>Year</th>
<th>EBIT</th>
<th>% Change in EBIT</th>
<th>Year</th>
<th>EBIT</th>
<th>% Change in EBIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>$756</td>
<td>-</td>
<td>2001</td>
<td>$2,832</td>
<td>12.16%</td>
</tr>
<tr>
<td>1988</td>
<td>$848</td>
<td>12.17%</td>
<td>2002</td>
<td>$2,384</td>
<td>-15.82%</td>
</tr>
<tr>
<td>1989</td>
<td>$1,177</td>
<td>38.80%</td>
<td>2003</td>
<td>$2,713</td>
<td>13.80%</td>
</tr>
<tr>
<td>1990</td>
<td>$1,368</td>
<td>16.23%</td>
<td>2004</td>
<td>$4,048</td>
<td>49.21%</td>
</tr>
<tr>
<td>1991</td>
<td>$1,124</td>
<td>-17.84%</td>
<td>2005</td>
<td>$4,107</td>
<td>1.46%</td>
</tr>
<tr>
<td>1992</td>
<td>$1,287</td>
<td>14.50%</td>
<td>2006</td>
<td>$5,355</td>
<td>30.39%</td>
</tr>
<tr>
<td>1993</td>
<td>$1,560</td>
<td>21.21%</td>
<td>2007</td>
<td>$6,829</td>
<td>27.53%</td>
</tr>
<tr>
<td>1994</td>
<td>$1,804</td>
<td>15.64%</td>
<td>2008</td>
<td>$7,404</td>
<td>8.42%</td>
</tr>
<tr>
<td>1995</td>
<td>$2,262</td>
<td>25.39%</td>
<td>2009</td>
<td>$5,697</td>
<td>-23.06%</td>
</tr>
<tr>
<td>1996</td>
<td>$3,024</td>
<td>33.69%</td>
<td>2010</td>
<td>$6,726</td>
<td>18.06%</td>
</tr>
<tr>
<td>1997</td>
<td>$3,945</td>
<td>30.46%</td>
<td>2011</td>
<td>$7,781</td>
<td>15.69%</td>
</tr>
<tr>
<td>1998</td>
<td>$3,843</td>
<td>-2.59%</td>
<td>2012</td>
<td>$8,863</td>
<td>13.91%</td>
</tr>
<tr>
<td>1999</td>
<td>$3,580</td>
<td>-6.84%</td>
<td>2013</td>
<td>$9,450</td>
<td>6.62%</td>
</tr>
<tr>
<td>2000</td>
<td>$2,525</td>
<td>-29.47%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Standard deviation in % change in EBIT = 19.17%

Recession: Decline in Operating Income
- 2009: Drop of 23.06%
- 2002: Drop of 15.82%
- 1991: Drop of 22.00%
- 1981-82: Increased by 12%
- Worst Year: Drop of 29.47%

Aswath Damodaran
## Disney: Safety Buffers?

<table>
<thead>
<tr>
<th>EBIT drops by</th>
<th>EBIT</th>
<th>Optimal Debt ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>$10,032</td>
<td>40%</td>
</tr>
<tr>
<td>10%</td>
<td>$9,029</td>
<td>40%</td>
</tr>
<tr>
<td>20%</td>
<td>$8,025</td>
<td>40%</td>
</tr>
<tr>
<td>30%</td>
<td>$7,022</td>
<td>40%</td>
</tr>
<tr>
<td>40%</td>
<td>$6,019</td>
<td>30%</td>
</tr>
<tr>
<td>50%</td>
<td>$5,016</td>
<td>30%</td>
</tr>
<tr>
<td>60%</td>
<td>$4,013</td>
<td>20%</td>
</tr>
</tbody>
</table>
Constraints on Ratings

- Management often specifies a 'desired rating' below which they do not want to fall.
- The rating constraint is driven by three factors:
  - it is one way of protecting against downside risk in operating income (so do not do both)
  - a drop in ratings might affect operating income
  - there is an ego factor associated with high ratings
- Caveat: Every rating constraint has a cost.
  - The cost of a rating constraint is the difference between the unconstrained value and the value of the firm with the constraint.
  - Managers need to be made aware of the costs of the constraints they impose.
Ratings Constraints for Disney

- At its optimal debt ratio of 40%, Disney has an estimated rating of A.
- If managers insisted on a AA rating, the optimal debt ratio for Disney is then 30% and the cost of the ratings constraint is fairly small:
  \[ \text{Cost of AA Rating Constraint} = \text{Value at 40% Debt} - \text{Value at 30% Debt} \]
  \[ \text{Debt} = \$153,531 \text{ m} - \$147,835 \text{ m} = \$5,696 \text{ million} \]
- If managers insisted on a AAA rating, the optimal debt ratio would drop to 20% and the cost of the ratings constraint would rise:
  \[ \text{Cost of AAA rating constraint} = \text{Value at 40% Debt} - \text{Value at 20% Debt} \]
  \[ \text{Debt} = \$153,531 \text{ m} - \$141,406 \text{ m} = \$12,125 \text{ million} \]
3. What if you do not buy back stock..

- The optimal debt ratio is ultimately a function of the underlying riskiness of the business in which you operate and your tax rate.

- Will the optimal be different if you invested in projects instead of buying back stock?
  - No. As long as the projects financed are in the same business mix that the company has always been in and your tax rate does not change significantly.
  - Yes, if the projects are in entirely different types of businesses or if the tax rate is significantly different.
Extension to a family group company: Tata Motor’s Optimal Capital Structure

<table>
<thead>
<tr>
<th>Debt Ratio</th>
<th>Beta</th>
<th>Cost of Equity</th>
<th>Bond Rating</th>
<th>Interest rate on debt</th>
<th>Tax Rate</th>
<th>Cost of Debt (after-tax)</th>
<th>WACC</th>
<th>Enterprise Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>0.8601</td>
<td>12.76%</td>
<td>Aaa/AAA</td>
<td>9.22%</td>
<td>32.45%</td>
<td>6.23%</td>
<td>12.76%</td>
<td>1,286,997₹</td>
</tr>
<tr>
<td>10%</td>
<td>0.9247</td>
<td>13.22%</td>
<td>Aa2/AA</td>
<td>9.52%</td>
<td>32.45%</td>
<td>6.43%</td>
<td>12.54%</td>
<td>1,333,263₹</td>
</tr>
<tr>
<td>20%</td>
<td>1.0054</td>
<td>13.80%</td>
<td>A3/A-</td>
<td>10.12%</td>
<td>32.45%</td>
<td>6.84%</td>
<td>12.41%</td>
<td>1,363,774₹</td>
</tr>
<tr>
<td>30%</td>
<td>1.1092</td>
<td>14.55%</td>
<td>B2/B</td>
<td>15.32%</td>
<td>32.45%</td>
<td>10.35%</td>
<td>13.29%</td>
<td>1,185,172₹</td>
</tr>
<tr>
<td>40%</td>
<td>1.2475</td>
<td>15.54%</td>
<td>Caa/CCC</td>
<td>17.57%</td>
<td>32.45%</td>
<td>11.87%</td>
<td>14.07%</td>
<td>1,061,143₹</td>
</tr>
<tr>
<td>50%</td>
<td>1.4412</td>
<td>16.93%</td>
<td>Ca2/CC</td>
<td>18.32%</td>
<td>32.45%</td>
<td>12.38%</td>
<td>14.65%</td>
<td>984,693₹</td>
</tr>
<tr>
<td>60%</td>
<td>1.7610</td>
<td>19.23%</td>
<td>Ca2/CC</td>
<td>18.32%</td>
<td>30.18%</td>
<td>12.79%</td>
<td>15.37%</td>
<td>904,764₹</td>
</tr>
<tr>
<td>70%</td>
<td>2.3749</td>
<td>23.65%</td>
<td>C2/C</td>
<td>19.32%</td>
<td>24.53%</td>
<td>14.58%</td>
<td>17.30%</td>
<td>741,800₹</td>
</tr>
<tr>
<td>80%</td>
<td>3.5624</td>
<td>32.19%</td>
<td>C2/C</td>
<td>19.32%</td>
<td>21.46%</td>
<td>15.17%</td>
<td>18.58%</td>
<td>663,028₹</td>
</tr>
<tr>
<td>90%</td>
<td>7.1247</td>
<td>57.81%</td>
<td>C2/C</td>
<td>19.32%</td>
<td>19.08%</td>
<td>15.63%</td>
<td>19.85%</td>
<td>599,379₹</td>
</tr>
</tbody>
</table>

Tata Motors looks like it is over levered (29% actual versus 20% optimal), perhaps because it is drawing on the debt capacity of other companies in the Tata Group.

Aswath Damodaran
Extension to a firm with volatile earnings: Vale’s Optimal Debt Ratio

<table>
<thead>
<tr>
<th>Debt Ratio</th>
<th>Beta</th>
<th>Cost of Equity</th>
<th>Bond Rating</th>
<th>Interest rate on debt</th>
<th>Tax Rate</th>
<th>Cost of Debt (after-tax)</th>
<th>WACC</th>
<th>Enterprise Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>0.8440</td>
<td>8.97%</td>
<td>Aaa/AAA</td>
<td>5.15%</td>
<td>34.00%</td>
<td>3.40%</td>
<td>8.97%</td>
<td>$98,306</td>
</tr>
<tr>
<td>10%</td>
<td>0.9059</td>
<td>9.43%</td>
<td>Aaa/AAA</td>
<td>5.15%</td>
<td>34.00%</td>
<td>3.40%</td>
<td>8.83%</td>
<td>$100,680</td>
</tr>
<tr>
<td>20%</td>
<td>0.9833</td>
<td>10.00%</td>
<td>Aaa/AAA</td>
<td>5.15%</td>
<td>34.00%</td>
<td>3.40%</td>
<td>8.68%</td>
<td>$103,171</td>
</tr>
<tr>
<td>30%</td>
<td>1.0827</td>
<td>10.74%</td>
<td>A1/A+</td>
<td>5.60%</td>
<td>34.00%</td>
<td>3.70%</td>
<td>8.62%</td>
<td>$104,183</td>
</tr>
<tr>
<td>40%</td>
<td>1.2154</td>
<td>11.71%</td>
<td>A3/A-</td>
<td>6.05%</td>
<td>34.00%</td>
<td>3.99%</td>
<td>8.63%</td>
<td>$104,152</td>
</tr>
<tr>
<td>50%</td>
<td>1.4011</td>
<td>13.08%</td>
<td>B1/B+</td>
<td>10.25%</td>
<td>34.00%</td>
<td>6.77%</td>
<td>9.92%</td>
<td>$85,298</td>
</tr>
<tr>
<td>60%</td>
<td>1.6796</td>
<td>15.14%</td>
<td>B3/B-</td>
<td>12.00%</td>
<td>34.00%</td>
<td>7.92%</td>
<td>10.81%</td>
<td>$75,951</td>
</tr>
<tr>
<td>70%</td>
<td>2.1438</td>
<td>18.56%</td>
<td>B3/B-</td>
<td>12.00%</td>
<td>34.00%</td>
<td>7.92%</td>
<td>11.11%</td>
<td>$73,178</td>
</tr>
<tr>
<td>80%</td>
<td>3.0722</td>
<td>25.41%</td>
<td>Ca2/CC</td>
<td>14.25%</td>
<td>34.00%</td>
<td>9.41%</td>
<td>12.61%</td>
<td>$62,090</td>
</tr>
<tr>
<td>90%</td>
<td>5.8574</td>
<td>45.95%</td>
<td>Ca2/CC</td>
<td>14.25%</td>
<td>34.00%</td>
<td>9.41%</td>
<td>13.06%</td>
<td>$59,356</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Last 12 months</th>
<th>-1</th>
<th>-2</th>
<th>-3</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$48,469</td>
<td>$48,058</td>
<td>$48,123</td>
<td>$47,343</td>
<td>$51,248</td>
</tr>
<tr>
<td>EBITDA</td>
<td>$19,361</td>
<td>$17,662</td>
<td>$18,183</td>
<td>$16,299</td>
<td>$18,501</td>
</tr>
<tr>
<td>EBIT</td>
<td>$15,487</td>
<td>$13,346</td>
<td>$13,206</td>
<td>$12,033</td>
<td>$14,518</td>
</tr>
<tr>
<td>Pre-tax operating margin</td>
<td>31.95%</td>
<td>27.77%</td>
<td>49.42%</td>
<td>48.65%</td>
<td>39.45%</td>
</tr>
</tbody>
</table>

Replacing Vale’s current operating income with the average over the last three years pushes up the optimal to 50%.

Aswath Damodaran
Optimal Debt Ratio for a young, growth firm: Baidu

<table>
<thead>
<tr>
<th>Debt Ratio</th>
<th>Beta</th>
<th>Cost of Equity</th>
<th>Bond Rating</th>
<th>Interest rate on debt</th>
<th>Tax Rate</th>
<th>Cost of Debt (after-tax)</th>
<th>WACC</th>
<th>Enterprise Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>1.3021</td>
<td>12.54%</td>
<td>Aaa/AAA</td>
<td>4.70%</td>
<td>25.00%</td>
<td>3.53%</td>
<td>12.54%</td>
<td>$337,694</td>
</tr>
<tr>
<td>10%</td>
<td>1.4106</td>
<td>13.29%</td>
<td>A3/A-</td>
<td>5.60%</td>
<td>25.00%</td>
<td>4.20%</td>
<td>12.38%</td>
<td>$343,623</td>
</tr>
<tr>
<td>20%</td>
<td>1.5463</td>
<td>14.23%</td>
<td>Ca2/CC</td>
<td>13.80%</td>
<td>25.00%</td>
<td>10.35%</td>
<td>13.45%</td>
<td>$306,548</td>
</tr>
<tr>
<td>30%</td>
<td>1.7632</td>
<td>15.74%</td>
<td>Caa/CCC</td>
<td>14.80%</td>
<td>17.38%</td>
<td>12.23%</td>
<td>14.68%</td>
<td>$272,853</td>
</tr>
<tr>
<td>40%</td>
<td>2.0675</td>
<td>17.85%</td>
<td>D2/D</td>
<td>16.30%</td>
<td>11.83%</td>
<td>14.37%</td>
<td>16.46%</td>
<td>$235,510</td>
</tr>
<tr>
<td>50%</td>
<td>2.4810</td>
<td>20.72%</td>
<td>D2/D</td>
<td>16.30%</td>
<td>9.47%</td>
<td>14.76%</td>
<td>17.74%</td>
<td>$214,337</td>
</tr>
<tr>
<td>60%</td>
<td>3.1012</td>
<td>25.02%</td>
<td>D2/D</td>
<td>16.30%</td>
<td>7.89%</td>
<td>15.01%</td>
<td>19.02%</td>
<td>$196,657</td>
</tr>
<tr>
<td>70%</td>
<td>4.1350</td>
<td>32.20%</td>
<td>D2/D</td>
<td>16.30%</td>
<td>6.76%</td>
<td>15.20%</td>
<td>20.30%</td>
<td>$181,672</td>
</tr>
<tr>
<td>80%</td>
<td>6.2024</td>
<td>46.54%</td>
<td>D2/D</td>
<td>16.30%</td>
<td>5.92%</td>
<td>15.34%</td>
<td>21.58%</td>
<td>$168,808</td>
</tr>
<tr>
<td>90%</td>
<td>12.4049</td>
<td>89.59%</td>
<td>D2/D</td>
<td>16.30%</td>
<td>5.26%</td>
<td>15.44%</td>
<td>22.86%</td>
<td>$157,646</td>
</tr>
</tbody>
</table>

The optimal debt ratio for Baidu is between 0 and 10%, close to its current debt ratio of 5.23%, and much lower than the optimal debt ratios computed for Disney, Vale and Tata Motors.
Extension to a private business

Optimal Debt Ratio for Bookscape

Debt value of leases = $12,136 million (only debt)
Estimated market value of equity = Net Income * Average PE for Publicly Traded Book Retailers = 1.575 * 20 = $31.5 million
Debt ratio = 12,136/(12,136+31,500) = 27.81%

The firm value is maximized (and the cost of capital is minimized) at a debt ratio of 30%. At its existing debt ratio of 27.81%, Bookscape is at its optimal.
Limitations of the Cost of Capital approach

- **It is static**: The most critical number in the entire analysis is the operating income. If that changes, the optimal debt ratio will change.

- **It ignores indirect bankruptcy costs**: The operating income is assumed to stay fixed as the debt ratio and the rating changes.

- **Beta and Ratings**: It is based upon rigid assumptions of how market risk and default risk get borne as the firm borrows more money and the resulting costs.
II. Enhanced Cost of Capital Approach

- **Distress cost affected operating income**: In the enhanced cost of capital approach, the indirect costs of bankruptcy are built into the expected operating income. As the rating of the firm declines, the operating income is adjusted to reflect the loss in operating income that will occur when customers, suppliers and investors react.

- **Dynamic analysis**: Rather than look at a single number for operating income, you can draw from a distribution of operating income (thus allowing for different outcomes).
Estimating the Distress Effect- Disney

<table>
<thead>
<tr>
<th>Rating</th>
<th>Drop in EBITDA (Low)</th>
<th>Drop in EBITDA (Medium)</th>
<th>Drop in EBITDA (High)</th>
</tr>
</thead>
<tbody>
<tr>
<td>To A</td>
<td>No effect</td>
<td>No effect</td>
<td>2.00%</td>
</tr>
<tr>
<td>To A-</td>
<td>No effect</td>
<td>2.00%</td>
<td>5.00%</td>
</tr>
<tr>
<td>To BBB</td>
<td>5.00%</td>
<td>10.00%</td>
<td>15.00%</td>
</tr>
<tr>
<td>To BB+</td>
<td>10.00%</td>
<td>20.00%</td>
<td>25.00%</td>
</tr>
<tr>
<td>To B-</td>
<td>15.00%</td>
<td>25.00%</td>
<td>30.00%</td>
</tr>
<tr>
<td>To C</td>
<td>25.00%</td>
<td>40.00%</td>
<td>50.00%</td>
</tr>
<tr>
<td>To D</td>
<td>30.00%</td>
<td>50.00%</td>
<td>100.00%</td>
</tr>
</tbody>
</table>
The optimal debt ratio stays at 40% but the cliff becomes much steeper.

Aswath Damodaran
Extending this approach to analyzing Financial Service Firms

- Interest coverage ratio spreads, which are critical in determining the bond ratings, have to be estimated separately for financial service firms; applying manufacturing company spreads will result in absurdly low ratings for even the safest banks and very low optimal debt ratios.

- It is difficult to estimate the debt on a financial service company’s balance sheet. Given the mix of deposits, repurchase agreements, short-term financing, and other liabilities that may appear on a financial service firm’s balance sheet, one solution is to focus only on long-term debt, defined tightly, and to use interest coverage ratios defined using only long-term interest expenses.

- Financial service firms are regulated and have to meet capital ratios that are defined in terms of book value. If, in the process of moving to an optimal market value debt ratio, these firms violate the book capital ratios, they could put themselves in jeopardy.
Capital Structure for a bank:  
A Regulatory Capital Approach

- Consider a bank with $100 million in loans outstanding and a book value of equity of $6 million. Furthermore, assume that the regulatory requirement is that equity capital be maintained at 5% of loans outstanding. Finally, assume that this bank wants to increase its loan base by $50 million to $150 million and to augment its equity capital ratio to 7% of loans outstanding.

  Loans outstanding after Expansion = $150 million  
  Equity after expansion = 7% of $150 = $10.5 million  
  Existing Equity = $6.0 million  
  New Equity needed = $4.5 million

- Your need for “external” equity as a bank/financial service company will depend upon
  a. Your growth rate: Higher growth -> More external equity  
  b. Existing capitalization vs Target capitalization: Under capitalized -> More external equity  
  d. Current dividends: More dividends -> More external equity

Aswath Damodaran
Deutsche Bank’s Financial Mix

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset Base</td>
<td>439,851 €</td>
<td>453,047 €</td>
<td>466,638 €</td>
<td>480,637 €</td>
<td>495,056 €</td>
<td>509,908 €</td>
</tr>
<tr>
<td>Capital ratio</td>
<td>15.13%</td>
<td>15.71%</td>
<td>16.28%</td>
<td>16.85%</td>
<td>17.43%</td>
<td>18.00%</td>
</tr>
<tr>
<td>Tier 1 Capital</td>
<td>66,561 €</td>
<td>71,156 €</td>
<td>75,967 €</td>
<td>81,002 €</td>
<td>86,271 €</td>
<td>91,783 €</td>
</tr>
<tr>
<td>Change in regulatory capital</td>
<td></td>
<td>4,595 €</td>
<td>4,811 €</td>
<td>5,035 €</td>
<td>5,269 €</td>
<td>5,512 €</td>
</tr>
<tr>
<td>Book Equity</td>
<td>76,829 €</td>
<td>81,424 €</td>
<td>86,235 €</td>
<td>91,270 €</td>
<td>96,539 €</td>
<td>102,051 €</td>
</tr>
<tr>
<td>ROE</td>
<td>-1.08%</td>
<td>0.74%</td>
<td>2.55%</td>
<td>4.37%</td>
<td>6.18%</td>
<td>8.00%</td>
</tr>
<tr>
<td>Net Income</td>
<td>-716 €</td>
<td>602 €</td>
<td>2,203 €</td>
<td>3,988 €</td>
<td>5,971 €</td>
<td>8,164 €</td>
</tr>
<tr>
<td>- Investment in Regulatory Capital</td>
<td></td>
<td>4,595 €</td>
<td>4,811 €</td>
<td>5,035 €</td>
<td>5,269 €</td>
<td>5,512 €</td>
</tr>
<tr>
<td>FCFE</td>
<td>-3,993 €</td>
<td>-2,608 €</td>
<td>-1,047 €</td>
<td>702 €</td>
<td>2,652 €</td>
<td></td>
</tr>
</tbody>
</table>

The cumulative FCFE over the next 5 years is -4,294 million Euros. Clearly, it does not make the sense to pay dividends or buy back stock.

Aswath Damodaran
Financing Strategies for a financial institution

- **The Regulatory minimum strategy:** In this strategy, financial service firms try to stay with the bare minimum equity capital, as required by the regulatory ratios. In the most aggressive versions of this strategy, firms exploit loopholes in the regulatory framework to invest in those businesses where regulatory capital ratios are set too low (relative to the risk of these businesses).

- **The Self-regulatory strategy:** The objective for a bank raising equity is not to meet regulatory capital ratios but to ensure that losses from the business can be covered by the existing equity. In effect, financial service firms can assess how much equity they need to hold by evaluating the riskiness of their businesses and the potential for losses.

- **Combination strategy:** In this strategy, the regulatory capital ratios operate as a floor for established businesses, with the firm adding buffers for safety where needed.
Determinants of the Optimal Debt Ratio:

1. The marginal tax rate

- The primary benefit of debt is a tax benefit. The higher the marginal tax rate, the greater the benefit to borrowing:

<table>
<thead>
<tr>
<th>Tax Rate</th>
<th>Disney</th>
<th>Vale</th>
<th>Tata Motors</th>
<th>Baidu</th>
<th>Bookscape</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>10%</td>
<td>20%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>20%</td>
<td>40%</td>
<td>0%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>30%</td>
<td>40%</td>
<td>30%</td>
<td>20%</td>
<td>10%</td>
<td>30%</td>
</tr>
<tr>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>20%</td>
<td>10%</td>
<td>30%</td>
</tr>
<tr>
<td>50%</td>
<td>40%</td>
<td>40%</td>
<td>20%</td>
<td>10%</td>
<td>30%</td>
</tr>
</tbody>
</table>
2. Pre-tax Cash flow Return

<table>
<thead>
<tr>
<th>Company</th>
<th>EBITDA</th>
<th>EBIT</th>
<th>Enterprise Value</th>
<th>EBITDA/EV</th>
<th>EBIT/EV</th>
<th>Optimal Debt</th>
<th>Optimal Debt Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disney</td>
<td>$12,517</td>
<td>$10,032</td>
<td>$133,908</td>
<td>9.35%</td>
<td>7.49%</td>
<td>$55,136</td>
<td>40.00%</td>
</tr>
<tr>
<td>Vale</td>
<td>$20,167</td>
<td>$15,667</td>
<td>$112,352</td>
<td>17.95%</td>
<td>13.94%</td>
<td>$35,845</td>
<td>30.00%</td>
</tr>
<tr>
<td>Tata Motors</td>
<td>250,116₹</td>
<td>166,605₹</td>
<td>1,427,478₹</td>
<td>17.52%</td>
<td>11.67%</td>
<td>325,986₹</td>
<td>20.00%</td>
</tr>
<tr>
<td>Baidu</td>
<td>¥13,073</td>
<td>¥10,887</td>
<td>¥342,269</td>
<td>3.82%</td>
<td>3.18%</td>
<td>¥35,280</td>
<td>10.00%</td>
</tr>
<tr>
<td>Bookscape</td>
<td>$4,150</td>
<td>$2,536</td>
<td>$42,636</td>
<td>9.73%</td>
<td>5.95%</td>
<td>$13,091</td>
<td>30.00%</td>
</tr>
</tbody>
</table>

Higher cash flows, as a percent of value, give you a higher debt capacity, though less so in emerging markets with substantial country risk.
3. Operating Risk

- Firms that face more risk or uncertainty in their operations (and more variable operating income as a consequence) will have lower optimal debt ratios than firms that have more predictable operations.

- Operating risk enters the cost of capital approach in two places:
  - **Unlevered beta**: Firms that face more operating risk will tend to have higher unlevered betas. As they borrow, debt will magnify this already large risk and push up costs of equity much more steeply.
  - **Bond ratings**: For any given level of operating income, firms that face more risk in operations will have lower ratings. The ratings are based upon normalized income.
4. The only macro determinant: Equity vs Debt Risk Premiums

Figure 16: Equity Risk Premiums and Bond Default Spreads

Aswath Damodaran
Application Test: Your firm’s optimal financing mix

- Using the optimal capital structure spreadsheet provided:
  1. Estimate the optimal debt ratio for your firm
  2. Estimate the new cost of capital at the optimal
  3. Estimate the effect of the change in the cost of capital on firm value
  4. Estimate the effect on the stock price

- In terms of the mechanics, what would you need to do to get to the optimal immediately?
III. The APV Approach to Optimal Capital Structure

- In the adjusted present value approach, the value of the firm is written as the sum of the value of the firm without debt (the unlevered firm) and the effect of debt on firm value:
  
  \[
  \text{Firm Value} = \text{Unlevered Firm Value} + (\text{Tax Benefits of Debt} - \text{Expected Bankruptcy Cost from the Debt})
  \]

- The optimal dollar debt level is the one that maximizes firm value.
Implementing the APV Approach

- Step 1: Estimate the unlevered firm value. This can be done in one of two ways:
  - Estimating the unlevered beta, a cost of equity based upon the unlevered beta and valuing the firm using this cost of equity (which will also be the cost of capital, with an unlevered firm)
  - Alternatively, Unlevered Firm Value = Current Market Value of Firm - Tax Benefits of Debt (Current) + Expected Bankruptcy cost from Debt

- Step 2: Estimate the tax benefits at different levels of debt. The simplest assumption to make is that the savings are perpetual, in which case
  - Tax benefits = Dollar Debt * Tax Rate

- Step 3: Estimate a probability of bankruptcy at each debt level, and multiply by the cost of bankruptcy (including both direct and indirect costs) to estimate the expected bankruptcy cost.
Estimating Expected Bankruptcy Cost

- Probability of Bankruptcy
  - Estimate the synthetic rating that the firm will have at each level of debt
  - Estimate the probability that the firm will go bankrupt over time, at that level of debt (Use studies that have estimated the empirical probabilities of this occurring over time - Altman does an update every year)

- Cost of Bankruptcy
  - The direct bankruptcy cost is the easier component. It is generally between 5-10% of firm value, based upon empirical studies
  - The indirect bankruptcy cost is much tougher. It should be higher for sectors where operating income is affected significantly by default risk (like airlines) and lower for sectors where it is not (like groceries)
## Ratings and Default Probabilities: Results from Altman study of bonds

<table>
<thead>
<tr>
<th>Rating</th>
<th>Likelihood of Default</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>0.07%</td>
</tr>
<tr>
<td>AA</td>
<td>0.51%</td>
</tr>
<tr>
<td>A+</td>
<td>0.60%</td>
</tr>
<tr>
<td>A</td>
<td>0.66%</td>
</tr>
<tr>
<td>A-</td>
<td>2.50%</td>
</tr>
<tr>
<td>BBB</td>
<td>7.54%</td>
</tr>
<tr>
<td>BB</td>
<td>16.63%</td>
</tr>
<tr>
<td>B+</td>
<td>25.00%</td>
</tr>
<tr>
<td>B</td>
<td>36.80%</td>
</tr>
<tr>
<td>B-</td>
<td>45.00%</td>
</tr>
<tr>
<td>CCC</td>
<td>59.01%</td>
</tr>
<tr>
<td>CC</td>
<td>70.00%</td>
</tr>
<tr>
<td>C</td>
<td>85.00%</td>
</tr>
<tr>
<td>D</td>
<td>100.00%</td>
</tr>
</tbody>
</table>

Altman estimated these probabilities by looking at bonds in each ratings class ten years prior and then examining the proportion of these bonds that defaulted over the ten years.
Disney: Estimating Unlevered Firm Value

Current Value of firm = $121,878 + $15,961 = $137,839
- Tax Benefit on Current Debt = $15,961 * 0.361 = $5,762
+ Expected Bankruptcy Cost = 0.66% * (0.25 * 137,839) = $227

Unlevered Value of Firm = $132,304

- Cost of Bankruptcy for Disney = 25% of firm value
- Probability of Bankruptcy = 0.66%, based on firm’s current rating of A
- Tax Rate = 36.1%
The optimal debt ratio is 40%, which is the point at which firm value is maximized.

Aswath Damodaran
IV. Relative Analysis

- The “safest” place for any firm to be is close to the industry average.
- Subjective adjustments can be made to these averages to arrive at the right debt ratio.
  - Higher tax rates -> Higher debt ratios (Tax benefits)
  - Lower insider ownership -> Higher debt ratios (Greater discipline)
  - More stable income -> Higher debt ratios (Lower bankruptcy costs)
  - More intangible assets -> Lower debt ratios (More agency problems)
Comparing to industry averages

<table>
<thead>
<tr>
<th>Company</th>
<th>Debt to Capital Ratio</th>
<th>Net Debt to Capital Ratio</th>
<th>Comparable group</th>
<th>Debt to Capital Ratio</th>
<th>Net Debt to Capital Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Book value</td>
<td>Market value</td>
<td>Book value</td>
<td>Market value</td>
<td>Book value</td>
</tr>
<tr>
<td>Disney</td>
<td>22.88%</td>
<td>11.58%</td>
<td>17.70%</td>
<td>8.98%</td>
<td>39.03%</td>
</tr>
<tr>
<td>Vale</td>
<td>39.02%</td>
<td>35.48%</td>
<td>34.90%</td>
<td>31.38%</td>
<td>34.43%</td>
</tr>
<tr>
<td>Tata Motors</td>
<td>58.51%</td>
<td>29.28%</td>
<td>22.44%</td>
<td>19.25%</td>
<td>35.96%</td>
</tr>
<tr>
<td>Baidu</td>
<td>32.93%</td>
<td>5.23%</td>
<td>20.12%</td>
<td>2.32%</td>
<td>6.37%</td>
</tr>
</tbody>
</table>

Aswath Damodaran
Getting past simple averages

**Step 1:** Run a regression of debt ratios on the variables that you believe determine debt ratios in the sector. For example,

\[
\text{Debt Ratio} = a + b \times \text{(Tax rate)} + c \times \text{(Earnings Variability)} + d \times \text{(EBITDA/Firm Value)}
\]

Check this regression for statistical significance (t statistics) and predictive ability (R squared)

**Step 2:** Estimate the values of the proxies for the firm under consideration. Plugging into the cross sectional regression, we can obtain an estimate of predicted debt ratio.

**Step 3:** Compare the actual debt ratio to the predicted debt ratio.

Aswath Damodaran
Applying the Regression Methodology: Global Auto Firms

- Using a sample of 56 global auto firms, we arrived at the following regression:
  Debt to capital = 0.09 + 0.63 (Effective Tax Rate) + 1.01 (EBITDA/ Enterprise Value) - 0.93 (Cap Ex/ Enterprise Value)

- The R squared of the regression is 21%. This regression can be used to arrive at a predicted value for Tata Motors of:
  Predicted Debt Ratio = 0.09 + 0.63 (0.252) +1.01 (0.1167) - 0.93 (0.1949) = .1854 or 18.54%

- Based upon the capital structure of other firms in the automobile industry, Tata Motors should have a market value debt ratio of 18.54%. It is over levered at its existing debt ratio of 29.28%.
Extending to the entire market

- Using 2014 data for US listed firms, we looked at the determinants of the market debt to capital ratio. The regression provides the following results –

\[
\text{DFR} = 0.27 - 0.24 \text{ETR} - 0.10 \text{g} - 0.065 \text{INST} - 0.338 \text{CVOI} + 0.59 \frac{\text{EBITDA}}{\text{Market Value of Equity} + \text{Debt} - \text{Cash}}
\]

(DFR = Debt / (Debt + Market Value of Equity))

ETR = Effective tax rate in most recent twelve months

INST = % of Shares held by institutions

CVOI = Std dev in OI in last 10 years/Average OI in last 10 years

E/V = EBITDA/ (Market Value of Equity + Debt - Cash)

The regression has an **R-squared of 8%**.
Applying the Regression

- Disney had the following values for these inputs in 2008. Estimate the optimal debt ratio using the debt regression.
  - ETR = 31.02%
  - Expected Revenue Growth = 6.45%
  - INST = 70.2%
  - CVOI = 0.0296
  - E/V = 9.35%

Optimal Debt Ratio
= 0.27 - 0.24 (.3102) -0.10 (.0645) – 0.065 (.702) -0.338 (.0296) + 0.59 (.0935)
= 0.1886 or 18.86%%

- What does this optimal debt ratio tell you?

- Why might it be different from the optimal calculated using the weighted average cost of capital?
Summarizing the optimal debt ratios...

<table>
<thead>
<tr>
<th></th>
<th>Disney</th>
<th>Vale</th>
<th>Tata Motors</th>
<th>Baidu</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual Debt Ratio</td>
<td>11.58%</td>
<td>35.48%</td>
<td>29.28%</td>
<td>5.23%</td>
</tr>
<tr>
<td>Optimal</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I. Operating income</td>
<td>35.00%</td>
<td>—</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>II. Standard Cost of capital</td>
<td>40.00%</td>
<td>30.00% (actual)</td>
<td>20.00%</td>
<td>10.00%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>50.00% (normalized)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>III. Enhanced Cost of Capital</td>
<td>40.00%</td>
<td>30.00% (actual)</td>
<td>10.00%</td>
<td>10.00%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>40.00% (normalized)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>IV. APV</td>
<td>40.00%</td>
<td>30.00%</td>
<td>20.00%</td>
<td>20.00%</td>
</tr>
<tr>
<td>V. Comparable</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To industry</td>
<td>28.54%</td>
<td>26.03%</td>
<td>18.72%</td>
<td>1.83%</td>
</tr>
<tr>
<td>To market</td>
<td>23.14%</td>
<td>—</td>
<td>-</td>
<td></td>
</tr>
</tbody>
</table>
GETTING TO THE OPTIMAL: TIMING AND FINANCING CHOICES

You can take it slow.. Or perhaps not...
Maximize the value of the business (firm)

The Investment Decision
Invest in assets that earn a return greater than the minimum acceptable hurdle rate

The Financing Decision
Find the right kind of debt for your firm and the right mix of debt and equity to fund your operations

The Dividend Decision
If you cannot find investments that make your minimum acceptable rate, return the cash to owners of your business

The hurdle rate should reflect the riskiness of the investment and the mix of debt and equity used to fund it.

The return should reflect the magnitude and the timing of the cashflows as well as all side effects.

The optimal mix of debt and equity maximizes firm value.

The right kind of debt matches the tenor of your assets.

How much cash you can return depends upon current & potential investment opportunities.

How you choose to return cash to the owners will depend whether they prefer dividends or buybacks.
Now that we have an optimal.. And an actual.. What next?

- At the end of the analysis of financing mix (using whatever tool or tools you choose to use), you can come to one of three conclusions:
  1. The firm has the right financing mix
  2. It has too little debt (it is under levered)
  3. It has too much debt (it is over levered)

- The next step in the process is
  - Deciding how much quickly or gradually the firm should move to its optimal
  - Assuming that it does, the right kind of financing to use in making this adjustment
A Framework for Getting to the Optimal Debt Ratio

Is the actual debt ratio greater than or lesser than the optimal debt ratio?

Actual > Optimal
Overlevered

Is the firm under bankruptcy threat?

Yes

Reduce Debt quickly
1. Equity for Debt swap
2. Sell Assets; use cash
to pay off debt
3. Renegotiate with lenders

No

Does the firm have good projects?
ROE > Cost of Equity
ROC > Cost of Capital

Yes

Take good projects with
new equity or with retained
earnings.

No

1. Pay off debt with retained earnings.
2. Reduce or eliminate dividends.
3. Issue new equity and pay off debt.

Actual < Optimal
Underlevered

Is the firm a takeover target?

Yes

Increase leverage quickly
1. Debt/Equity swaps
2. Borrow money &
buy shares.

No

Does the firm have good projects?
ROE > Cost of Equity
ROC > Cost of Capital

Yes

Take good projects with debt.

No

Do your stockholders like dividends?

Yes

Pay Dividends

No

Buy back stock

Aswath Damodaran
Disney: Applying the Framework

Is the actual debt ratio greater than or lesser than the optimal debt ratio?

Actual > Optimal
Overlevered

Is the firm under bankruptcy threat?

Yes
Reduce Debt quickly
1. Equity for Debt swap
2. Sell Assets; use cash to pay off debt
3. Renegotiate with lenders

No
Does the firm have good projects?
1. Pay off debt with retained earnings.
2. Reduce or eliminate dividends
3. Issue new equity and pay off debt.

Actual < Optimal
Actual (11.58%) < Optimal (40%)

Is the firm a takeover target?

Yes
No. Large mkt cap & positive Jensen’s α

Increase leverage quickly
1. Debt/Equity swaps
2. Borrow money & buy shares.

Does the firm have good projects?
1. Debt/Equity swaps
2. Borrow money & buy shares.

ROC > Cost of Capital
Take good projects With debt.

No
Do your stockholders like dividends?

Yes
Pay Dividends

No
Buy back stock

Yes
Take good projects with new equity or with retained earnings.

No
Pay off debt with retained earnings.
2. Reduce or eliminate dividends
3. Issue new equity and pay off debt.
Application Test: Getting to the Optimal

Based upon your analysis of both the firm’s capital structure and investment record, what path would you map out for the firm?

a. Immediate change in leverage
b. Gradual change in leverage
c. No change in leverage

Would you recommend that the firm change its financing mix by

a. Paying off debt/Buying back equity
b. Take projects with equity/debt
The Mechanics of Changing Debt Ratio quickly...

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Debt</td>
</tr>
<tr>
<td>Operating Assets in place</td>
<td>Equity</td>
</tr>
<tr>
<td>Growth Assets</td>
<td></td>
</tr>
<tr>
<td>Sell operating assets</td>
<td>Issue new stock to retire debt or get debt holders to accept equity in the firm.</td>
</tr>
<tr>
<td>and use cash to pay down debt.</td>
<td></td>
</tr>
</tbody>
</table>

To increase the debt ratio

- Borrow money and buy back stock or pay a large special dividend
- Sell operating assets and use cash to buy back stock or pay or special dividend
The mechanics of changing debt ratios over time... gradually...

- To change debt ratios over time, you use the same mix of tools that you used to change debt ratios gradually:
  - Dividends and stock buybacks: Dividends and stock buybacks will reduce the value of equity.
  - Debt repayments: will reduce the value of debt.

- The complication of changing debt ratios over time is that firm value is itself a moving target.
  - If equity is fairly valued today, the equity value should change over time to reflect the expected price appreciation:
    - Expected Price appreciation = Cost of equity – Dividend Yield
  - Debt will also change over time, in conjunction as firm value changes.
Designing Debt: The Fundamental Principle

- The objective in designing debt is to make the cash flows on debt match up as closely as possible with the cash flows that the firm makes on its assets.
- By doing so, we reduce our risk of default, increase debt capacity and increase firm value.
Firm with mismatched debt

Firm Value

Value of Debt

Aswath Damodaran
Firm with matched Debt
Design the perfect financing instrument

- The perfect financing instrument will
  - Have all of the tax advantages of debt
  - While preserving the flexibility offered by equity

Start with the Cash Flows on Assets/Projects

- Duration
- Currency
- Effect of Inflation
- Uncertainty about Future
- Growth Patterns
- Cyclicality & Other Effects

Define Debt Characteristics

- Duration/Maturity
- Currency Mix
- Fixed vs. Floating Rate
  - More floating rate if CF move with inflation
  - With greater uncertainty on future
- Straight versus Convertible
  - Convertible if cash flows low now but high exp. growth
- Special Features on Debt
  - Options to make cash flows on debt match cash flows on assets

Design debt to have cash flows that match up to cash flows on the assets financed.
Ensuring that you have not crossed the line drawn by the tax code

- All of this design work is lost, however, if the security that you have designed does not deliver the tax benefits.
- In addition, there may be a trade off between mismatching debt and getting greater tax benefits.
While keeping equity research analysts, ratings agencies and regulators applauding

- Ratings agencies want companies to issue equity, since it makes them safer.
- Equity research analysts want them not to issue equity because it dilutes earnings per share.
- Regulatory authorities want to ensure that you meet their requirements in terms of capital ratios (usually book value).
- Financing that leaves all three groups happy is nirvana.

Consider ratings agency & analyst concerns

<table>
<thead>
<tr>
<th>Analyst Concerns</th>
<th>Ratings Agency</th>
<th>Regulatory Concerns</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Effect on EPS</td>
<td>- Effect on Ratios</td>
<td>- Measures used</td>
</tr>
<tr>
<td>- Value relative to comparables</td>
<td>- Ratios relative to comparables</td>
<td></td>
</tr>
</tbody>
</table>

Can securities be designed that can make these different entities happy.

Aswath Damodaran
Debt or Equity: The Strange Case of Trust Preferred

- Trust preferred stock has
  - A fixed dividend payment, specified at the time of the issue
  - That is tax deductible
  - And failing to make the payment can give these shareholders voting rights

- When trust preferred was first created, ratings agencies treated it as equity. As they have become more savvy, ratings agencies have started giving firms only partial equity credit for trust preferred.
Assuming that trust preferred stock gets treated as equity by ratings agencies, which of the following firms is the most appropriate firm to be issuing it?

a. A firm that is under levered, but has a rating constraint that would be violated if it moved to its optimal

b. A firm that is over levered that is unable to issue debt because of the rating agency concerns.
Soothe bondholder fears

- There are some firms that face skepticism from bondholders when they go out to raise debt, because
  - Of their past history of defaults or other actions
  - They are small firms without any borrowing history
- Bondholders tend to demand much higher interest rates from these firms to reflect these concerns.

Factor in agency conflicts between stock and bond holders

<table>
<thead>
<tr>
<th>Observability of Cash Flows by Lenders</th>
<th>Type of Assets financed</th>
<th>Existing Debt covenants</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Less observable cash flows lead to more conflicts</td>
<td>- Tangible and liquid assets create less agency problems</td>
<td>- Restrictions on Financing</td>
</tr>
</tbody>
</table>

If agency problems are substantial, consider issuing convertible bond.

Aswath Damodaran
And do not lock in market mistakes that work against you

- Ratings agencies can sometimes under rate a firm, and markets can under price a firm’s stock or bonds. If this occurs, firms should not lock in these mistakes by issuing securities for the long term. In particular,
  - Issuing equity or equity based products (including convertibles), when equity is under priced transfers wealth from existing stockholders to the new stockholders
  - Issuing long term debt when a firm is under rated locks in rates at levels that are far too high, given the firm’s default risk.

- What is the solution
  - If you need to use equity?
  - If you need to use debt?
Designing Debt: Bringing it all together

1. Start with the Cash Flows on Assets/Projects
   - Duration
   - Currency
   - Effect of Inflation
   - Uncertainty about Future Growth Patterns
   - Cyclicality & Other Effects

2. Define Debt Characteristics
   - Duration/Maturity
   - Currency Mix
   - Fixed vs. Floating Rate
     * More floating rate
     - if CF move with inflation
     - with greater uncertainty on future
   - Straight versus Convertible
     * Convertible if cash flows low now but high exp. growth
   - Special Features on Debt
     - Options to make cash flows on debt match cash flows on assets

3. Design debt to have cash flows that match up to cash flows on the assets financed

4. Overlay tax preferences
   - Deductibility of cash flows for tax purposes
   - Differences in tax rates across different locales

5. Consider ratings agency & analyst concerns
   - Analyst Concerns
     - Effect on EPS
     - Value relative to comparable
   - Ratings Agency
     - Effect on Ratios
     - Ratios relative to comparables
   - Regulatory Concerns
     - Measures used

6. Consider Information Asymmetries
   - Uncertainty about Future Cashflows
     - When there is more uncertainty, it may be better to use short term debt
   - Credibility & Quality of the Firm
     - Firms with credibility problems will issue more short term debt

7. Factor in agency conflicts between stock and bond holders
   - Observability of Cash Flows by Lenders
     - Less observable cash flows lead to more conflicts
   - Type of Assets financed
     - Tangible and liquid assets create less agency problems
   - Existing Debt covenants
     - Restrictions on Financing

8. If agency problems are substantial, consider issuing convertible bonds

9. Can securities be designed that can make these different entities happy?

10. Commodity Bonds
    - Catastrophe Notes

11. Zero Coupons

12. Operating Leases
    - MIP's
    - Surplus Notes

13. Convertibles
    - Puttable Bonds
    - Rating Sensitive Notes
    - LYONs

---

Design debt to have cash flows that match up to cash flows on the assets financed.
Approaches for evaluating Asset Cash Flows

I. Intuitive Approach
- Are the projects typically long term or short term? What is the cash flow pattern on projects?
- How much growth potential does the firm have relative to current projects?
- How cyclical are the cash flows? What specific factors determine the cash flows on projects?

II. Project Cash Flow Approach
- Estimate expected cash flows on a typical project for the firm
- Do scenario analyses on these cash flows, based upon different macroeconomic scenarios

III. Historical Data
- Operating Cash Flows
- Firm Value
## I. Intuitive Approach - Disney

<table>
<thead>
<tr>
<th>Business</th>
<th>Project Cash Flow Characteristics</th>
<th>Type of Financing</th>
</tr>
</thead>
</table>
| Studio entertainment | Movie projects are likely to  
• Be short-term  
• Have cash outflows primarily in dollars (because Disney makes most of its movies in the U.S.), but cash inflows could have a substantial foreign currency component (because of overseas revenues)  
• Have net cash flows that are heavily driven by whether the movie is a hit, which is often difficult to predict | Debt should be  
1. Short-term  
2. Mixed currency debt, reflecting audience make-up.  
3. If possible, tied to the success of movies.                                                                                                                                                                                                                                                      |
| Media networks    | Projects are likely to be  
1. Short-term  
2. Primarily in dollars, though foreign component is growing, especially for ESPN.  
3. Driven by advertising revenues and show success (Nielsen ratings) | Debt should be  
1. Short-term  
2. Primarily dollar debt  
3. If possible, linked to network ratings                                                                                                                                                                                                                                                      |
| Park resorts      | Projects are likely to be  
1. Very long-term  
2. Currency will be a function of the region (rather than country) where park is located.  
3. Affected by success of studio entertainment and media networks divisions | Debt should be  
1. Long-term  
2. Mix of currencies, based on tourist makeup at the park.                                                                                                                                                                                                                                                                                               |
| Consumer products | Projects are likely to be short- to medium-term and linked to the success of the movie division; most of Disney’s product offerings and licensing revenues are derived from their movie productions | Debt should be  
1. Medium-term  
2. Dollar debt                                                                                                                                                                                                                                                                                                                                                       |
| Interactive      | Projects are likely to be short-term, with high growth potential and significant risk. While cash flows will initially be primarily in US dollars, the mix of currencies will shift as the business ages.                                                                                                                                                                                                                                                                                   | Debt should be short-term, convertible US dollar debt.                                                                                                                                                                                                                                               |
Application Test: Choosing your Financing Type

- Based upon the business that your firm is in, and the typical investments that it makes, what kind of financing would you expect your firm to use in terms of:
  a. Duration (long term or short term)
  b. Currency
  c. Fixed or Floating rate
  d. Straight or Convertible
II. Project Specific Financing

- With project specific financing, you match the financing choices to the project being funded. The benefit is that the debt is truly customized to the project.

- Project specific financing makes the most sense when you have a few large, independent projects to be financed. It becomes both impractical and costly when firms have portfolios of projects with interdependent cashflows.
## Duration of Disney Theme Park

<table>
<thead>
<tr>
<th>Year</th>
<th>Annual Cashflow</th>
<th>Terminal Value</th>
<th>Present Value @8.46%</th>
<th>Present Value *t</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>-$2,000</td>
<td></td>
<td>-$2,000</td>
<td>0</td>
</tr>
<tr>
<td>1</td>
<td>-$1,000</td>
<td></td>
<td>-$922</td>
<td>-$922</td>
</tr>
<tr>
<td>2</td>
<td>-$859</td>
<td></td>
<td>-$730</td>
<td>-$1,460</td>
</tr>
<tr>
<td>3</td>
<td>-$267</td>
<td></td>
<td>-$210</td>
<td>-$629</td>
</tr>
<tr>
<td>4</td>
<td>$340</td>
<td></td>
<td>$246</td>
<td>$983</td>
</tr>
<tr>
<td>5</td>
<td>$466</td>
<td></td>
<td>$311</td>
<td>$1,553</td>
</tr>
<tr>
<td>6</td>
<td>$516</td>
<td></td>
<td>$317</td>
<td>$1,903</td>
</tr>
<tr>
<td>7</td>
<td>$555</td>
<td></td>
<td>$314</td>
<td>$2,200</td>
</tr>
<tr>
<td>8</td>
<td>$615</td>
<td></td>
<td>$321</td>
<td>$2,568</td>
</tr>
<tr>
<td>9</td>
<td>$681</td>
<td>$11,275</td>
<td>$328</td>
<td>$2,952</td>
</tr>
<tr>
<td>10</td>
<td>$715</td>
<td>$11,275</td>
<td>$5,321</td>
<td>$53,206</td>
</tr>
</tbody>
</table>

**Duration of the Project = 62,355/3296 = 18.92 years**
The perfect theme park debt...

- The perfect debt for this theme park would have a duration of roughly 19 years and be in a mix of Latin American currencies (since it is located in Brazil), reflecting where the visitors to the park are coming from.

- If possible, you would tie the interest payments on the debt to the number of visitors at the park.
III. Firm-wide financing

- Rather than look at individual projects, you could consider the firm to be a portfolio of projects. The firm’s past history should then provide clues as to what type of debt makes the most sense.

- Operating Cash Flows
  - The question of how sensitive a firm’s asset cash flows are to a variety of factors, such as interest rates, inflation, currency rates and the economy, can be directly tested by regressing changes in the operating income against changes in these variables.
  - This analysis is useful in determining the coupon/interest payment structure of the debt.

- Firm Value
  - The firm value is clearly a function of the level of operating income, but it also incorporates other factors such as expected growth & cost of capital.
  - The firm value analysis is useful in determining the overall structure of the debt, particularly maturity.
## Disney: Historical Data

<table>
<thead>
<tr>
<th>Date</th>
<th>Operating Income</th>
<th>Enterprise Value (V)</th>
<th>% Chg in OI</th>
<th>% Chg in V</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>9450</td>
<td>$126,815</td>
<td>6.62%</td>
<td>21.09%</td>
</tr>
<tr>
<td>2012</td>
<td>8863</td>
<td>$104,729</td>
<td>13.91%</td>
<td>56.85%</td>
</tr>
<tr>
<td>2011</td>
<td>7781</td>
<td>$66,769</td>
<td>15.69%</td>
<td>-9.19%</td>
</tr>
<tr>
<td>2010</td>
<td>6726</td>
<td>$73,524</td>
<td>18.06%</td>
<td>22.84%</td>
</tr>
<tr>
<td>2009</td>
<td>5697</td>
<td>$59,855</td>
<td>-23.06%</td>
<td>-18.11%</td>
</tr>
<tr>
<td>2008</td>
<td>$7,404</td>
<td>$73,091</td>
<td>8.42%</td>
<td>-6.27%</td>
</tr>
<tr>
<td>2007</td>
<td>$6,829</td>
<td>$77,980</td>
<td>27.53%</td>
<td>2.98%</td>
</tr>
<tr>
<td>2006</td>
<td>$5,355</td>
<td>$75,720</td>
<td>30.39%</td>
<td>27.80%</td>
</tr>
<tr>
<td>2005</td>
<td>$4,107</td>
<td>$59,248</td>
<td>1.46%</td>
<td>2.55%</td>
</tr>
<tr>
<td>2004</td>
<td>$4,048</td>
<td>$57,776</td>
<td>49.21%</td>
<td>9.53%</td>
</tr>
<tr>
<td>2003</td>
<td>$2,713</td>
<td>$52,747</td>
<td>13.80%</td>
<td>20.45%</td>
</tr>
<tr>
<td>2002</td>
<td>$2,384</td>
<td>$43,791</td>
<td>-15.82%</td>
<td>-9.01%</td>
</tr>
<tr>
<td>2001</td>
<td>$2,832</td>
<td>$48,128</td>
<td>12.16%</td>
<td>-45.53%</td>
</tr>
<tr>
<td>2000</td>
<td>$2,525</td>
<td>$88,355</td>
<td>-22.64%</td>
<td>35.67%</td>
</tr>
<tr>
<td>1999</td>
<td>$3,264</td>
<td>$65,125</td>
<td>-15.07%</td>
<td>-5.91%</td>
</tr>
<tr>
<td>1998</td>
<td>$3,843</td>
<td>$69,213</td>
<td>-2.59%</td>
<td>6.20%</td>
</tr>
<tr>
<td>1997</td>
<td>$3,945</td>
<td>$65,173</td>
<td>30.46%</td>
<td>18.25%</td>
</tr>
<tr>
<td>1996</td>
<td>$3,024</td>
<td>$55,116</td>
<td>33.69%</td>
<td>77.65%</td>
</tr>
<tr>
<td>1995</td>
<td>$2,262</td>
<td>$31,025</td>
<td>25.39%</td>
<td>39.75%</td>
</tr>
<tr>
<td>1994</td>
<td>$1,804</td>
<td>$22,200</td>
<td>15.64%</td>
<td>9.04%</td>
</tr>
<tr>
<td>1993</td>
<td>$1,560</td>
<td>$20,360</td>
<td>21.21%</td>
<td>6.88%</td>
</tr>
<tr>
<td>1992</td>
<td>$1,287</td>
<td>$19,049</td>
<td>28.19%</td>
<td>23.89%</td>
</tr>
<tr>
<td>1991</td>
<td>$1,004</td>
<td>$15,376</td>
<td>-21.99%</td>
<td>26.50%</td>
</tr>
<tr>
<td>1990</td>
<td>$1,287</td>
<td>$12,155</td>
<td>16.05%</td>
<td>-23.64%</td>
</tr>
<tr>
<td>1989</td>
<td>$1,109</td>
<td>$15,918</td>
<td>40.56%</td>
<td>101.93%</td>
</tr>
<tr>
<td>1988</td>
<td>$789</td>
<td>$7,883</td>
<td>11.60%</td>
<td>-23.91%</td>
</tr>
<tr>
<td>1987</td>
<td>$707</td>
<td>$10,360</td>
<td>53.03%</td>
<td>83.69%</td>
</tr>
<tr>
<td>1986</td>
<td>$462</td>
<td>$5,640</td>
<td>25.20%</td>
<td>61.23%</td>
</tr>
<tr>
<td>1985</td>
<td>$369</td>
<td>$3,498</td>
<td>157.99%</td>
<td>24.37%</td>
</tr>
</tbody>
</table>
## The Macroeconomic Data

<table>
<thead>
<tr>
<th>Date</th>
<th>Change in T.Bond rate</th>
<th>% Chg in GDP</th>
<th>% Change in CPI</th>
<th>% Change in US $</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>1.07%</td>
<td>1.83%</td>
<td>1.18%</td>
<td>4.89%</td>
</tr>
<tr>
<td>2012</td>
<td>-0.11%</td>
<td>2.20%</td>
<td>-1.03%</td>
<td>2.75%</td>
</tr>
<tr>
<td>2011</td>
<td>-1.37%</td>
<td>1.81%</td>
<td>1.48%</td>
<td>-4.59%</td>
</tr>
<tr>
<td>2010</td>
<td>-0.53%</td>
<td>2.39%</td>
<td>1.97%</td>
<td>-3.64%</td>
</tr>
<tr>
<td>2009</td>
<td>1.29%</td>
<td>-3.07%</td>
<td>-3.98%</td>
<td>5.79%</td>
</tr>
<tr>
<td>2008</td>
<td>-1.44%</td>
<td>-1.18%</td>
<td>-4.26%</td>
<td>10.88%</td>
</tr>
<tr>
<td>2007</td>
<td>-0.65%</td>
<td>2.93%</td>
<td>2.19%</td>
<td>-11.30%</td>
</tr>
<tr>
<td>2006</td>
<td>0.30%</td>
<td>3.40%</td>
<td>-1.84%</td>
<td>-2.28%</td>
</tr>
<tr>
<td>2005</td>
<td>0.16%</td>
<td>3.68%</td>
<td>0.66%</td>
<td>3.98%</td>
</tr>
<tr>
<td>2004</td>
<td>0.13%</td>
<td>3.72%</td>
<td>1.34%</td>
<td>-3.92%</td>
</tr>
<tr>
<td>2003</td>
<td>0.05%</td>
<td>4.32%</td>
<td>-0.65%</td>
<td>-14.59%</td>
</tr>
<tr>
<td>2002</td>
<td>-0.97%</td>
<td>2.80%</td>
<td>1.44%</td>
<td>-11.17%</td>
</tr>
<tr>
<td>2001</td>
<td>-0.18%</td>
<td>-0.04%</td>
<td>-2.50%</td>
<td>7.45%</td>
</tr>
<tr>
<td>2000</td>
<td>-0.98%</td>
<td>2.24%</td>
<td>0.96%</td>
<td>7.73%</td>
</tr>
<tr>
<td>1999</td>
<td>1.56%</td>
<td>4.70%</td>
<td>1.04%</td>
<td>1.68%</td>
</tr>
<tr>
<td>1998</td>
<td>-1.03%</td>
<td>4.51%</td>
<td>0.11%</td>
<td>-4.08%</td>
</tr>
<tr>
<td>1997</td>
<td>-0.63%</td>
<td>4.33%</td>
<td>-1.43%</td>
<td>9.40%</td>
</tr>
<tr>
<td>1996</td>
<td>0.80%</td>
<td>4.43%</td>
<td>0.31%</td>
<td>4.14%</td>
</tr>
<tr>
<td>1995</td>
<td>-2.09%</td>
<td>2.01%</td>
<td>-0.08%</td>
<td>-0.71%</td>
</tr>
<tr>
<td>1994</td>
<td>1.92%</td>
<td>4.12%</td>
<td>0.27%</td>
<td>-5.37%</td>
</tr>
<tr>
<td>1993</td>
<td>-0.83%</td>
<td>2.50%</td>
<td>-0.72%</td>
<td>0.56%</td>
</tr>
<tr>
<td>1992</td>
<td>-0.02%</td>
<td>4.15%</td>
<td>0.64%</td>
<td>6.89%</td>
</tr>
<tr>
<td>1991</td>
<td>-1.26%</td>
<td>1.09%</td>
<td>-2.89%</td>
<td>0.69%</td>
</tr>
<tr>
<td>1990</td>
<td>0.12%</td>
<td>0.65%</td>
<td>0.43%</td>
<td>-8.00%</td>
</tr>
<tr>
<td>1989</td>
<td>-1.11%</td>
<td>2.66%</td>
<td>0.51%</td>
<td>2.04%</td>
</tr>
<tr>
<td>1988</td>
<td>0.26%</td>
<td>3.66%</td>
<td>0.60%</td>
<td>1.05%</td>
</tr>
<tr>
<td>1987</td>
<td>1.53%</td>
<td>4.49%</td>
<td>2.54%</td>
<td>-12.01%</td>
</tr>
<tr>
<td>1986</td>
<td>-1.61%</td>
<td>2.83%</td>
<td>-2.33%</td>
<td>-15.26%</td>
</tr>
<tr>
<td>1985</td>
<td>-2.27%</td>
<td>4.19%</td>
<td>3.89%</td>
<td>-13.51%</td>
</tr>
</tbody>
</table>
I. Sensitivity to Interest Rate Changes

- How sensitive is the firm’s value and operating income to changes in the level of interest rates?
- The answer to this question is important because it
  - it provides a measure of the duration of the firm’s projects
  - it provides insight into whether the firm should be using fixed or floating rate debt.
Firm Value versus Interest Rate Changes

- Regressing changes in firm value against changes in interest rates over this period yields the following regression –
  
  \[
  \text{Change in Firm Value} = 0.1790 - 2.3251 \times \text{(Change in Interest Rates)}
  \]

  \[
  (2.74) \quad (0.39)
  \]

  - T statistics are in brackets.

  - The coefficient on the regression (-2.33) measures how much the value of Disney as a firm changes for a unit change in interest rates.
Why the coefficient on the regression is duration..

- The duration of a straight bond or loan issued by a company can be written in terms of the coupons (interest payments) on the bond (loan) and the face value of the bond to be –

\[
\text{Duration of Bond} = \frac{dP/P}{dr/r} = \frac{\sum_{t=1}^{N} t \cdot \text{Coupon}_t + N \cdot \text{Face Value}}{(1+r)^t + (1+r)^N} - \frac{\sum_{t=1}^{N} \text{Coupon}_t + \text{Face Value}}{(1+r)^t + (1+r)^N}
\]

- The duration of a bond measures how much the price of the bond changes for a unit change in interest rates.

- Holding other factors constant, the duration of a bond will increase with the maturity of the bond, and decrease with the coupon rate on the bond.

Aswath Damodaran
Duration: Comparing Approaches

Traditional Duration Measures

\[ \frac{\delta P}{\delta r} = \delta P = a + b (\delta r) \]

\( \delta P/\delta r = \) Percentage Change in Value for a percentage change in Interest Rates

Uses:
1. Projected Cash Flows
2. Cash Flows are unaffected by changes in interest rates
3. Changes in interest rates are small.

Assumes:
1. Cash Flows are unaffected by changes in interest rates
2. Changes in interest rates are small.

Regression:

Uses:
1. Historical data on changes in firm value (market) and interest rates
2. Past project cash flows are similar to future project cash flows.
3. Relationship between cash flows and interest rates is stable.
4. Changes in market value reflect changes in the value of the firm.
Regressing changes in operating cash flow against changes in interest rates over this period yields the following regression –

\[
\text{Change in Operating Income} = 0.1698 - 7.9339 (\text{Change in Interest Rates})
\]

\[
(2.69^a) \quad (1.40)
\]

**Conclusion**: Disney’s operating income has been affected a lot more than its firm value has by changes in interest rates.
II. Sensitivity to Changes in GDP/ GNP

- How sensitive is the firm’s value and operating income to changes in the GNP/GDP?
- The answer to this question is important because
  - it provides insight into whether the firm’s cash flows are cyclical and
  - whether the cash flows on the firm’s debt should be designed to protect against cyclical factors.
- If the cash flows and firm value are sensitive to movements in the economy, the firm will either have to issue less debt overall, or add special features to the debt to tie cash flows on the debt to the firm’s cash flows.
Regression Results

- Regressing changes in firm value against changes in the GDP over this period yields the following regression –

  \[
  \text{Change in Firm Value} = 0.0067 + 6.7000 \times \text{(GDP Growth)}
  \]

  (0.06)  (2.03a)

  **Conclusion**: Disney is sensitive to economic growth

- Regressing changes in operating cash flow against changes in GDP over this period yields the following regression –

  \[
  \text{Change in Operating Income} = 0.0142 + 6.6443 \times \text{(GDP Growth)}
  \]

  (0.13)  (2.05a)

  **Conclusion**: Disney’s operating income is sensitive to economic growth as well.
III. Sensitivity to Currency Changes

- How sensitive is the firm’s value and operating income to changes in exchange rates?

- The answer to this question is important, because:
  - it provides a measure of how sensitive cash flows and firm value are to changes in the currency
  - it provides guidance on whether the firm should issue debt in another currency that it may be exposed to.

- If cash flows and firm value are sensitive to changes in the dollar, the firm should:
  - figure out which currency its cash flows are in;
  - and issued some debt in that currency
Regression Results

- Regressing changes in firm value against changes in the dollar over this period yields the following regression –
  \[
  \text{Change in Firm Value} = 0.1774 - 0.5705 \times (\text{Change in Dollar})
  \]
  \[(2.76) \quad (0.67)\]

**Conclusion**: Disney’s value is sensitive to exchange rate changes, decreasing as the dollar strengthens. However, the effect is statistically insignificant.

- Regressing changes in operating cash flow against changes in the dollar over this period yields the following regression –
  \[
  \text{Change in Operating Income} = 0.1680 - 1.6773 \times (\text{Change in Dollar})
  \]
  \[(2.82^a) \quad (2.13^a)\]

**Conclusion**: Disney’s operating income is more strongly impacted by the dollar than its value is. A stronger dollar seems to hurt operating income.
IV. Sensitivity to Inflation

- How sensitive is the firm’s value and operating income to changes in the inflation rate?

- The answer to this question is important, because
  - it provides a measure of whether cash flows are positively or negatively impacted by inflation.
  - it then helps in the design of debt; whether the debt should be fixed or floating rate debt.

- If cash flows move with inflation, increasing (decreasing) as inflation increases (decreases), the debt should have a larger floating rate component.
Regression Results

- Regressing changes in firm value against changes in inflation over this period yields the following regression –
  \[
  \text{Change in Firm Value} = 0.1855 + 2.9966 \times (\text{Change in Inflation Rate})
  \]
  \[
  (2.96) \quad (0.90)
  \]
  Conclusion: Disney’s firm value does seem to increase with inflation, but not by much (statistical significance is low)

- Regressing changes in operating cash flow against changes in inflation over this period yields the following regression –
  \[
  \text{Change in Operating Income} = 0.1919 + 8.1867 \times (\text{Change in Inflation Rate})
  \]
  \[
  (3.43^a) \quad (2.76^a)
  \]
  Conclusion: Disney’s operating income increases in periods when inflation increases, suggesting that Disney does have pricing power.
Summarizing...

- Looking at the four macroeconomic regressions, we would conclude that
  - Disney’s assets collectively have a duration of about 2.33 years
  - Disney is increasingly affected by economic cycles
  - Disney is hurt by a stronger dollar
  - Disney’s operating income tends to move with inflation

- All of the regression coefficients have substantial standard errors associated with them. One way to reduce the error (a la bottom up betas) is to use sector-wide averages for each of the coefficients.
These weights reflect the estimated values of the businesses.

<table>
<thead>
<tr>
<th>Business</th>
<th>Interest rates</th>
<th>GDP Growth</th>
<th>Inflation</th>
<th>Currency</th>
<th>Weights</th>
</tr>
</thead>
<tbody>
<tr>
<td>Media Networks</td>
<td>-3.70</td>
<td>0.56</td>
<td>1.41</td>
<td>-1.23</td>
<td>49.27%</td>
</tr>
<tr>
<td>Parks &amp; Resorts</td>
<td>-4.50</td>
<td>0.70</td>
<td>-3.05</td>
<td>-1.58</td>
<td>33.81%</td>
</tr>
<tr>
<td>Studio Entertainment</td>
<td>-6.47</td>
<td>0.22</td>
<td>-1.45</td>
<td>-3.21</td>
<td>13.49%</td>
</tr>
<tr>
<td>Consumer Products</td>
<td>-4.88</td>
<td>0.13</td>
<td>-5.51</td>
<td>-3.01</td>
<td>2.18%</td>
</tr>
<tr>
<td>Interactive</td>
<td>-1.01</td>
<td>0.25</td>
<td>-3.55</td>
<td>-2.86</td>
<td>1.25%</td>
</tr>
<tr>
<td>Disney Operations</td>
<td>-4.34</td>
<td>0.55</td>
<td>-0.70</td>
<td>-1.67</td>
<td>100.00%</td>
</tr>
</tbody>
</table>
The debt issued should be long term and should have duration of about 4.3 years.

A significant portion of the debt should be floating rate debt, reflecting Disney’s capacity to pass inflation through to its customers and the fact that operating income tends to increase as interest rates go up.

Given Disney’s sensitivity to a stronger dollar, a portion of the debt should be in foreign currencies. The specific currency used and the magnitude of the foreign currency debt should reflect where Disney makes its revenues. Based upon 2013 numbers at least, this would indicate that about 18% of its debt should be in foreign currencies (and perhaps more, since even their US dollar income can be affected by currency movements).
Analyzing Disney’s Current Debt

- Disney has $14.3 billion in interest-bearing debt with a face-value weighted average maturity of 7.92 years. Allowing for the fact that the maturity of debt is higher than the duration, this would indicate that Disney’s debt may be a little longer than would be optimal, but not by much.

- Of the debt, about 5.49% of the debt is in non-US dollar currencies (Indian rupees and Hong Kong dollars), but the rest is in US dollars and the company has no Euro debt. Based on our analysis, we would suggest that Disney increase its proportion of Euro debt to about 12% and tie the choice of currency on future debt issues to its expansion plans.

- Disney has no convertible debt and about 5.67% of its debt is floating rate debt, which looks low, given the company’s pricing power. While the mix of debt in 2013 may be reflective of a desire to lock in low long-term interest rates on debt, as rates rise, the company should consider expanding its use of foreign currency debt.
Adjusting Debt at Disney

- It can swap some of its existing fixed rate, dollar debt for floating rate, foreign currency debt. Given Disney’s standing in financial markets and its large market capitalization, this should not be difficult to do.

- If Disney is planning new debt issues, either to get to a higher debt ratio or to fund new investments, it can use primarily floating rate, foreign currency debt to fund these new investments. Although it may be mismatching the funding on these investments, its debt matching will become better at the company level.
Debt Design for Bookscape & Vale

- **Bookscape**: Given Bookscape’s dependence on revenues at its New York bookstore, we would design the debt to be

  **Recommendation**: Long-term, dollar denominated, fixed rate debt

  **Actual**: Long term operating lease on the store

- **Vale**: Vale’s mines are spread around the world, and it generates a large portion of its revenues in China (37%). Its mines typically have very long lives and require large up-front investments, and the costs are usually in the local currencies but its revenues are in US dollars.

  **Recommendation**: Long term, dollar-denominated debt (with hedging of local currency risk exposure) and if possible, tied to commodity prices.

  **Actual**: The existing debt at Vale is primarily US dollar debt (65.48%), with an average maturity of 14.70 years. All of the debt, as far as we can assess, is fixed rate and there is no commodity-linked debt.
And for Tata Motors and Baidu

- **Tata Motors**: As an manufacturing firm, with big chunks of its revenues coming from India and China (about 24% apiece) and the rest spread across developed markets.
  - **Recommendation**: Medium to long term, fixed rate debt in a mix of currencies reflecting operations.
  - **Actual**: The existing debt at Tata Motors is a mix of Indian rupee debt (about 71%) and Euro debt (about 29%), with an average maturity of 5.33 years and it is almost entirely fixed rate debt.

- **Baidu**: Baidu has relatively little debt at the moment, reflecting its status as a young, technology company.
  - **Recommendation**: Convertible, Chinese Yuan debt.
  - **Actual**: About 82% of Baidu’s debt is in US dollars and Euros currently, with an average maturity of 5.80 years. A small portion is floating rate debt, but very little of the debt is convertible.
RETURNING CASH TO THE OWNERS: DIVIDEND POLICY

“Companies don’t have cash. They hold cash for their stockholders.”
First Principles

Maximize the value of the business (firm)

The Investment Decision
Invest in assets that earn a return greater than the minimum acceptable hurdle rate

The Financing Decision
Find the right kind of debt for your firm and the right mix of debt and equity to fund your operations

The Dividend Decision
If you cannot find investments that make your minimum acceptable rate, return the cash to owners of your business

The hurdle rate should reflect the riskiness of the investment and the mix of debt and equity used to fund it.

The return should reflect the magnitude and the timing of the cashflows as well as all side effects.

The optimal mix of debt and equity maximizes firm value.

The right kind of debt matches the tenor of your assets.

How much cash you can return depends upon current & potential investment opportunities.

How you choose to return cash to the owners will depend whether they prefer dividends or buybacks.

Aswath Damodaran
Steps to the Dividend Decision...

- **Cashflow from Operations**
  - Cashflows to Debt (Principal repaid, Interest Expenses)
  - Cashflows from Operations to Equity Investors

- **How much did you borrow?**
  - Reinvestment back into the business

- **How good are your investment choices?**
  - Cash available for return to stockholders
  - Cash held back by the company

- **What is a reasonable cash balance?**
  - Stock Buybacks
  - Dividends

- **What do your stockholders prefer?**
  - Cash Paid out

Aswath Damodaran
I. Dividends are sticky

Dividend Changes at US companies

Increase
Decrease
No change

Aswath Damodaran
The last quarter of 2008 put stickiness to the test.. Number of S&P 500 companies that...

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Dividend Increase</th>
<th>Dividend initiated</th>
<th>Dividend decrease</th>
<th>Dividend suspensions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1 2007</td>
<td>102</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Q2 2007</td>
<td>63</td>
<td>1</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>Q3 2007</td>
<td>59</td>
<td>2</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>Q4 2007</td>
<td>63</td>
<td>7</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Q1 2008</td>
<td>93</td>
<td>3</td>
<td>7</td>
<td>4</td>
</tr>
<tr>
<td>Q2 2008</td>
<td>65</td>
<td>0</td>
<td>9</td>
<td>0</td>
</tr>
<tr>
<td>Q3 2008</td>
<td>45</td>
<td>2</td>
<td>6</td>
<td>8</td>
</tr>
<tr>
<td>Q4 2008</td>
<td>32</td>
<td>0</td>
<td>17</td>
<td>10</td>
</tr>
</tbody>
</table>
II. Dividends tend to follow earnings
III. Are affected by tax laws...

In 2003

In the last quarter of 2012

- As the possibility of tax rates reverting back to pre-2003 levels rose, 233 companies paid out $31 billion in dividends.
- Of these companies, 101 had insider holdings in excess of 20% of the outstanding stock.
IV. More and more firms are buying back stock, rather than pay dividends...
V. And there are differences across countries...
Measures of Dividend Policy

- **Dividend Payout** = Dividends/ Net Income
  - Measures the percentage of earnings that the company pays in dividends
  - If the net income is negative, the payout ratio cannot be computed.

- **Dividend Yield** = Dividends per share/ Stock price
  - Measures the return that an investor can make from dividends alone
  - Becomes part of the expected return on the investment.
Dividend Payout Ratios

Dividend Payout Ratios in 2014

Aswath Damodaran
Dividend Yields: January 2013

Dividend Yields in 2014

Aswath Damodaran
Figure 10.7: Life Cycle Analysis of Dividend Policy

<table>
<thead>
<tr>
<th>External funding needs</th>
<th>High, but constrained by infrastructure</th>
<th>High, relative to firm value.</th>
<th>Moderates, relative to firm value.</th>
<th>Low, as projects dry up.</th>
<th>Low, as projects dry up.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal financing</td>
<td>Negative or low</td>
<td>Negative or low</td>
<td>Low, relative to funding needs</td>
<td>High, relative to funding needs</td>
<td>More than funding needs</td>
</tr>
<tr>
<td>Capacity to pay dividends</td>
<td>None</td>
<td>None</td>
<td>Very low</td>
<td>Increasing</td>
<td>High</td>
</tr>
<tr>
<td>Growth stage</td>
<td>Stage 1 Start-up</td>
<td>Stage 2 Rapid Expansion</td>
<td>Stage 3 High Growth</td>
<td>Stage 4 Mature Growth</td>
<td>Stage 5 Decline</td>
</tr>
</tbody>
</table>
Dividend Yields and Payout Ratios: Growth Classes

Dividend Yields and Payout Ratios: By Growth Class

Aswath Damodaran
Dividend Policy: Disney, Vale, Tata Motors, Baidu and Deutsche Bank

<table>
<thead>
<tr>
<th></th>
<th>Disney</th>
<th>Vale</th>
<th>Tata Motors</th>
<th>Baidu</th>
<th>Deutsche Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend Yield - Last 12 months</td>
<td>1.09%</td>
<td>6.56%</td>
<td>1.31%</td>
<td>0.00%</td>
<td>1.96%</td>
</tr>
<tr>
<td>Dividend Payout ratio - Last 12 months</td>
<td>21.58%</td>
<td>113.45%</td>
<td>16.09%</td>
<td>0.00%</td>
<td>362.63%</td>
</tr>
<tr>
<td>Dividend Yield - 2008-2012</td>
<td>1.17%</td>
<td>4.01%</td>
<td>1.82%</td>
<td>0.00%</td>
<td>3.14%</td>
</tr>
<tr>
<td>Dividend Payout - 2008-2012</td>
<td>17.11%</td>
<td>37.69%</td>
<td>15.53%</td>
<td>0.00%</td>
<td>37.39%</td>
</tr>
</tbody>
</table>
Three Schools Of Thought On Dividends

1. If there are no tax disadvantages associated with dividends & companies can issue stock, at no issuance cost, to raise equity, whenever needed

   Dividends do not matter, and dividend policy does not affect value.

2. If dividends create a tax disadvantage for investors (relative to capital gains)

   Dividends are bad, and increasing dividends will reduce value

3. If dividends create a tax advantage for investors (relative to capital gains) and/or stockholders like dividends

   Dividends are good, and increasing dividends will increase value

Aswath Damodaran
The balanced viewpoint

- If a company has excess cash, and few good investment opportunities (NPV>0), returning money to stockholders (dividends or stock repurchases) is good.

- If a company does not have excess cash, and/or has several good investment opportunities (NPV>0), returning money to stockholders (dividends or stock repurchases) is bad.
The Dividends don’t matter school
The Miller Modigliani Hypothesis

- The Miller-Modigliani Hypothesis: Dividends do not affect value
  - Basis:
    - If a firm's investment policies (and hence cash flows) don't change, the value of the firm cannot change as it changes dividends.
    - If a firm pays more in dividends, it will have to issue new equity to fund the same projects. By doing so, it will reduce expected price appreciation on the stock but it will be offset by a higher dividend yield.
    - If we ignore personal taxes, investors have to be indifferent to receiving either dividends or capital gains.
  - Underlying Assumptions:
    (a) There are no tax differences to investors between dividends and capital gains.
    (b) If companies pay too much in cash, they can issue new stock, with no flotation costs or signaling consequences, to replace this cash.
    (c) If companies pay too little in dividends, they do not use the excess cash for bad projects or acquisitions.
II. The Dividends are “bad” school: And the evidence to back them up...

![Graph: Tax rates on dividends and capital gains - US]

- Dividend tax rate
- Capital gains tax rate
What do investors in your stock think about dividends? Clues on the ex-dividend day!

- Assume that you are the owner of a stock that is approaching an ex-dividend day and you know that dollar dividend with certainty. In addition, assume that you have owned the stock for several years.

\[ P = \text{Price at which you bought the stock a “while” back} \]
\[ P_b = \text{Price before the stock goes ex-dividend} \]
\[ P_a = \text{Price after the stock goes ex-dividend} \]
\[ D = \text{Dividends declared on stock} \]
\[ t_o, t_{cg} = \text{Taxes paid on ordinary income and capital gains respectively} \]
Cashflows from Selling around Ex-Dividend Day

- The cash flows from selling before ex-dividend day are:
  \[ P_b - (P_b - P) \cdot t_{cg} \]

- The cash flows from selling after ex-dividend day are:
  \[ P_a - (P_a - P) \cdot t_{cg} + D(1-t_o) \]

- Since the average investor should be indifferent between selling before the ex-dividend day and selling after the ex-dividend day:
  \[ P_b - (P_b - P) \cdot t_{cg} = P_a - (P_a - P) \cdot t_{cg} + D(1-t_o) \]

- Some basic algebra leads us to the following:
  \[ \frac{P_b - P_a}{D} = \frac{1 - t_o}{1 - t_{cg}} \]
Intuitive Implications

- The relationship between the price change on the ex-dividend day and the dollar dividend will be determined by the difference between the tax rate on dividends and the tax rate on capital gains for the typical investor in the stock.

<table>
<thead>
<tr>
<th>Tax Rates</th>
<th>Ex-dividend day behavior</th>
</tr>
</thead>
<tbody>
<tr>
<td>If dividends and capital gains are taxed equally</td>
<td>Price change = Dividend</td>
</tr>
<tr>
<td>If dividends are taxed at a higher rate than capital gains</td>
<td>Price change &lt; Dividend</td>
</tr>
<tr>
<td>If dividends are taxed at a lower rate than capital gains</td>
<td>Price change &gt; Dividend</td>
</tr>
</tbody>
</table>
The empirical evidence...

1966-1969
- Ordinary tax rate = 70%
- Capital gains rate = 28%
- Price chg/ Dividend = 0.78

1981-1985
- Ordinary tax rate = 50%
- Capital gains rate = 20%
- Price chg/ Dividend = 0.85

1986-1990
- Ordinary tax rate = 28%
- Capital gains rate = 28%
- Price chg/ Dividend = 0.90
Dividend Arbitrage

□ Assume that you are a tax exempt investor, and that you know that the price drop on the ex-dividend day is only 90% of the dividend. How would you exploit this differential?

a. Invest in the stock for the long term
b. Sell short the day before the ex-dividend day, buy on the ex-dividend day
c. Buy just before the ex-dividend day, and sell after.
d. ________________________________
Example of dividend capture strategy with tax factors

- XYZ company is selling for $50 at close of trading May 3. On May 4, XYZ goes ex-dividend; the dividend amount is $1. The price drop (from past examination of the data) is only 90% of the dividend amount.

- The transactions needed by a tax-exempt U.S. pension fund for the arbitrage are as follows:
  1. Buy 1 million shares of XYZ stock cum-dividend at $50/share.
  2. Wait till stock goes ex-dividend; Sell stock for $49.10/share \((50 - 1 \times 0.90)\)
  3. Collect dividend on stock.

- Net profit = - 50 million + 49.10 million + 1 million = $0.10 million
Two bad reasons for paying dividends

1. The bird in the hand fallacy

- **Argument**: Dividends now are more certain than capital gains later. Hence dividends are more valuable than capital gains. Stocks that pay dividends will therefore be more highly valued than stocks that do not.

- **Counter**: The appropriate comparison should be between dividends today and price appreciation today. The stock price drops on the ex-dividend day.
2. We have excess cash this year...

- **Argument**: The firm has excess cash on its hands this year, no investment projects this year and wants to give the money back to stockholders.

- **Counter**: So why not just repurchase stock? If this is a one-time phenomenon, the firm has to consider future financing needs. The cost of raising new financing in future years, especially by issuing new equity, can be staggering.
The Cost of Raising Capital

Figure 10.12: Issuance Costs for Stocks and Bonds

Cost as % of funds raised

Cost of Issuing bonds  □ Cost of Issuing Common Stock

Aswath Damodaran
Three “good” reasons for paying dividends...

- **Clientele Effect**: The investors in your company like dividends.
- **The Signalling Story**: Dividends can be signals to the market that you believe that you have good cash flow prospects in the future.
- **The Wealth Appropriation Story**: Dividends are one way of transferring wealth from lenders to equity investors (this is good for equity investors but bad for lenders)
1. The Clientele Effect
The “strange case” of Citizen’s Utility

Class A shares pay cash dividend

Class B shares offer the same amount as a stock dividend & can be converted to class A shares
Evidence from Canadian firms

<table>
<thead>
<tr>
<th>Company</th>
<th>Premium for cash dividend shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidated Bathurst</td>
<td>+ 19.30%</td>
</tr>
<tr>
<td>Donfasco</td>
<td>+ 13.30%</td>
</tr>
<tr>
<td>Dome Petroleum</td>
<td>+ 0.30%</td>
</tr>
<tr>
<td>Imperial Oil</td>
<td>+12.10%</td>
</tr>
<tr>
<td>Newfoundland Light &amp; Power</td>
<td>+ 1.80%</td>
</tr>
<tr>
<td>Royal Trustco</td>
<td>+ 17.30%</td>
</tr>
<tr>
<td>Stelco</td>
<td>+ 2.70%</td>
</tr>
<tr>
<td>TransAlta</td>
<td>+1.10%</td>
</tr>
<tr>
<td>Average across companies</td>
<td>+ 7.54%</td>
</tr>
</tbody>
</table>
A clientele based explanation

- **Basis:** Investors may form clienteles based upon their tax brackets. Investors in high tax brackets may invest in stocks which do not pay dividends and those in low tax brackets may invest in dividend paying stocks.

- **Evidence:** A study of 914 investors' portfolios was carried out to see if their portfolio positions were affected by their tax brackets. The study found that
  - (a) Older investors were more likely to hold high dividend stocks and
  - (b) Poorer investors tended to hold high dividend stocks
## Results from Regression: Clientele Effect

The regression model is given by:

\[ \text{Dividend Yield}_t = a + b \beta_t + c \text{Age}_t + d \text{Income}_t + e \text{Differential Tax Rate}_t + \varepsilon_t \]

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Implies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>4.22%</td>
<td>Higher beta stocks pay lower dividends.</td>
</tr>
<tr>
<td>Beta Coefficient</td>
<td>-2.145</td>
<td>Firms with older investors pay higher dividends.</td>
</tr>
<tr>
<td>Age/100</td>
<td>3.131</td>
<td>Firms with wealthier investors pay lower dividends.</td>
</tr>
<tr>
<td>Income/1000</td>
<td>-3.726</td>
<td>If ordinary income is taxed at a higher rate than capital gains, the firm pays less dividends.</td>
</tr>
<tr>
<td>Differential Tax Rate</td>
<td>-2.849</td>
<td></td>
</tr>
</tbody>
</table>
Dividend Policy and Clientele

Assume that you run a phone company, and that you have historically paid large dividends. You are now planning to enter the telecommunications and media markets. Which of the following paths are you most likely to follow?

a. Courageously announce to your stockholders that you plan to cut dividends and invest in the new markets.

b. Continue to pay the dividends that you used to, and defer investment in the new markets.

c. Continue to pay the dividends that you used to, make the investments in the new markets, and issue new stock to cover the shortfall.

d. Other

Aswath Damodaran
2. Dividends send a signal”
Increases in dividends are good news..
But higher or new dividends may signal bad news (not good)

Dividend Initiations and Earnings Growth

Dividends Initiated here

Annual Earnings Growth Rate

<table>
<thead>
<tr>
<th>Year relative to dividend initiation (Before and after)</th>
<th>0.00%</th>
<th>5.00%</th>
<th>10.00%</th>
<th>15.00%</th>
<th>20.00%</th>
<th>25.00%</th>
<th>30.00%</th>
<th>35.00%</th>
<th>40.00%</th>
<th>45.00%</th>
</tr>
</thead>
<tbody>
<tr>
<td>-4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Aswath Damodaran
Both dividend increases and decreases are becoming less informative...

*Market Reaction to Dividend Changes over time: US companies*

- Dividend Increases
- Dividend Decreases
3. Dividend increases may be good for stocks... but bad for bonds..

EXCESS RETURNS ON STOCKS AND BONDS AROUND DIVIDEND CHANGES

CAR (Div Up)

CAR (Div down)

Stock price rises

Bond price drops

Day (0: Announcement date)
What managers believe about dividends...

<table>
<thead>
<tr>
<th>Statement of Management Beliefs</th>
<th>Agree</th>
<th>No Opinion</th>
<th>Disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. A firm’s dividend payout ratio affects the price of the stock.</td>
<td>61%</td>
<td>33%</td>
<td>6%</td>
</tr>
<tr>
<td>2. Dividend payments provide a signaling device of future prospects.</td>
<td>52%</td>
<td>41%</td>
<td>7%</td>
</tr>
<tr>
<td>3. The market uses divided announcements as information for assessing firm value.</td>
<td>43%</td>
<td>51%</td>
<td>6%</td>
</tr>
<tr>
<td>4. Investors have different perceptions of the relative riskiness of dividends and retained earnings.</td>
<td>56%</td>
<td>42%</td>
<td>2%</td>
</tr>
<tr>
<td>5. Investors are basically indifferent with regard to returns from dividends and capital gains.</td>
<td>6%</td>
<td>30%</td>
<td>64%</td>
</tr>
<tr>
<td>6. A stockholder is attracted to firms that have dividend policies appropriate to the stockholder’s tax environment.</td>
<td>44%</td>
<td>49%</td>
<td>7%</td>
</tr>
<tr>
<td>7. Management should be responsive to shareholders’ preferences regarding dividends.</td>
<td>41%</td>
<td>49%</td>
<td>10%</td>
</tr>
</tbody>
</table>
ASSESSING DIVIDEND POLICY: OR HOW MUCH CASH IS TOO MUCH?

It is my cash and I want it now...
Maximize the value of the business (firm)

The Investment Decision
Invest in assets that earn a return greater than the minimum acceptable hurdle rate

The Financing Decision
Find the right kind of debt for your firm and the right mix of debt and equity to fund your operations

The Dividend Decision
If you cannot find investments that make your minimum acceptable rate, return the cash to owners of your business

The hurdle rate should reflect the riskiness of the investment and the mix of debt and equity used to fund it.

The return should reflect the magnitude and the timing of the cashflows as well as all side effects.

The optimal mix of debt and equity maximizes firm value.

The right kind of debt matches the tenor of your assets.

How much cash you can return depends upon current & potential investment opportunities.

How you choose to return cash to the owners will depend whether they prefer dividends or buybacks.
Assessing Dividend Policy

- **Approach 1: The Cash/Trust Nexus**
  - Assess how much cash a firm has available to pay in dividends, relative what it returns to stockholders. Evaluate whether you can trust the managers of the company as custodians of your cash.

- **Approach 2: Peer Group Analysis**
  - Pick a dividend policy for your company that makes it comparable to other firms in its peer group.
I. The Cash/Trust Assessment

Step 1: How much did the company actually pay out during the period in question?

Step 2: How much could the company have paid out during the period under question?

Step 3: How much do I trust the management of this company with excess cash?

- How well did they make investments during the period in question?
- How well has my stock performed during the period in question?
How much has the company returned to stockholders?

- As firms increasing use stock buybacks, we have to measure cash returned to stockholders as not only dividends but also buybacks.
- For instance, for the five companies we are analyzing the cash returned looked as follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>Disney</th>
<th>Vale</th>
<th>Tata Motors</th>
<th>Baidu</th>
<th>Deutsche Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dividends</td>
<td>Buybacks</td>
<td>Dividends</td>
<td>Dividends</td>
<td>Buybacks</td>
</tr>
<tr>
<td>2008</td>
<td>$648</td>
<td>$648</td>
<td>$2,993</td>
<td>$741</td>
<td>7,595₹</td>
</tr>
<tr>
<td>2009</td>
<td>$653</td>
<td>$2,669</td>
<td>$2,771</td>
<td>$9</td>
<td>3,496₹</td>
</tr>
<tr>
<td>2010</td>
<td>$756</td>
<td>$4,993</td>
<td>$3,037</td>
<td>$1,930</td>
<td>10,195₹</td>
</tr>
<tr>
<td>2011</td>
<td>$1,076</td>
<td>$3,015</td>
<td>$9,062</td>
<td>$3,051</td>
<td>15,031₹</td>
</tr>
<tr>
<td>2012</td>
<td>$1,324</td>
<td>$4,087</td>
<td>$6,006</td>
<td>$0</td>
<td>15,088₹</td>
</tr>
<tr>
<td>2008-12</td>
<td>$4,457</td>
<td>$15,412</td>
<td>$23,869</td>
<td>$5,731</td>
<td>51,405₹</td>
</tr>
</tbody>
</table>
A Measure of How Much a Company Could have Afforded to Pay out: FCFE

- The Free Cashflow to Equity (FCFE) is a measure of how much cash is left in the business after non-equity claimholders (debt and preferred stock) have been paid, and after any reinvestment needed to sustain the firm’s assets and future growth.

Net Income
+ Depreciation & Amortization
= Cash flows from Operations to Equity Investors
- Preferred Dividends
- Capital Expenditures
- Working Capital Needs
= FCFE before net debt cash flow (Owner’s Earnings)
+ New Debt Issues
- Debt Repayments
= FCFE after net debt cash flow
Estimating FCFE when Leverage is Stable

- The cash flow from debt (debt issue, netted out against repayment) can be a volatile number, creating big increases or decreases in FCFE, depending upon the period examined.

- To provide a more balanced measure, you can estimate a FCFE, assuming a stable debt ratio had been used to fund reinvestment over the period.

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

Debt Ratio = Debt/Capital Ratio (either an actual or a target)
## Disney’s FCFE and Cash Returned: 2008 – 2012

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td>$6,136</td>
<td>$5,682</td>
<td>$4,807</td>
<td>$3,963</td>
<td>$3,307</td>
<td>$23,895</td>
</tr>
<tr>
<td>- (Cap. Exp - Depr)</td>
<td>$604</td>
<td>$1,797</td>
<td>$1,718</td>
<td>$397</td>
<td>$122</td>
<td>$4,638</td>
</tr>
<tr>
<td>- δ Working Capital</td>
<td>($133)</td>
<td>$940</td>
<td>$950</td>
<td>$308</td>
<td>($109)</td>
<td>$1,956</td>
</tr>
<tr>
<td>Free CF to Equity (pre-debt)</td>
<td>$5,665</td>
<td>$2,945</td>
<td>$2,139</td>
<td>$3,258</td>
<td>$3,294</td>
<td>$17,301</td>
</tr>
<tr>
<td>+ Net Debt Issued</td>
<td>$1,881</td>
<td>$4,246</td>
<td>$2,743</td>
<td>$1,190</td>
<td>($235)</td>
<td>$9,825</td>
</tr>
<tr>
<td>= Free CF to Equity (actual debt)</td>
<td>$7,546</td>
<td>$7,191</td>
<td>$4,882</td>
<td>$4,448</td>
<td>$3,059</td>
<td>$27,126</td>
</tr>
<tr>
<td>Free CF to Equity (target debt ratio)</td>
<td>$5,720</td>
<td>$3,262</td>
<td>$2,448</td>
<td>$3,340</td>
<td>$3,296</td>
<td>$18,065</td>
</tr>
<tr>
<td>Dividends</td>
<td>$1,324</td>
<td>$1,076</td>
<td>$756</td>
<td>$653</td>
<td>$648</td>
<td>$4,457</td>
</tr>
<tr>
<td>Dividends + Buybacks</td>
<td>$5,411</td>
<td>$4,091</td>
<td>$5,749</td>
<td>$3,322</td>
<td>$1,296</td>
<td>$19,869</td>
</tr>
</tbody>
</table>

Disney returned about $1.5 billion more than the $18.1 billion it had available as FCFE with a normalized debt ratio of 11.58% (its current debt ratio).
How companies get big cash balances: Microsoft in 1996...

- Consider the following inputs for Microsoft in 1996.
  - Net Income = $2,176 Million
  - Capital Expenditures = $494 Million
  - Depreciation = $480 Million
  - Change in Non-Cash Working Capital = $35 Million
  - Debt = None

\[
\text{FCFE} = \text{Net Income} - (\text{Cap ex} - \text{Depr}) - \text{Change in non-cash WC} - \text{Debt CF} \\
= \$2,176 - (494 - 480) - \$35 - 0 = \$2,127 \text{ Million}
\]

- By this estimation, Microsoft could have paid $2,127 Million in dividends/stock buybacks in 1996. They paid no dividends and bought back no stock. Where will the $2,127 million show up in Microsoft’s balance sheet?
FCFE for a Bank?

- We redefine reinvestment as investment in regulatory capital.

\[ \text{FCFEBank} = \text{Net Income} - \text{Increase in Regulatory Capital (Book Equity)} \]

- Consider a bank with $10 billion in loans outstanding and book equity of $750 million. If it maintains its capital ratio of 7.5%, intends to grow its loan base by 10% (to $11 billion) and expects to generate $150 million in net income:

\[ \text{FCFE} = 150 \text{ million} - (11,000 - 10,000) \times 0.075 = 75 \text{ million} \]

*Deutsche Bank: FCFE estimates (November 2013)*

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Adjusted Assets (grows 3% each year)</td>
<td>439,851 €</td>
<td>453,047 €</td>
<td>466,638 €</td>
<td>480,637 €</td>
<td>495,056 €</td>
<td>509,908 €</td>
</tr>
<tr>
<td>Tier 1 as % of Risk Adj assets</td>
<td>15.13%</td>
<td>15.71%</td>
<td>16.28%</td>
<td>16.85%</td>
<td>17.43%</td>
<td>18.00%</td>
</tr>
<tr>
<td>Tier 1 Capital</td>
<td>66,561 €</td>
<td>71,156 €</td>
<td>75,967 €</td>
<td>81,002 €</td>
<td>86,271 €</td>
<td>91,783 €</td>
</tr>
<tr>
<td>Change in regulatory capital</td>
<td>4,595 €</td>
<td>4,811 €</td>
<td>5,035 €</td>
<td>5,269 €</td>
<td>5,512 €</td>
<td>5,512 €</td>
</tr>
<tr>
<td>Book Equity</td>
<td>76,829 €</td>
<td>81,424 €</td>
<td>86,235 €</td>
<td>91,270 €</td>
<td>96,539 €</td>
<td>102,051 €</td>
</tr>
<tr>
<td>ROE (increases to 8%)</td>
<td>-1.08%</td>
<td>0.74%</td>
<td>2.55%</td>
<td>4.37%</td>
<td>6.18%</td>
<td>8.00%</td>
</tr>
<tr>
<td>Net Income</td>
<td>-716 €</td>
<td>602 €</td>
<td>2,203 €</td>
<td>3,988 €</td>
<td>5,971 €</td>
<td>8,164 €</td>
</tr>
<tr>
<td>- Investment in Regulatory Capital</td>
<td>4,595 €</td>
<td>4,811 €</td>
<td>5,035 €</td>
<td>5,269 €</td>
<td>5,512 €</td>
<td>5,512 €</td>
</tr>
<tr>
<td>FCFE</td>
<td>-3,993 €</td>
<td>-2,608 €</td>
<td>-1,047 €</td>
<td>702 €</td>
<td>2,652 €</td>
<td></td>
</tr>
</tbody>
</table>
Dividends versus FCFE: Across the globe

*Figure 11.2: Dividends versus FCFE in 2014*
Cash Buildup and Investor Blowback: Chrysler in 1994

Chrysler: FCFE, Dividends and Cash Balance

Year

Cash Flow
($500) $0 $500 $1,000 $1,500 $2,000 $2,500 $3,000

Cash Balance
0 $1,000 $2,000 $3,000 $4,000 $5,000 $6,000 $7,000 $8,000 $9,000

Free CF to Equity - Cash to Stockholders - Cumulated Cash

Aswath Damodaran
Application Test: Estimating your firm’s FCFE

- In General,
  - Net Income
  - + Depreciation & Amortization
  - - Capital Expenditures
  - - Change in Non-Cash Working Capital
  - - Preferred Dividend
  - - Principal Repaid
  - + New Debt Issued
  
  = FCFE

- Compare to
  - Dividends (Common)
  - + Stock Buybacks

If cash flow statement used
- Net Income
- + Depreciation & Amortization
- + Capital Expenditures
- + Changes in Non-cash WC
- + Preferred Dividend
- + Increase in LT Borrowing
- + Decrease in LT Borrowing
- + Change in ST Borrowing
  
  = FCFE

- Compared to
  - Common Dividend
  - Stock Buybacks
A Practical Framework for Analyzing Dividend Policy

How much did the firm pay out? How much could it have afforded to pay out?

<table>
<thead>
<tr>
<th>What it could have paid out</th>
<th>What it actually paid out</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td>Dividends</td>
</tr>
<tr>
<td>- (Cap Ex - Depr’ n) (1-DR)</td>
<td>+ Equity Repurchase</td>
</tr>
<tr>
<td>- Chg Working Capital (1-DR)</td>
<td></td>
</tr>
<tr>
<td>= FCFE</td>
<td></td>
</tr>
</tbody>
</table>

- Firm pays out too little: FCFE > Dividends
  - Do you trust managers in the company with your cash?
    - Look at past project choice:
      - Compare ROE to Cost of Equity
      - ROC to WACC
  - Firm has history of good project choice and good projects in the future
  - Give managers the flexibility to keep cash and set dividends

- Firm pays out too much: FCFE < Dividends
  - What investment opportunities does the firm have?
    - Look at past project choice:
      - Compare ROE to Cost of Equity
      - ROC to WACC
  - Firm has good projects
  - Firm should cut dividends and reinvest more
  - Firm should deal with its investment problem first and then cut dividends
A Dividend Matrix

<table>
<thead>
<tr>
<th>Quality of projects taken: Excess Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poor projects</td>
</tr>
<tr>
<td>Cash Surplus + Poor Projects</td>
</tr>
<tr>
<td>Significant pressure to pay out more to</td>
</tr>
<tr>
<td>stockholders as dividends or stock</td>
</tr>
<tr>
<td>buybacks</td>
</tr>
<tr>
<td>Cash Deficit + Poor Projects</td>
</tr>
<tr>
<td>Reduce or eliminate cash return but real</td>
</tr>
<tr>
<td>problem is in investment policy.</td>
</tr>
<tr>
<td>Cash Deficit + Good Projects</td>
</tr>
<tr>
<td>Maximum flexibility in setting dividend</td>
</tr>
<tr>
<td>policy</td>
</tr>
</tbody>
</table>

| Good projects                            |
| Cash Surplus + Good Projects             |
|                                           |
|                                           |
|                                           |

<table>
<thead>
<tr>
<th>Cash Returned, relative to Free Cash flow to Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Return &lt; FCFE</td>
</tr>
<tr>
<td>Cash Deficit + Good Projects</td>
</tr>
<tr>
<td>Reduce cash payout, if any, to stockholders</td>
</tr>
<tr>
<td>Cash Deficit + Poor Projects</td>
</tr>
<tr>
<td>Reduce or eliminate cash return but real problem</td>
</tr>
<tr>
<td>is in investment policy.</td>
</tr>
</tbody>
</table>

Aswath Damodaran
More on Microsoft

- Microsoft had accumulated a cash balance of $43 billion by 2002 by paying out no dividends while generating huge FCFE. At the end of 2003, there was no evidence that Microsoft was being penalized for holding such a large cash balance or that stockholders were becoming restive about the cash balance. There was no hue and cry demanding more dividends or stock buybacks. Why?

- In 2004, Microsoft announced a huge special dividend of $33 billion and made clear that it would try to return more cash to stockholders in the future. What do you think changed?
Case 1: Disney in 2003

- **FCFE versus Dividends**
  - Between 1994 & 2003, Disney generated $969 million in FCFE each year.
  - Between 1994 & 2003, Disney paid out $639 million in dividends and stock buybacks each year.

- **Cash Balance**
  - Disney had a cash balance in excess of $4 billion at the end of 2003.

- **Performance measures**
  - Between 1994 and 2003, Disney has generated a return on equity, on its projects, about 2% less than the cost of equity, on average each year.
  - Between 1994 and 2003, Disney’s stock has delivered about 3% less than the cost of equity, on average each year.
  - The underperformance has been primarily post 1996 (after the Capital Cities acquisition).
Can you trust Disney’s management?

- Given Disney’s track record between 1994 and 2003, if you were a Disney stockholder, would you be comfortable with Disney’s dividend policy?
  - a. Yes
  - b. No

- Does the fact that the company is run by Michael Eisner, the CEO for the last 10 years and the initiator of the Cap Cities acquisition have an effect on your decision.
  - a. Yes
  - b. No

Aswath Damodaran
The Bottom Line on Disney Dividends in 2003

- Disney could have afforded to pay more in dividends during the period of the analysis.
- It chose not to, and used the cash for acquisitions (Capital Cities/ABC) and ill fated expansion plans (Go.com).
- While the company may have flexibility to set its dividend policy a decade ago, its actions over that decade have frittered away this flexibility.
- **Bottom line**: Large cash balances would not be tolerated in this company. Expect to face relentless pressure to pay out more dividends.
Following up: Disney in 2009

- Between 2004 and 2008, Disney made significant changes:
  - It replaced its CEO, Michael Eisner, with a new CEO, Bob Iger, who at least on the surface seemed to be more receptive to stockholder concerns.
  - Its stock price performance improved (positive Jensen’s alpha)
  - Its project choice improved (ROC moved from being well below cost of capital to above)

- The firm also shifted from cash returned $< FCFE$ to cash returned $> FCFE$ and avoided making large acquisitions.

- If you were a stockholder in 2009 and Iger made a plea to retain cash in Disney to pursue investment opportunities, would you be more receptive?
  a. Yes
  b. No
Final twist: Disney in 2013

- Disney did return to holding cash between 2008 and 2013, with dividends and buybacks amounting TO $2.6 billion less than the FCFE (with a target debt ratio) over this period.
- Disney continues to earn a return on capital well in excess of the cost of capital and its stock has doubled over the last two years.
- Now, assume that Bob Iger asks you for permission to withhold even more cash to cover future investment needs. Are you likely to go along?
  a. Yes
  b. No
## Case 2: Vale – Dividends versus FCFE

<table>
<thead>
<tr>
<th></th>
<th>Aggregate</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td>$57,404</td>
<td>$5,740</td>
</tr>
<tr>
<td>Dividends</td>
<td>$36,766</td>
<td>$3,677</td>
</tr>
<tr>
<td>Dividend Payout Ratio</td>
<td>$1</td>
<td>$1</td>
</tr>
<tr>
<td>Stock Buybacks</td>
<td>$6,032</td>
<td>$603</td>
</tr>
<tr>
<td>Dividends + Buybacks</td>
<td>$42,798</td>
<td>$4,280</td>
</tr>
<tr>
<td>Cash Payout Ratio</td>
<td>$1</td>
<td></td>
</tr>
<tr>
<td>Free CF to Equity (pre-debt)</td>
<td>($1,903)</td>
<td>($190)</td>
</tr>
<tr>
<td>Free CF to Equity (actual debt)</td>
<td>$1,036</td>
<td>$104</td>
</tr>
<tr>
<td>Free CF to Equity (target debt ratio)</td>
<td>$19,138</td>
<td>$1,914</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash payout as % of pre-debt FCFE</th>
<th>FCFE negative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash payout as % of actual FCFE</td>
<td>4131.08%</td>
</tr>
<tr>
<td>Cash payout as % of target FCFE</td>
<td>223.63%</td>
</tr>
</tbody>
</table>
Vale: Its your call..

- Vale’s managers have asked you for permission to cut dividends (to more manageable levels). Are you likely to go along?
  a. Yes
  b. No

- The reasons for Vale’s dividend problem lie in its equity structure. Like most Brazilian companies, Vale has two classes of shares - common shares with voting rights and preferred shares without voting rights. However, Vale has committed to paying out 35% of its earnings as dividends to the preferred stockholders. If they fail to meet this threshold, the preferred shares get voting rights. If you own the preferred shares, would your answer to the question above change?
  a. Yes
  b. No
Mandated Dividend Payouts

Assume now that the government decides to mandate a minimum dividend payout for all companies. Given our discussion of FCFE, what types of companies will be hurt the most by such a mandate?

a. Large companies making huge profits
b. Small companies losing money
c. High growth companies that are losing money
d. High growth companies that are making money

What if the government mandates a cap on the dividend payout ratio (and a requirement that all companies reinvest a portion of their profits)?

<table>
<thead>
<tr>
<th>Summary of calculations</th>
<th>Average</th>
<th>Standard Deviation</th>
<th>Maximum</th>
<th>Minimum</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Free CF to Equity</strong></td>
<td>$571.10</td>
<td>$1,382.29</td>
<td>$3,764.00</td>
<td>($612.50)</td>
</tr>
<tr>
<td><strong>Dividends</strong></td>
<td>$1,496.30</td>
<td>$448.77</td>
<td>$2,112.00</td>
<td>$831.00</td>
</tr>
<tr>
<td><strong>Dividends+Repurchases</strong></td>
<td>$1,496.30</td>
<td>$448.77</td>
<td>$2,112.00</td>
<td>$831.00</td>
</tr>
<tr>
<td><strong>Dividend Payout Ratio</strong></td>
<td>84.77%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Cash Paid as % of FCFE</strong></td>
<td>262.00%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>ROE - Required return</strong></td>
<td>-1.67%</td>
<td>11.49%</td>
<td>20.90%</td>
<td>-21.59%</td>
</tr>
</tbody>
</table>
BP: Just Desserts!

By MATTHEW L. WALD

British Petroleum said yesterday that it would cut its dividend by 58 percent, take a pre-tax restructuring charge of $2.82 billion for the second quarter and lay off 11,500 employees, or 10 percent of its worldwide workforce. The moves came five weeks after Robert B. Horton, B.P.'s chairman, resigned under pressure from the company's outside directors.

Analysts anticipated a dividend cut by the oil company, the world's third largest, but the one announced was at the low end of their expectations. In response, shares of the company's American depositary rights, each of which represents 12 shares of the London-based company, dropped $4.85, or 7.58 percent, to $49.37. It was the most active issue on the New York Stock Exchange, with 6.48 million shares traded.

The Royal Dutch/Shell group also reported a disappointing quarter yesterday, with earnings on a replacement-cost basis — excluding gains or losses on inventory holdings — of $886 million, down 22 percent.

Quick Recovery Seems Unlikely

Adding to the gloom at B.P., the new chief executive, David A. G. Simmon, said the prospects for a quick recovery were poor. "External trading conditions are expected to remain difficult, particularly for the downstream oil and chemicals businesses, with growth prospects for the world's economies remaining uncertain," he said in a statement. Downstream oil and chemicals is an industry term for refining and marketing operations, as distinct from oil production.

Downstream margins in the United States would be hurt later this year, he predicted, when clean air rules take effect. And gasoline must be reformulated to reduce pollution. "In Europe, recovery will depend upon seasonal heating oil demand," Mr. Simmon said.

The crude oil market, he predicted, would remain balanced unless Iraqi oil was allowed to re-enter the market. The company said it was well positioned to take advantage of any increase in oil prices, but the company's oil production in the United States is declining. B.P. is the largest producer in Alaska.

The market for petrochemicals in Europe remains weak.

B.P.'s second quarter profits, before one-time transactions, exceeded by $193 million from $515 million, valuing inventories on a replacement-cost basis. James J. Macri, as analyst at Standard & Poor's, estimated that after exceptional items, earnings per share fell to 30 cents in the second quarter, compared with 87 cents a year earlier.

Analysts attributed B.P.'s problems to the company's acquisitions in the last few years, and heavy capital expenditures. Summing up the company's recent history, Frank P. Nicosia of Prudential Securities Research said, "Debt rose, interest expense rose, and profits have gone to hell."

Mr. Murchison, who worked for Standard Oil of Ohio, and then B.P. after B.P. acquired Sohio, said, "What you've got is a company that thought oil prices were going to go to $30 and spent like it, in terms of capital." If B.P.'s costs of finding oil are the same as the industry average, he said, then the company has been spending enough to replace 120 percent to 130 percent of its annual production, which is not a successful strategy if prices do not rise.

In addition, he said, the company had been spending twice as much on its refining and marketing operations as it was recording in depreciation. Another analyst at a large stock brokerage house, who spoke on the condition of anonymity, said, "They took all the old Sohio stations and turned them into modern B.P. stations: they took all the B.P. stations and turned them into ultramodern stations."

"The analyst said that while some of the cuts 'were obviously came in,'
Managing changes in dividend policy

<table>
<thead>
<tr>
<th>Category</th>
<th>Periods Around Announcement Date</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Prior Quarter</td>
</tr>
<tr>
<td>Simultaneous announcement of earnings decline/loss ($N = 176$)</td>
<td>−7.23%</td>
</tr>
<tr>
<td>Prior announcement of earnings decline or loss ($N = 208$)</td>
<td>−7.58%</td>
</tr>
<tr>
<td>Simultaneous announcement of investment or growth opportunities ($N = 16$)</td>
<td>−7.69%</td>
</tr>
</tbody>
</table>

Aswath Damodaran

### Summary of calculations

<table>
<thead>
<tr>
<th></th>
<th>Average</th>
<th>Standard Deviation</th>
<th>Maximum</th>
<th>Minimum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free CF to Equity</td>
<td>($34.20)</td>
<td>$109.74</td>
<td>$96.89</td>
<td>($242.17)</td>
</tr>
<tr>
<td>Dividends</td>
<td>$40.87</td>
<td>$32.79</td>
<td>$101.36</td>
<td>$5.97</td>
</tr>
<tr>
<td>Dividends+Repurchases</td>
<td>$40.87</td>
<td>$32.79</td>
<td>$101.36</td>
<td>$5.97</td>
</tr>
<tr>
<td>Dividend Payout Ratio</td>
<td>18.59%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash Paid as % of FCFE</td>
<td>-119.52%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROE - Required return</td>
<td>1.69%</td>
<td>19.07%</td>
<td>29.26%</td>
<td>-19.84%</td>
</tr>
</tbody>
</table>
High growth firms are sometimes advised to initiate dividends because it increases the potential stockholder base for the company (since there are some investors - like pension funds - that cannot buy stocks that do not pay dividends) and, by extension, the stock price. Do you agree with this argument?

a. Yes
b. No

Why?
## 5. Tata Motors

<table>
<thead>
<tr>
<th></th>
<th>Aggregate</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td>$421,338.00</td>
<td>$42,133.80</td>
</tr>
<tr>
<td>Dividends</td>
<td>$74,214.00</td>
<td>$7,421.40</td>
</tr>
<tr>
<td>Dividend Payout Ratio</td>
<td>17.61%</td>
<td>15.09%</td>
</tr>
<tr>
<td>Stock Buybacks</td>
<td>$970.00</td>
<td>$97.00</td>
</tr>
<tr>
<td>Dividends + Buybacks</td>
<td>$75,184.00</td>
<td>$7,518.40</td>
</tr>
<tr>
<td>Cash Payout Ratio</td>
<td>17.84%</td>
<td></td>
</tr>
<tr>
<td>Free CF to Equity (pre-debt)</td>
<td>($106,871.00)</td>
<td>($10,687.10)</td>
</tr>
<tr>
<td>Free CF to Equity (actual debt)</td>
<td>$825,262.00</td>
<td>$82,526.20</td>
</tr>
<tr>
<td>Free CF to Equity (target debt ratio)</td>
<td>$47,796.36</td>
<td>$4,779.64</td>
</tr>
<tr>
<td>Cash payout as % of pre-debt FCFE</td>
<td>FCFE negative</td>
<td></td>
</tr>
<tr>
<td>Cash payout as % of actual FCFE</td>
<td>9.11%</td>
<td></td>
</tr>
<tr>
<td>Cash payout as % of target FCFE</td>
<td>157.30%</td>
<td></td>
</tr>
</tbody>
</table>

Negative FCFE, largely because of acquisitions.

Aswath Damodaran
Summing up...

<table>
<thead>
<tr>
<th>Quality of projects taken: ROE versus Cost of Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poor projects</td>
</tr>
<tr>
<td>Good projects</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Dividends paid out relative to FCFE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Surplus + Poor Projects</td>
</tr>
<tr>
<td>Signiﬁcant pressure to pay out more to stockholders as dividends or stock buybacks</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Cash Surplus + Good Projects</td>
</tr>
<tr>
<td>Baidu</td>
</tr>
<tr>
<td>Maximum ﬂexibility in setting dividend policy</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Deutsche Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Deficit + Poor Projects</td>
</tr>
<tr>
<td>Cut out dividends but real problem is in investment policy.</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Disney</td>
</tr>
<tr>
<td>Cash Deficit + Good Projects</td>
</tr>
<tr>
<td>Reduce cash payout, if any, to stockholders</td>
</tr>
</tbody>
</table>

| Vale                                 |
| Tata Mtrs                           |

Aswath Damodaran
Application Test: Assessing your firm’s dividend policy

- Compare your firm’s dividends to its FCFE, looking at the last 5 years of information.

- Based upon your earlier analysis of your firm’s project choices, would you encourage the firm to return more cash or less cash to its owners?

- If you would encourage it to return more cash, what form should it take (dividends versus stock buybacks)?
II. The Peer Group Approach

- In the peer group approach, you compare your company to similar companies (usually in the same market and sector) to assess whether and if yes, how much to pay in dividends.

<table>
<thead>
<tr>
<th>Company</th>
<th>Dividend Yield 2013</th>
<th>Average 2008-12</th>
<th>Dividend Yield 2013</th>
<th>Average 2008-12</th>
<th>Comparable Group</th>
<th>Dividend Yield</th>
<th>Dividend Payout</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disney</td>
<td>1.09%</td>
<td>1.17%</td>
<td>21.58%</td>
<td>17.11%</td>
<td>US Entertainment</td>
<td>0.96%</td>
<td>22.51%</td>
</tr>
<tr>
<td>Vale</td>
<td>6.56%</td>
<td>4.01%</td>
<td>113.45%</td>
<td>37.69%</td>
<td>Global Diversified Mining &amp; Iron Ore (Market cap &gt; $1 b)</td>
<td>3.07%</td>
<td>316.32%</td>
</tr>
<tr>
<td>Tata Motors</td>
<td>1.31%</td>
<td>1.82%</td>
<td>16.09%</td>
<td>15.53%</td>
<td>Global Autos (Market Cap &gt; $1 b)</td>
<td>2.13%</td>
<td>27.00%</td>
</tr>
<tr>
<td>Baidu</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>Global Online Advertising</td>
<td>0.09%</td>
<td>8.66%</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>1.96%</td>
<td>3.14%</td>
<td>362.63%</td>
<td>37.39%</td>
<td>European Banks</td>
<td>1.96%</td>
<td>79.32%</td>
</tr>
</tbody>
</table>
A closer look at Disney’s peer group

<table>
<thead>
<tr>
<th>Company</th>
<th>Market Cap</th>
<th>Dividends</th>
<th>Dividends + Buybacks</th>
<th>Net Income</th>
<th>FCFE</th>
<th>Dividend Yield</th>
<th>Dividend Payout</th>
<th>Cash Return/FCFE</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Walt Disney Company</td>
<td>$134,256</td>
<td>$1,324</td>
<td>$5,411</td>
<td>$6,136</td>
<td>$1,503</td>
<td>0.99%</td>
<td>21.58%</td>
<td>360.01%</td>
</tr>
<tr>
<td>Twenty-First Century Fox, Inc.</td>
<td>$79,796</td>
<td>$415</td>
<td>$2,477</td>
<td>$7,097</td>
<td>$2,408</td>
<td>0.52%</td>
<td>6.78%</td>
<td>102.87%</td>
</tr>
<tr>
<td>Time Warner Inc</td>
<td>$63,077</td>
<td>$1,060</td>
<td>$4,939</td>
<td>$3,019</td>
<td>-$4,729</td>
<td>1.68%</td>
<td>27.08%</td>
<td>NA</td>
</tr>
<tr>
<td>Viacom, Inc.</td>
<td>$38,974</td>
<td>$555</td>
<td>$5,219</td>
<td>$2,395</td>
<td>-$2,219</td>
<td>1.42%</td>
<td>23.17%</td>
<td>NA</td>
</tr>
<tr>
<td>The Madison Square Garden Co.</td>
<td>$4,426</td>
<td>$0</td>
<td>$0</td>
<td>$142</td>
<td>-$119</td>
<td>0.00%</td>
<td>0.00%</td>
<td>NA</td>
</tr>
<tr>
<td>Lions Gate Entertainment Corp.</td>
<td>$4,367</td>
<td>$0</td>
<td>$0</td>
<td>$232</td>
<td>-$697</td>
<td>0.00%</td>
<td>0.00%</td>
<td>NA</td>
</tr>
<tr>
<td>Live Nation Entertainment, Inc.</td>
<td>$3,894</td>
<td>$0</td>
<td>$0</td>
<td>-$163</td>
<td>$288</td>
<td>0.00%</td>
<td>NA</td>
<td>0.00%</td>
</tr>
<tr>
<td>Cinemark Holdings Inc</td>
<td>$3,844</td>
<td>$101</td>
<td>$101</td>
<td>$169</td>
<td>-$180</td>
<td>2.64%</td>
<td>63.04%</td>
<td>NA</td>
</tr>
<tr>
<td>MGM Holdings Inc</td>
<td>$3,673</td>
<td>$0</td>
<td>$59</td>
<td>$129</td>
<td>$536</td>
<td>0.00%</td>
<td>0.00%</td>
<td>11.00%</td>
</tr>
<tr>
<td>Regal Entertainment Group</td>
<td>$3,013</td>
<td>$132</td>
<td>$132</td>
<td>$145</td>
<td>-$18</td>
<td>4.39%</td>
<td>77.31%</td>
<td>NA</td>
</tr>
<tr>
<td>DreamWorks Animation SKG Inc.</td>
<td>$2,975</td>
<td>$0</td>
<td>$34</td>
<td>-$36</td>
<td>-$572</td>
<td>0.00%</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>AMC Entertainment Holdings</td>
<td>$2,001</td>
<td>$0</td>
<td>$0</td>
<td>$63</td>
<td>-$52</td>
<td>0.00%</td>
<td>0.00%</td>
<td>NA</td>
</tr>
<tr>
<td>World Wrestling Entertainment</td>
<td>$1,245</td>
<td>$36</td>
<td>$36</td>
<td>$31</td>
<td>-$27</td>
<td>2.88%</td>
<td>317.70%</td>
<td>NA</td>
</tr>
<tr>
<td>SFX Entertainment Inc.</td>
<td>$1,047</td>
<td>$0</td>
<td>$0</td>
<td>-$16</td>
<td>-$137</td>
<td>0.00%</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Carmike Cinemas Inc.</td>
<td>$642</td>
<td>$0</td>
<td>$0</td>
<td>$96</td>
<td>$64</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.27%</td>
</tr>
<tr>
<td>Rentrak Corporation</td>
<td>$454</td>
<td>$0</td>
<td>$0</td>
<td>-$23</td>
<td>-$13</td>
<td>0.00%</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Reading International, Inc.</td>
<td>$177</td>
<td>$0</td>
<td>$0</td>
<td>-$1</td>
<td>$15</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Average</td>
<td>$20,462</td>
<td>$213</td>
<td>$1,083</td>
<td>$1,142</td>
<td>-$232</td>
<td>0.85%</td>
<td>41.28%</td>
<td>79.02%</td>
</tr>
<tr>
<td>Median</td>
<td>$3,673</td>
<td>$0</td>
<td>$34</td>
<td>$129</td>
<td>-$27</td>
<td>0.00%</td>
<td>6.78%</td>
<td>5.63%</td>
</tr>
</tbody>
</table>

Aswath Damodaran
Regressing dividend yield and payout against expected growth across all US companies in January 2014 yields:

\[
\text{PYT} = 0.649 - 0.296 \text{ (BETA)} - 0.800 \text{ (EGR)} + 0.300 \text{ (DCAP)} \quad R^2 = 19.6\%
\]

\[
(32.16) \quad (15.40) \quad (8.90) \quad (7.33)
\]

\[
\text{YLD} = 0.0324 - 0.0154 \text{ (BETA)} - 0.038 \text{ (EGR)} + 0.023 \text{ (DCAP)} R^2 = 25.8\%
\]

\[
(38.81) \quad (19.41) \quad (13.25) \quad (13.45)
\]

\text{PYT} = \text{Dividend Payout Ratio} = \text{Dividends/Net Income}

\text{YLD} = \text{Dividend Yield} = \text{Dividends/Current Price}

\text{BETA} = \text{Beta (Regression or Bottom up) for company}

\text{EGR} = \text{Expected growth rate in earnings over next 5 years (analyst estimates)}

\text{DCAP} = \text{Total Debt} / (\text{Total Debt} + \text{Market Value of equity})
Using the market regression on Disney

- To illustrate the applicability of the market regression in analyzing the dividend policy of Disney, we estimate the values of the independent variables in the regressions for the firm.
  - Beta for Disney (bottom up) = 1.00
  - Disney’s expected growth in earnings per share = 14.73% (analyst estimate)
  - Disney’s market debt to capital ratio = 11.58%

- Substituting into the regression equations for the dividend payout ratio and dividend yield, we estimate a predicted payout ratio:
  - Predicted Payout = 0.649 – 0.296 (1.00) – 0.800 (0.1473) + 0.300 (0.1158) = 0.2695
  - Predicted Yield = 0.0324 – 0.0154 (1.00) – 0.038 (0.1473) + 0.023 (0.1158) = 0.0140

- Based on this analysis, Disney with its dividend yield of 1.09% and a payout ratio of approximately 21.58% is paying too little in dividends. This analysis, however, fails to factor in the huge stock buybacks made by Disney over the last few years.
Cynic: A person who knows the price of everything but the value of nothing.

Oscar Wilde
First Principles

The Investment Decision
Invest in assets that earn a return greater than the minimum acceptable hurdle rate

The Financing Decision
Find the right kind of debt for your firm and the right mix of debt and equity to fund your operations

The Dividend Decision
If you cannot find investments that make your minimum acceptable rate, return the cash to owners of your business

Maximize the value of the business (firm)

The hurdle rate should reflect the riskiness of the investment and the mix of debt and equity used to fund it.

The return should reflect the magnitude and the timing of the cashflows as well as all side effects.

The optimal mix of debt and equity maximizes firm value.

The right kind of debt matches the tenor of your assets.

How much cash you can return depends upon current & potential investment opportunities.

How you choose to return cash to the owners will depend whether they prefer dividends or buybacks.

Aswath Damodaran
Three approaches to valuation

- **Intrinsic valuation**: The value of an asset is a function of its fundamentals – cash flows, growth and risk. In general, discounted cash flow models are used to estimate intrinsic value.

- **Relative valuation**: The value of an asset is estimated based upon what investors are paying for similar assets. In general, this takes the form of value or price multiples and comparing firms within the same business.

- **Contingent claim valuation**: When the cash flows on an asset are contingent on an external event, the value can be estimated using option pricing models.
One tool for estimating intrinsic value: Discounted Cash Flow Valuation

**Cash flows from existing assets**
The base earnings will reflect the earnings power of the existing assets of the firm, net of taxes and any reinvestment needed to sustain the base earnings.

**Value of growth**
The future cash flows will reflect expectations of how quickly earnings will grow in the future (as a positive) and how much the company will have to reinvest to generate that growth (as a negative). The net effect will determine the value of growth.

Expected Cash Flow in year $t = E(CF) = \text{Expected Earnings in year } t - \text{Reinvestment needed for growth}$

**Expected Cash Flow in year $t = E(CF) = \text{Expected Earnings in year } t - \text{Reinvestment needed for growth}$**

**Value of asset**
$$\text{Value of asset} = \frac{E(CF_1)}{(1 + r)} + \frac{E(CF_2)}{(1 + r)^2} + \frac{E(CF_3)}{(1 + r)^3} + \ldots + \frac{E(CF_n)}{(1 + r)^n}$$

**Risk in the Cash flows**
The risk in the investment is captured in the discount rate as a beta in the cost of equity and the default spread in the cost of debt.

**Steady state**
The value of growth comes from the capacity to generate excess returns. The length of your growth period comes from the strength & sustainability of your competitive advantages.
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.

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

where,
- \(CF\ to\ Equity_t\) = 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.
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.

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

where,

- \( \text{CF to Firm}_t \) = Expected Cashflow to Firm in period \( t \)
- \( WACC \) = Weighted Average Cost of Capital
Choosing a Cash Flow to Discount

- When you cannot estimate the free cash flows to equity or the firm, the only cash flow that you can discount is dividends. For financial service firms, it is difficult to estimate free cash flows. For Deutsche Bank, we will be discounting dividends.

- If a firm’s debt ratio is not expected to change over time, the free cash flows to equity can be discounted to yield the value of equity. For Tata Motors, we will discount free cash flows to equity.

- If a firm’s debt ratio might change over time, free cash flows to equity become cumbersome to estimate. Here, we would discount free cash flows to the firm. For Vale and Disney, we will discount the free cash flow to the firm.
The Ingredients that determine value.

Cashflows can be
a. After debt payments to equity
   - Dividends
   - Free Cashflow to Equity
b. Before debt payments to firm
   - Free Cashflow to Firm

Growth rate can be
a. In Equity Earnings
   - Net Income
   - Earnings per share
b. In Operating Earnings

Firm is in stable growth which it can sustain forever

Expected Cashflows during extraordinary growth phase

Discount the cashflows and terminal value to the present

Discount Rate can be
a. Cost of equity, if cashflows are equity cashflows
b. Cost of capital, if cashflows are to the firm

Present value is
a. Value of equity, if cashflows to equity discounted at cost of equity
b. Value of operating assets of the firm, if cashflows to firm discounted at the cost of capital
I. Estimating Cash Flows

Cash Flow used

Cash flow to equity

- Dividends
- Augmented Dividends
  - Dividends
  - + Stock Buybacks

Free Cash flow to Firm
- EBIT (1 - tax rate)
- (Cap Ex - Depreciation)
- Change in Working Capital

Free Cash flow to Equity
(Potential Dividend)
- Net Income
- (Cap Ex - Depreciation)
- Change in Working Capital
- (Debt issued - Debt repaid)
Dividends and Modified Dividends for Deutsche Bank

- In 2007, Deutsche Bank paid out dividends of 2,146 million Euros on net income of 6,510 million Euros. In early 2008, we valued Deutsche Bank using the dividends it paid in 2007. In my 2008 valuation I am assuming the dividends are not only reasonable but sustainable.

- In November 2013, Deutsche Bank’s dividend policy was in flux. Not only did it report losses but it was on a pathway to increase its regulatory capital ratio. Rather than focus on the dividends (which were small), we estimated the potential dividends (by estimating the free cash flows to equity after investments in regulatory capital).

<table>
<thead>
<tr>
<th>Asset Base</th>
<th>Current</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>Steady state</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>€ 439,851</td>
<td>€ 453,047</td>
<td>€ 466,638</td>
<td>€ 480,637</td>
<td>€ 495,056</td>
<td>€ 509,908</td>
<td>€ 517,556</td>
</tr>
<tr>
<td>Capital ratio</td>
<td>15.13%</td>
<td>15.71%</td>
<td>16.28%</td>
<td>16.85%</td>
<td>17.43%</td>
<td>18.00%</td>
<td>18.00%</td>
</tr>
<tr>
<td>Tier 1 Capital</td>
<td>€ 66,561</td>
<td>€ 71,156</td>
<td>€ 75,967</td>
<td>€ 81,002</td>
<td>€ 86,271</td>
<td>€ 91,783</td>
<td>€ 93,160</td>
</tr>
<tr>
<td>Change in regulatory capital</td>
<td>€ 4,595</td>
<td>€ 4,811</td>
<td>€ 5,035</td>
<td>€ 5,269</td>
<td>€ 5,512</td>
<td>€ 1,377</td>
<td></td>
</tr>
<tr>
<td>Book Equity</td>
<td>€ 76,829</td>
<td>€ 81,424</td>
<td>€ 86,235</td>
<td>€ 91,270</td>
<td>€ 96,539</td>
<td>€ 102,051</td>
<td>€ 103,605</td>
</tr>
<tr>
<td>ROE</td>
<td>-1.08%</td>
<td>0.74%</td>
<td>2.55%</td>
<td>4.37%</td>
<td>6.18%</td>
<td>8.00%</td>
<td>8.00%</td>
</tr>
<tr>
<td>Net Income</td>
<td>-€ 716</td>
<td>€ 602</td>
<td>€ 2,203</td>
<td>€ 3,988</td>
<td>€ 5,971</td>
<td>€ 8,164</td>
<td>€ 8,287</td>
</tr>
<tr>
<td>- Investment in Regulatory Capital</td>
<td>€ 4,595</td>
<td>€ 4,811</td>
<td>€ 5,035</td>
<td>€ 5,269</td>
<td>€ 5,512</td>
<td>€ 1,554</td>
<td></td>
</tr>
<tr>
<td>FCFE</td>
<td>-€ 3,993</td>
<td>-€ 2,608</td>
<td>-€ 1,047</td>
<td>€ 702</td>
<td>€ 2,652</td>
<td>€ 6,733</td>
<td></td>
</tr>
</tbody>
</table>
## Estimating FCFE (past) : Tata Motors

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Income</th>
<th>Cap Ex</th>
<th>Depreciation</th>
<th>Change in WC</th>
<th>Change in Debt</th>
<th>Equity Reinvestment</th>
<th>Equity Reinvestment Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008-09</td>
<td>-25,053₹</td>
<td>99,708₹</td>
<td>25,072₹</td>
<td>13,441₹</td>
<td>25,789₹</td>
<td>62,288₹</td>
<td>-248.63%</td>
</tr>
<tr>
<td>2009-10</td>
<td>29,151₹</td>
<td>84,754₹</td>
<td>39,602₹</td>
<td>-26,009₹</td>
<td>5,605₹</td>
<td>13,538₹</td>
<td>46.44%</td>
</tr>
<tr>
<td>2010-11</td>
<td>92,736₹</td>
<td>81,240₹</td>
<td>46,510₹</td>
<td>50,484₹</td>
<td>24,951₹</td>
<td>60,263₹</td>
<td>64.98%</td>
</tr>
<tr>
<td>2011-12</td>
<td>135,165₹</td>
<td>138,756₹</td>
<td>56,209₹</td>
<td>22,801₹</td>
<td>30,846₹</td>
<td>74,502₹</td>
<td>55.12%</td>
</tr>
<tr>
<td>2012-13</td>
<td>98,926₹</td>
<td>187,570₹</td>
<td>75,648₹</td>
<td>680₹</td>
<td>32,970₹</td>
<td>79,632₹</td>
<td>80.50%</td>
</tr>
<tr>
<td>Aggregate</td>
<td>330,925₹</td>
<td>592,028₹</td>
<td>243,041₹</td>
<td>61,397₹</td>
<td>120,160₹</td>
<td>290,224₹</td>
<td>87.70%</td>
</tr>
</tbody>
</table>
Estimating FCFF: Disney

- In the fiscal year ended September 2013, Disney reported the following:
  - Operating income (adjusted for leases) = $10,032 million
  - Effective tax rate = 31.02%
  - Capital Expenditures (including acquisitions) = $5,239 million
  - Depreciation & Amortization = $2.192 million
  - Change in non-cash working capital = $103 million

- The free cash flow to the firm can be computed as follows:
  - After-tax Operating Income = 10,032 (1 - .3102) = $6,920
  - Net Cap Expenditures = $5,239 - $2,192 = $3,629
  - Change in Working Capital = $103
  - Free Cashflow to Firm (FCFF) = $3,188

- The reinvestment and reinvestment rate are as follows:
  - Reinvestment = $3,629 + $103 = $3,732 million
  - Reinvestment Rate = $3,732/ $6,920 = 53.93%
II. 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.

- The cost of equity is the rate at which we discount cash flows to equity (dividends or free cash flows to equity). The cost of capital is the rate at which we discount free cash flows to the firm.
Cost of Equity: Deutsche Bank 2008 versus 2013

- In early 2008, we estimated a beta of 1.162 for Deutsche Bank, which used in conjunction with the Euro risk-free rate of 4% (in January 2008) and an equity risk premium of 4.50%, yielded a cost of equity of 9.23%.

  \[
  \text{Cost of Equity}_{\text{Jan 2008}} = \text{Riskfree Rate}_{\text{Jan 2008}} + \text{Beta} \times \text{Mature Market Risk Premium}
  \]

  \[
  = 4.00\% + 1.162 \times (4.5\%) = 9.23\%
  \]

- In November 2013, the Euro risk-free rate had dropped to 1.75% and the Deutsche’s equity risk premium had risen to 6.12%:

  \[
  \text{Cost of equity}_{\text{Nov ‘13}} = \text{Riskfree Rate}_{\text{Nov ‘13}} + \text{Beta (ERP)}
  \]

  \[
  = 1.75\% + 1.1516 \times (6.12\%) = 8.80\%
  \]
We will be valuing Tata Motors in rupee terms. That is a choice. Any company can be valued in any currency. Earlier, we estimated a levered beta for equity of 1.1007 for Tata Motor’s operating assets. Since we will be discounting FCFE with the income from cash included in the cash, we recomputed a beta for Tata Motors as a company (with cash):

\[ \text{Levered Beta}_{\text{Company}} = 1.1007 \times \left( \frac{1428}{1630} \right) + 0 \times \left( \frac{202}{1630} \right) = 0.964 \]

With a nominal rupee risk-free rate of 6.57 percent and an equity risk premium of 7.19% for Tata Motors, we arrive at a cost of equity of 13.50%.

\[ \text{Cost of Equity} = 6.57\% + 0.964 \times (7.19\%) = 13.50\% \]
The beta for Disney’s stock in November 2013 was 1.0013. The T. bond rate at that time was 2.75%. Using an estimated equity risk premium of 5.76%, we estimated the cost of equity for Disney to be 8.52%:

\[
\text{Cost of Equity} = 2.75\% + 1.0013(5.76\%) = 8.52\%
\]

Disney’s bond rating in May 2009 was A, and based on this rating, the estimated pretax cost of debt for Disney is 3.75%. Using a marginal tax rate of 36.1, the after-tax cost of debt for Disney is 2.40%.

\[
\text{After-Tax Cost of Debt} = 3.75\% (1 – 0.361) = 2.40\%
\]

The cost of capital was calculated using these costs and the weights based on market values of equity (121,878) and debt (15,961):

\[
\text{Cost of capital} = 8.52\% \frac{121,878}{(15,961+121,878)} + 2.40\% \frac{15,961}{(15,961+121,878)} = 7.81\%
\]
But costs of equity and capital can and should change over time...

<table>
<thead>
<tr>
<th>Year</th>
<th>Beta</th>
<th>Cost of Equity</th>
<th>After-tax Cost of Debt</th>
<th>Debt Ratio</th>
<th>Cost of capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1.0013</td>
<td>8.52%</td>
<td>2.40%</td>
<td>11.50%</td>
<td>7.81%</td>
</tr>
<tr>
<td>2</td>
<td>1.0013</td>
<td>8.52%</td>
<td>2.40%</td>
<td>11.50%</td>
<td>7.81%</td>
</tr>
<tr>
<td>3</td>
<td>1.0013</td>
<td>8.52%</td>
<td>2.40%</td>
<td>11.50%</td>
<td>7.81%</td>
</tr>
<tr>
<td>4</td>
<td>1.0013</td>
<td>8.52%</td>
<td>2.40%</td>
<td>11.50%</td>
<td>7.81%</td>
</tr>
<tr>
<td>5</td>
<td>1.0013</td>
<td>8.52%</td>
<td>2.40%</td>
<td>11.50%</td>
<td>7.81%</td>
</tr>
<tr>
<td>6</td>
<td>1.0010</td>
<td>8.52%</td>
<td>2.40%</td>
<td>13.20%</td>
<td>7.71%</td>
</tr>
<tr>
<td>7</td>
<td>1.0008</td>
<td>8.51%</td>
<td>2.40%</td>
<td>14.90%</td>
<td>7.60%</td>
</tr>
<tr>
<td>8</td>
<td>1.0005</td>
<td>8.51%</td>
<td>2.40%</td>
<td>16.60%</td>
<td>7.50%</td>
</tr>
<tr>
<td>9</td>
<td>1.0003</td>
<td>8.51%</td>
<td>2.40%</td>
<td>18.30%</td>
<td>7.39%</td>
</tr>
<tr>
<td>10</td>
<td>1.0000</td>
<td>8.51%</td>
<td>2.40%</td>
<td>20.00%</td>
<td>7.29%</td>
</tr>
</tbody>
</table>
III. Expected Growth

Expected Growth

Net Income

Retention Ratio = 1 - Dividends/Net Income

Return on Equity = Net Income/Book Value of Equity

Operating Income

Reinvestment Rate = (Net Cap Ex + Chg in WC)/EBIT(1-t)

Return on Capital = EBIT(1-t)/Book Value of Capital

- In 2007, Deutsche Bank reported net income of 6.51 billion Euros on a book value of equity of 33.475 billion Euros at the start of the year (end of 2006), and paid out 2.146 billion Euros as dividends.

\[
\text{Return on Equity} = \frac{\text{Net Income}_{2007}}{\text{Book Value of Equity}_{2006}} = \frac{6,510}{33,475} = 19.45\%
\]

\[
\text{Retention Ratio} = 1 - \frac{\text{Dividends}}{\text{Net Income}} = 1 - \frac{2,146}{6,510} = 67.03\%
\]

- If Deutsche Bank maintains the return on equity (ROE) and retention ratio that it delivered in 2007 for the long run:

\[
\text{Expected Growth Rate}_{\text{Existing Fundamentals}} = 0.6703 \times 0.1945 = 13.04\%
\]

- If we replace the net income in 2007 with average net income of $3,954 million, from 2003 to 2007:

\[
\text{Normalized Return on Equity} = \frac{\text{Average Net Income}_{2003-07}}{\text{Book Value of Equity}_{2006}} = \frac{3,954}{33,475} = 11.81\%
\]

\[
\text{Normalized Retention Ratio} = 1 - \frac{\text{Dividends}}{\text{Net Income}} = 1 - \frac{2,146}{3,954} = 45.72\%
\]

\[
\text{Expected Growth Rate}_{\text{Normalized Fundamentals}} = 0.4572 \times 0.1181 = 5.40\%
\]
## Estimating growth in Net Income: Tata Motors

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Income (₹)</th>
<th>Cap Ex (₹)</th>
<th>Depreciation (₹)</th>
<th>Change in WC (₹)</th>
<th>Change in Debt (₹)</th>
<th>Equity Reinvestment (₹)</th>
<th>Equity Reinvestment Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008-09</td>
<td>-25,053</td>
<td>99,708</td>
<td>25,072</td>
<td>13,441</td>
<td>25,789</td>
<td>62,288</td>
<td>-248.63%</td>
</tr>
<tr>
<td>2009-10</td>
<td>29,151</td>
<td>84,754</td>
<td>39,602</td>
<td>-26,009</td>
<td>5,605</td>
<td>13,538</td>
<td>46.44%</td>
</tr>
<tr>
<td>2010-11</td>
<td>92,736</td>
<td>81,240</td>
<td>46,510</td>
<td>50,484</td>
<td>24,951</td>
<td>60,263</td>
<td>64.98%</td>
</tr>
<tr>
<td>2011-12</td>
<td>135,165</td>
<td>138,756</td>
<td>56,209</td>
<td>22,801</td>
<td>30,846</td>
<td>74,502</td>
<td>55.12%</td>
</tr>
<tr>
<td>2012-13</td>
<td>98,926</td>
<td>187,570</td>
<td>75,648</td>
<td>680</td>
<td>32,970</td>
<td>79,632</td>
<td>80.50%</td>
</tr>
<tr>
<td>Aggregate</td>
<td>330,925</td>
<td>592,028</td>
<td>243,041</td>
<td>61,397</td>
<td>120,160</td>
<td>290,224</td>
<td>87.70%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Income (₹)</th>
<th>BV of Equity at start of the year (₹)</th>
<th>ROE</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008-09</td>
<td>-25,053</td>
<td>91,658</td>
<td>-27.33%</td>
</tr>
<tr>
<td>2009-10</td>
<td>29,151</td>
<td>63,437</td>
<td>45.95%</td>
</tr>
<tr>
<td>2010-11</td>
<td>92,736</td>
<td>84,200</td>
<td>110.14%</td>
</tr>
<tr>
<td>2011-12</td>
<td>135,165</td>
<td>194,181</td>
<td>69.61%</td>
</tr>
<tr>
<td>2012-13</td>
<td>98,926</td>
<td>330,056</td>
<td>29.97%</td>
</tr>
<tr>
<td>Aggregate</td>
<td>330,925</td>
<td>763,532</td>
<td>43.34%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2013 value</th>
<th>Average values: 2008-2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinvestment rate</td>
<td>80.50%</td>
<td>87.70%</td>
</tr>
<tr>
<td>ROE</td>
<td>29.97%</td>
<td>43.34%</td>
</tr>
<tr>
<td>Expected growth</td>
<td>24.13%</td>
<td>38.01%</td>
</tr>
</tbody>
</table>

Aswath Damodaran
A high ROE, other things remaining equal, should yield a higher expected growth rate in equity earnings.

The ROE for a firm is a function of both the quality of its investments and how much debt it uses in funding these investments. In particular

$$\text{ROE} = \text{ROC} + \frac{\text{D/E}}{} \times (\text{ROC} - i (1-t))$$

where,

$$\text{ROC} = \frac{(\text{EBIT} \times (1 - \text{tax rate}))}{(\text{Book Value of Capital})}$$

$$\text{BV of Capital} = \text{BV of Debt} + \text{BV of Equity} - \text{Cash}$$

$$\text{D/E} = \frac{\text{Debt}}{\text{Equity}} \text{ ratio}$$

$$i = \text{Interest rate on debt}$$

$$t = \text{Tax rate on ordinary income.}$$
Decomposing ROE

- Assume that you are analyzing a company with a 15% return on capital, an after-tax cost of debt of 5% and a book debt to equity ratio of 100%. Estimate the ROE for this company.

- Now assume that another company in the same sector has the same ROE as the company that you have just analyzed but no debt. Will these two firms have the same growth rates in earnings per share if they have the same dividend payout ratio?

- Will they have the same equity value?
Estimating Growth in EBIT: Disney

- We started with the reinvestment rate that we computed from the 2013 financial statements:
  \[
  \text{Reinvestment rate} = \frac{(3,629 + 103)}{10,032 (1-.3102)} = 53.93\%
  \]
  We computed the reinvestment rate in prior years to ensure that the 2013 values were not unusual or outliers.

- We compute the return on capital, using operating income in 2013 and capital invested at the start of the year:
  \[
  \text{Return on Capital}_{2013} = \frac{\text{EBIT (1-t)}}{\text{(BV of Equity + BV of Debt - Cash)}} = \frac{10,032 (1-.361)}{41,958 + 16,328 - 3,387} = 12.61\%
  \]
  Disney’s return on capital has improved gradually over the last decade and has levelled off in the last two years.

- If Disney maintains its 2013 reinvestment rate and return on capital for the next five years, its growth rate will be 6.80 percent.
  \[
  \text{Expected Growth Rate from Existing Fundamentals} = 53.93\% \times 12.61\% = 6.8\%
  \]
When everything is in flux: Changing growth and margins

- The elegant connection between reinvestment and growth in operating income breaks down, when you have a company in transition, where margins are changing over time.

- If that is the case, you have to estimate cash flows in three steps:
  - Forecast revenue growth and revenues in future years, taking into account market potential and competition.
  - Forecast a “target” margin in the future and a pathway from current margins to the target.
  - Estimate reinvestment from revenues, using a sales to capital ratio (measuring the dollars of revenues you get from each dollar of investment).
Here is an example: Baidu’s Expected FCFF

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue growth</th>
<th>Revenues</th>
<th>Operating Margin</th>
<th>EBIT</th>
<th>Tax rate</th>
<th>EBIT (1-t)</th>
<th>Chg in Revenues</th>
<th>Sales/ Capital</th>
<th>Reinvestm ent</th>
<th>FCFF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base year</td>
<td>$28,756</td>
<td>48.72%</td>
<td>$14,009</td>
<td>16.31%</td>
<td>$11,724</td>
<td>2.64</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>25.00%</td>
<td>$35,945</td>
<td>47.35%</td>
<td>$17,019</td>
<td>16.31%</td>
<td>$14,243</td>
<td>$7,189</td>
<td>2.64</td>
<td>$2,722</td>
<td>$11,521</td>
</tr>
<tr>
<td>2</td>
<td>25.00%</td>
<td>$44,931</td>
<td>45.97%</td>
<td>$20,657</td>
<td>16.31%</td>
<td>$17,288</td>
<td>$8,986</td>
<td>2.64</td>
<td>$3,403</td>
<td>$13,885</td>
</tr>
<tr>
<td>3</td>
<td>25.00%</td>
<td>$56,164</td>
<td>44.60%</td>
<td>$25,051</td>
<td>16.31%</td>
<td>$20,965</td>
<td>$11,233</td>
<td>2.64</td>
<td>$4,253</td>
<td>$16,712</td>
</tr>
<tr>
<td>4</td>
<td>25.00%</td>
<td>$70,205</td>
<td>43.23%</td>
<td>$30,350</td>
<td>16.31%</td>
<td>$25,400</td>
<td>$14,041</td>
<td>2.64</td>
<td>$5,316</td>
<td>$20,084</td>
</tr>
<tr>
<td>5</td>
<td>25.00%</td>
<td>$87,756</td>
<td>41.86%</td>
<td>$36,734</td>
<td>16.31%</td>
<td>$30,743</td>
<td>$17,551</td>
<td>2.64</td>
<td>$6,646</td>
<td>$24,097</td>
</tr>
<tr>
<td>6</td>
<td>20.70%</td>
<td>$105,922</td>
<td>40.49%</td>
<td>$42,885</td>
<td>18.05%</td>
<td>$35,145</td>
<td>$18,166</td>
<td>2.64</td>
<td>$6,878</td>
<td>$28,267</td>
</tr>
<tr>
<td>7</td>
<td>16.40%</td>
<td>$123,293</td>
<td>39.12%</td>
<td>$48,227</td>
<td>19.79%</td>
<td>$38,685</td>
<td>$17,371</td>
<td>2.64</td>
<td>$6,577</td>
<td>$32,107</td>
</tr>
<tr>
<td>8</td>
<td>12.10%</td>
<td>$138,212</td>
<td>37.74%</td>
<td>$52,166</td>
<td>21.52%</td>
<td>$40,938</td>
<td>$14,918</td>
<td>2.64</td>
<td>$5,649</td>
<td>$35,289</td>
</tr>
<tr>
<td>9</td>
<td>7.80%</td>
<td>$148,992</td>
<td>36.37%</td>
<td>$54,191</td>
<td>23.26%</td>
<td>$41,585</td>
<td>$10,781</td>
<td>2.64</td>
<td>$4,082</td>
<td>$37,503</td>
</tr>
<tr>
<td>10</td>
<td>3.50%</td>
<td>$154,207</td>
<td>35.00%</td>
<td>$53,972</td>
<td>25.00%</td>
<td>$40,479</td>
<td>$5,215</td>
<td>2.64</td>
<td>$1,974</td>
<td>$38,505</td>
</tr>
</tbody>
</table>
IV. Getting Closure in Valuation

- 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:

\[
\text{Value} = \sum_{t=1}^{N} \frac{\text{CF}_t}{(1+r)^t} + \frac{\text{Terminal Value}}{(1+r)^N}
\]

- When a firm’s cash flows grow at a “constant” rate forever, the present value of those cash flows can be written as:

Value = Expected Cash Flow Next Period / (r - g)

where,

- \( r \) = Discount rate (Cost of Equity or Cost of Capital)
- \( g \) = Expected growth rate forever.

- 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.
Getting to stable growth...

- 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)
Choosing a Growth Period: Examples

<table>
<thead>
<tr>
<th>Firm size/market size</th>
<th>Disney</th>
<th>Vale</th>
<th>Tata Motors</th>
<th>Baidu</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm is one of the largest players in the entertainment and theme park business, but the businesses are being redefined and are expanding.</td>
<td>The company is one of the largest mining companies in the world, and the overall market is constrained by limits on resource availability.</td>
<td>Firm has a large market share of Indian (domestic) market, but it is small by global standards. Growth is coming from Jaguar division in emerging markets.</td>
<td>Company is in a growing sector (online search) in a growing market (China).</td>
<td></td>
</tr>
<tr>
<td>Current excess returns</td>
<td>Firm is earning more than its cost of capital.</td>
<td>Returns on capital are largely a function of commodity prices. Have generally exceeded the cost of capital.</td>
<td>Firm has a return on capital that is higher than the cost of capital.</td>
<td>Firm earns significant excess returns.</td>
</tr>
<tr>
<td>Competitive advantages</td>
<td>Has some of the most recognized brand names in the world. Its movie business now houses Marvel superheros, Pixar animated characters &amp; Star Wars.</td>
<td>Cost advantages because of access to low-cost iron ore reserves in Brazil.</td>
<td>Has wide distribution/service network in India but competitive advantages are fading there. Competitive advantages in India are fading but Landrover/Jaguar has strong brand name value, giving Tata pricing power and growth potential.</td>
<td>Early entry into &amp; knowledge of the Chinese market, coupled with government-imposed barriers to entry on outsiders.</td>
</tr>
<tr>
<td>Length of high-growth period</td>
<td>Ten years, entirely because of its strong competitive advantages/</td>
<td>None, though with normalized earnings and moderate excess returns.</td>
<td>Five years, with much of the growth coming from outside India.</td>
<td>Ten years, with strong excess returns.</td>
</tr>
</tbody>
</table>
Valuing Vale in November 2013 (in US dollars)

Let's start with some history & estimate what a normalized year will look like

Assume that the company is in stable growth, growing 2% a year in perpetuity

Estimate the costs of equity & capital for Vale

<table>
<thead>
<tr>
<th>Business</th>
<th>Sample size</th>
<th>Unlevered beta of business</th>
<th>Revenues</th>
<th>Peer Group EV/Sales</th>
<th>Value of Business</th>
<th>Proportion of Vale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Metals &amp; Min</td>
<td>48</td>
<td>0.86</td>
<td>$9,013</td>
<td>1.97</td>
<td>$17,739</td>
<td>16.65%</td>
</tr>
<tr>
<td>Iron Ore</td>
<td>78</td>
<td>0.83</td>
<td>$32,717</td>
<td>2.48</td>
<td>$81,188</td>
<td>76.20%</td>
</tr>
<tr>
<td>Fertilizers</td>
<td>693</td>
<td>0.99</td>
<td>$3,777</td>
<td>1.52</td>
<td>$5,741</td>
<td>5.39%</td>
</tr>
<tr>
<td>Logistics</td>
<td>223</td>
<td>0.75</td>
<td>$1,644</td>
<td>1.14</td>
<td>$1,874</td>
<td>1.76%</td>
</tr>
<tr>
<td>Vale Operations</td>
<td></td>
<td>0.8440</td>
<td>$47,151</td>
<td>$106,543</td>
<td>100.00%</td>
<td></td>
</tr>
</tbody>
</table>

Market D/E = 54.99%
Marginal tax rate = 34.00% (Brazil)
Levered Beta = 0.844 (1+(1-.34)(.5499)) = 1.15
Cost of equity = 2.75% + 1.15 (7.38%) = 10.87%

Cost of capital = 11.23% (.6452) + 4.05% (1-.34) (.3548) = 8.20%

Assume that the company is in stable growth, growing 2% a year in perpetuity

\[
Reinvestment Rate = \frac{g}{ROC} = \frac{2\%}{17.25\%} = 11.59\%
\]

\[
Value of Operating Assets = \frac{17,626 (1 - .2092)(1 - .1159)}{(0.082 - 0.02)} = \$202,832
\]

Value of operating assets = \$202,832
+ Cash & Marketable Securities = \$7,133
- Debt = \$42,879
Value of equity = \$167,086
Value per share = \$32.44
Stock price (11/2013) = \$13.57
Estimating Stable Period Inputs after a high growth period: Disney

- **Respect the cap**: The growth rate forever is assumed to be 2.5. This is set lower than the riskfree rate (2.75%).

- **Stable period excess returns**: The return on capital for Disney will drop from its high growth period level of 12.61% to a stable growth return of 10%. This is still higher than the cost of capital of 7.29% but the competitive advantages that Disney has are unlikely to dissipate completely by the end of the 10th year.

- **Reinvest to grow**: Based on the expected growth rate in perpetuity (2.5%) and expected return on capital forever after year 10 of 10%, we compute s a stable period reinvestment rate of 25%:
  - Reinvestment Rate = Growth Rate / Return on Capital = 2.5% / 10% = 25%

- **Adjust risk and cost of capital**: The beta for the stock will drop to one, reflecting Disney’s status as a mature company.
  - Cost of Equity = Riskfree Rate + Beta * Risk Premium = 2.75% + 5.76% = 8.51%
  - The debt ratio for Disney will rise to 20%. Since we assume that the cost of debt remains unchanged at 3.75%, this will result in a cost of capital of 7.29%
  - Cost of capital = 8.51% (.80) + 3.75% (1-.361) (.20) = 7.29%

Aswath Damodaran
## V. From firm value to equity value per share

<table>
<thead>
<tr>
<th>Approach used</th>
<th>To get to equity value per share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount dividends per share at the cost of equity</td>
<td>Present value is value of equity per share</td>
</tr>
<tr>
<td>Discount aggregate FCFE at the cost of equity</td>
<td>Present value is value of aggregate equity. Subtract the value of equity options given to managers and divide by number of shares.</td>
</tr>
<tr>
<td>Discount aggregate FCFF at the cost of capital</td>
<td>PV = Value of operating assets + Cash &amp; 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</td>
</tr>
</tbody>
</table>
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%

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Income</th>
<th>Payout Ratio</th>
<th>Dividends</th>
<th>PV @ 9.23%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>4,167 €</td>
<td>54.28%</td>
<td>2,262 €</td>
<td>2,071 €</td>
</tr>
<tr>
<td>2009</td>
<td>4,392 €</td>
<td>54.28%</td>
<td>2,384 €</td>
<td>1,998 €</td>
</tr>
<tr>
<td>2010</td>
<td>4,629 €</td>
<td>54.28%</td>
<td>2,513 €</td>
<td>1,928 €</td>
</tr>
<tr>
<td>2011</td>
<td>4,879 €</td>
<td>54.28%</td>
<td>2,648 €</td>
<td>1,861 €</td>
</tr>
<tr>
<td>2012</td>
<td>5,143 €</td>
<td>54.28%</td>
<td>2,791 €</td>
<td>1,795 €</td>
</tr>
</tbody>
</table>
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 = $1 – \frac{g}{ROE} = 1 – \frac{0.03}{0.085} = 0.6471$ or 64.71%

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

Terminal Value = \(\frac{\text{Expected Dividends}_6}{\text{Cost of Equity} - g} = \frac{3,247}{0.085 - 0.03} = 62,318\) million Euros

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

Value of equity = \(€9,653 + €40,079 = €49,732\) million Euros

Value of equity per share = \(\frac{\text{Value of Equity}}{\# \text{Shares}} = \frac{49,732}{474.2} = 104.88\) Euros/share

Stock was trading at 89 Euros per share at the time of the analysis.
Valuing Deutsche Bank in 2013

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>Steady state</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Adjusted Assets (grows 3% a year for next 5 years)</td>
<td>439,851 €</td>
<td>453,047 €</td>
<td>466,638 €</td>
<td>480,637 €</td>
<td>495,056 €</td>
<td>509,908 €</td>
<td>517,556 €</td>
</tr>
<tr>
<td>Tier 1 Capital ratio (increases from 15.13% to 18.00% over next 5 years)</td>
<td>15.13%</td>
<td>15.71%</td>
<td>16.28%</td>
<td>16.85%</td>
<td>17.43%</td>
<td>18.00%</td>
<td>18.00%</td>
</tr>
<tr>
<td>Tier 1 Capital (Risk Adjusted Assets * Tier 1 Capital Ratio)</td>
<td>66,561 €</td>
<td>71,156 €</td>
<td>75,967 €</td>
<td>81,002 €</td>
<td>86,271 €</td>
<td>91,783 €</td>
<td>93,160 €</td>
</tr>
<tr>
<td>Change in regulatory capital (Tier 1)</td>
<td>4,595 €</td>
<td>4,811 €</td>
<td>5,035 €</td>
<td>5,269 €</td>
<td>5,512 €</td>
<td>1,377 €</td>
<td></td>
</tr>
<tr>
<td>Book Equity</td>
<td>76,829 €</td>
<td>81,424 €</td>
<td>86,235 €</td>
<td>91,270 €</td>
<td>96,539 €</td>
<td>102,051 €</td>
<td>103,605 €</td>
</tr>
<tr>
<td>ROE (expected to improve from -1.08% to 8.00% in year 5)</td>
<td>-1.08%</td>
<td>0.74%</td>
<td>2.55%</td>
<td>4.37%</td>
<td>6.18%</td>
<td>8.00%</td>
<td>8.00%</td>
</tr>
<tr>
<td>Net Income (Book Equity * ROE)</td>
<td>-716 €</td>
<td>602 €</td>
<td>2,203 €</td>
<td>3,988 €</td>
<td>5,971 €</td>
<td>8,164 €</td>
<td>8,287 €</td>
</tr>
<tr>
<td>- Investment in Regulatory Capital</td>
<td>4,595 €</td>
<td>4,811 €</td>
<td>5,035 €</td>
<td>5,269 €</td>
<td>5,512 €</td>
<td>1,554 €</td>
<td></td>
</tr>
<tr>
<td>FCFE</td>
<td>-3,993 €</td>
<td>-2,608 €</td>
<td>-1,047 €</td>
<td>702 €</td>
<td>2,652 €</td>
<td>6,733 €</td>
<td></td>
</tr>
<tr>
<td>Terminal value of equity</td>
<td>103,582.19 €</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Present value</td>
<td>-3,669.80 €</td>
<td>-2,202.88 €</td>
<td>-812.94 €</td>
<td>500.72 €</td>
<td>69,671.28 €</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of equity</td>
<td>8.80%</td>
<td>8.80%</td>
<td>8.80%</td>
<td>8.80%</td>
<td>8.80%</td>
<td>8.80%</td>
<td>8.00%</td>
</tr>
<tr>
<td>Value of equity today =</td>
<td>63,486.39 €</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of shares outstanding =</td>
<td>1019.50</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Value per share =</td>
<td>62.27 €</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stock price in November 2013 =</td>
<td>35.46 €</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Aswath Damodaran
Valuing Tata Motors with a FCFE model in November 2013: The high growth period

- We use the expected growth rate of 24.13%, estimated based upon the 2013 values for ROE (29.97%) and equity reinvestment rate (80.5%):
  - Expected growth rate = 29.97% * 80.5% = 24.13%

- The cost of equity for Tata Motors is 13.50%:
  Cost of equity = 6.57% + 0.964 (7.19%) = 13.50%

- The expected FCFE for the high growth period

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected growth rate</td>
<td></td>
<td>24.13%</td>
<td>24.13%</td>
<td>24.13%</td>
<td>24.13%</td>
<td>24.13%</td>
</tr>
<tr>
<td>Net Income</td>
<td>₹98,926</td>
<td>₹122,794</td>
<td>₹152,420</td>
<td>₹189,194</td>
<td>₹234,841</td>
<td>₹291,500</td>
</tr>
<tr>
<td>Equity Reinvestment Rate</td>
<td>80.50%</td>
<td>80.50%</td>
<td>80.50%</td>
<td>80.50%</td>
<td>80.50%</td>
<td>80.50%</td>
</tr>
<tr>
<td>Equity Reinvestment</td>
<td>₹79,632</td>
<td>₹98,845</td>
<td>₹122,693</td>
<td>₹152,295</td>
<td>₹189,039</td>
<td>₹234,648</td>
</tr>
<tr>
<td>FCFE</td>
<td>₹19,294</td>
<td>₹23,949</td>
<td>₹29,727</td>
<td>₹36,899</td>
<td>₹45,802</td>
<td>₹56,852</td>
</tr>
<tr>
<td>PV of FCFE@13.5%</td>
<td>₹21,100</td>
<td>₹23,075</td>
<td>₹25,235</td>
<td>₹27,597</td>
<td>₹30,180</td>
<td></td>
</tr>
</tbody>
</table>

Aswath Damodaran

Sum of PV of FCFE = ₹127,187
Stable growth and value....

- After year five, we will assume that the beta will increase to 1 and that the equity risk premium will decline to 6.98% percent (as the company becomes more global). The resulting cost of equity is 13.55 percent.
  
  \[
  \text{Cost of Equity in Stable Growth} = 6.57\% + 1(6.98\%) = 13.55\%
  \]

- We will assume that the growth in net income will drop to 6% and that the return on equity will drop to 13.55% (which is also the cost of equity).
  
  \[
  \text{Equity Reinvestment Rate}_{\text{Stable Growth}} = \frac{6\%}{13.55\%} = 44.28\%
  \]
  
  \[
  \text{FCFE in Year 6} = ₹291,500(1.06)(1 – 0.4428) = ₹136,822\text{million}
  \]
  
  \[
  \text{Terminal Value of Equity} = \frac{₹136,822}{(0.1355 – 0.06)} = ₹2,280,372\text{ million}
  \]

- To value equity in the firm today
  
  \[
  \text{Value of equity} = \text{PV of FCFE during high growth} + \text{PV of terminal value}
  \]
  
  \[
  = ₹127,187 + 2,280,372/1.1355^5 = ₹742,008\text{ million}
  \]
  
  - Dividing by 2694.08 million shares yields a value of equity per share of ₹275.42, about 40% lower than the stock price of ₹427.85 per share.
Baidu: My valuation (November 2013)

### Revenue growth of 25% a year for 5 years, tapering down to 3.5% in year 10

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue growth</th>
<th>Revenues</th>
<th>Operating Margin</th>
<th>EBIT</th>
<th>Tax rate</th>
<th>EBIT (1-t)</th>
<th>Reinvestment</th>
<th>FCFF</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>25.00%</td>
<td>¥35,949</td>
<td>16.31%</td>
<td>¥17,019</td>
<td>16.31%</td>
<td>¥14,243</td>
<td>¥2,722</td>
<td>¥11,521</td>
</tr>
<tr>
<td>2</td>
<td>25.00%</td>
<td>¥44,931</td>
<td>16.31%</td>
<td>¥20,657</td>
<td>16.31%</td>
<td>¥17,288</td>
<td>¥3,403</td>
<td>¥13,885</td>
</tr>
<tr>
<td>3</td>
<td>25.00%</td>
<td>¥56,164</td>
<td>16.31%</td>
<td>¥25,051</td>
<td>16.31%</td>
<td>¥21,288</td>
<td>¥4,253</td>
<td>¥16,712</td>
</tr>
<tr>
<td>4</td>
<td>25.00%</td>
<td>¥70,205</td>
<td>16.31%</td>
<td>¥30,350</td>
<td>16.31%</td>
<td>¥25,051</td>
<td>¥5,316</td>
<td>¥20,084</td>
</tr>
<tr>
<td>5</td>
<td>25.00%</td>
<td>¥87,756</td>
<td>16.31%</td>
<td>¥36,734</td>
<td>16.31%</td>
<td>¥30,350</td>
<td>¥6,646</td>
<td>¥24,097</td>
</tr>
<tr>
<td>6</td>
<td>20.70%</td>
<td>¥105,922</td>
<td>16.31%</td>
<td>¥48,285</td>
<td>16.31%</td>
<td>¥42,885</td>
<td>¥8,787</td>
<td>¥28,267</td>
</tr>
<tr>
<td>7</td>
<td>16.40%</td>
<td>¥123,293</td>
<td>16.31%</td>
<td>¥52,166</td>
<td>16.31%</td>
<td>¥56,164</td>
<td>¥10,522</td>
<td>¥32,107</td>
</tr>
<tr>
<td>8</td>
<td>12.70%</td>
<td>¥148,992</td>
<td>16.31%</td>
<td>¥53,972</td>
<td>16.31%</td>
<td>¥70,205</td>
<td>¥12,392</td>
<td>¥35,289</td>
</tr>
<tr>
<td>9</td>
<td>7.80%</td>
<td>¥154,207</td>
<td>16.31%</td>
<td></td>
<td>16.31%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>3.50%</td>
<td></td>
<td>16.31%</td>
<td></td>
<td>16.31%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Pre-tax operating margin decreases to 35% over time

### Sales to capital ratio maintained at 2.64 (current level)

### Terminal Value

\[
\text{Terminal Value}_{10} = \frac{\text{FCFF}_{10}}{.10 - .035} = ¥494,159
\]

### Cost of capital decreases to 10% from years 6-10

Cost of capital = 12.91% (.9477) + 3.45% (.0523) = 12.42%

**Beta**: 1.356

ERP = 8.77%

<table>
<thead>
<tr>
<th>Country</th>
<th>% of Revenues</th>
<th>ERP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>34.30%</td>
<td>8.75%</td>
</tr>
<tr>
<td>Chile</td>
<td>15.70%</td>
<td>6.95%</td>
</tr>
<tr>
<td>United States</td>
<td>13.00%</td>
<td>5.75%</td>
</tr>
<tr>
<td>Argentina</td>
<td>9.20%</td>
<td>15.88%</td>
</tr>
<tr>
<td>Peru</td>
<td>6.40%</td>
<td>8.75%</td>
</tr>
<tr>
<td>Colombia</td>
<td>3.80%</td>
<td>9.13%</td>
</tr>
<tr>
<td>Ecuador</td>
<td>2.70%</td>
<td>17.75%</td>
</tr>
<tr>
<td>W. Europe</td>
<td>7.60%</td>
<td>6.97%</td>
</tr>
<tr>
<td>Asia</td>
<td>7.30%</td>
<td>7.52%</td>
</tr>
</tbody>
</table>

In November 2013, the stock was trading at ¥160.06 per share.
## Disney: Inputs to Valuation

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

Aswath Damodaran
In November 2013, Disney was trading at $67.71/share. The current cashflow to firm is $62.56/share. The cost of capital is 7.81%, which is the weighted average cost of capital (WACC) of 8.52% on equity and 2.40% on debt. The reinvestment rate is 53.93%, and the return on capital is 12.61%. The terminal value is calculated as $7,980/(0.0729-0.025) = 165,323.

The stable growth model is used to calculate the value of the firm. The growth rate declines to 2.75% gradually to 2.75% over the next 10 years. The cost of capital declines gradually to 7.29%.

The expected growth is calculated as 0.5393*.1261=.068 or 6.8%. The current cashflow to firm is calculated as EBIT*(1-t) = 6,920 - (Cap Ex - Deprecn) = 3,629 - Chg Working capital = 103 = FCFF = 3,188. The reinvestment rate is 53.93%, and the return on capital is 12.61%.

The cost of capital is calculated as 8.52% on equity and 2.40% on debt. The riskfree rate is 2.75%, and the beta is 1.00. The levered beta is calculated as 1.0013. The unlevered beta for sectors is 0.9239, and the debt to equity ratio is 13.10%.

The beta and riskfree rate are used to calculate the cost of equity. The ERP for operations is calculated as 5.76%. The weights are E = 88.5% and D = 11.5%.

The current cashflow to firm is $62.56/share. The cost of capital is 7.81%, which is the weighted average cost of capital (WACC) of 8.52% on equity and 2.40% on debt. The reinvestment rate is 53.93%, and the return on capital is 12.61%.

The terminal value is calculated as $7,980/(0.0729-0.025) = 165,323.

The stable growth model is used to calculate the value of the firm. The growth rate declines to 2.75% gradually to 2.75% over the next 10 years. The cost of capital declines gradually to 7.29%.

The expected growth is calculated as 0.5393*.1261=.068 or 6.8%. The current cashflow to firm is calculated as EBIT*(1-t) = 6,920 - (Cap Ex - Deprecn) = 3,629 - Chg Working capital = 103 = FCFF = 3,188. The reinvestment rate is 53.93%, and the return on capital is 12.61%.

The cost of capital is calculated as 8.52% on equity and 2.40% on debt. The riskfree rate is 2.75%, and the beta is 1.00. The levered beta is calculated as 1.0013. The unlevered beta for sectors is 0.9239, and the debt to equity ratio is 13.10%.
Aswath Damodaran

Disney: Corporate Financing Decisions and Firm Value

Investment decision affects risk of assets being finance and financing decision affects hurdle rate

The Investment Decision
Invest in projects that earn a return greater than a minimum acceptable hurdle rate

The Dividend Decision
If you cannot find investments that earn more than the hurdle rate, return the cash to the owners of the businesss.

The Financing Decision
Choose a financing mix that minimizes the hurdle rate and match your financing to your assets.

Financing Choices
Mostly US $ debt with duration of 6 years

Strategic investments determine length of growth period

Existing Investments
ROC = 12.61%

New Investments
Return on Capital = 12.61%

Reinvestment Rate = 53.93%

Expected Growth Rate = 12.61% * 53.93% = 6.8%

Current EBIT (1-t) = $6,920

Reinvestment Rate

Finance Mix
D=11.5%; E=88.5%

Value of operating assets of the firm = $125,477
Value of Cash & Non-operating assets = $6,780
Value of Firm = $132,257
Market Value of outstanding debt = $15,961
Minority Interests = $2,721
Market Value of Equity = $113,575
Value of Equity in Options = $972
Value of Equity in Common Stock = $112,603
Market Value of Equity/share = $62.56

Cost of capital = 8.52% (.885) + 2.4% (.115) = 7.81%

### Table

<table>
<thead>
<tr>
<th>Year</th>
<th>Expected Growth</th>
<th>EBIT (1-t)</th>
<th>Reinvestment</th>
<th>FCFF</th>
<th>Terminal Value</th>
<th>Cost of capital</th>
<th>PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>6.80%</td>
<td>$7,391</td>
<td>$3,985</td>
<td>$3,405</td>
<td>7.81%</td>
<td>$3,158</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>6.80%</td>
<td>$7,893</td>
<td>$4,256</td>
<td>$3,637</td>
<td>7.81%</td>
<td>$3,129</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>6.80%</td>
<td>$8,430</td>
<td>$4,546</td>
<td>$3,884</td>
<td>7.81%</td>
<td>$3,099</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>6.80%</td>
<td>$9,003</td>
<td>$4,855</td>
<td>$4,148</td>
<td>7.81%</td>
<td>$3,070</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>6.80%</td>
<td>$9,615</td>
<td>$5,185</td>
<td>$4,430</td>
<td>7.81%</td>
<td>$3,041</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>5.94%</td>
<td>$10,187</td>
<td>$4,904</td>
<td>$5,283</td>
<td>7.71%</td>
<td>$3,367</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>5.08%</td>
<td>$10,704</td>
<td>$4,534</td>
<td>$6,170</td>
<td>7.60%</td>
<td>$3,654</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>4.22%</td>
<td>$11,156</td>
<td>$4,080</td>
<td>$7,076</td>
<td>7.50%</td>
<td>$3,899</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>3.36%</td>
<td>$11,531</td>
<td>$3,550</td>
<td>$7,981</td>
<td>7.39%</td>
<td>$4,094</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>2.50%</td>
<td>$11,819</td>
<td>$2,955</td>
<td>$8,864</td>
<td>7.29%</td>
<td>$94,966</td>
<td></td>
</tr>
</tbody>
</table>

$189,738 7.29%  $94,966

Value of Firm = $132,257
Market Value of outstanding debt = $15,961
Minority Interests = $2,721
Market Value of Equity = $113,575
Value of Equity in Options = $972
Value of Equity in Common Stock = $112,603
Market Value of Equity/share = $62.56

Value of operating assets of the firm = $125,477
Value of Cash & Non-operating assets = $6,780
Value of Firm = $132,257
Market Value of outstanding debt = $15,961
Minority Interests = $2,721
Market Value of Equity = $113,575
Value of Equity in Options = $972
Value of Equity in Common Stock = $112,603
Market Value of Equity/share = $62.56

Aswath Damodaran
Ways of changing value...

Cashflows from existing assets
Cashflows before debt payments, but after taxes and reinvestment to maintain existing assets

Growth from new investments
Growth created by making new investments; function of amount and quality of investments

Efficiency Growth
Growth generated by using existing assets better

Expected Growth during high growth period

Length of the high growth period
Since value creating growth requires excess returns, this is a function of
- Magnitude of competitive advantages
- Sustainability of competitive advantages

Cost of capital to apply to discounting cashflows
Determined by
- Operating risk of the company
- Default risk of the company
- Mix of debt and equity used in financing

Stable growth firm, with no or very limited excess returns

Are you investing optimally for future growth?

How well do you manage your existing investments/assets?

Are you building on your competitive advantages?

Are you using the right amount and kind of debt for your firm?

Are there scope for more efficient utilization of existing assets?

Aswath Damodaran
Aswath Damodaran

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%

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

Riskfree Rate: Riskfree rate = 2.75%

Beta 1.3175

ERP for operations 5.76%

Unlevered Beta for Sectors: 0.9239
D/E=66.67%

Stable Growth

Expected Growth
50* .14 = 0.07 or 7%

Cost of capital =6.76%
Tax rate=36.1%; ROC= 10%;
Reinvestment Rate=2.5/10=25%

In November 2013, Disney was trading at $67.71/share
Move to optimal debt ratio, with higher beta.

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

First 5 years

<table>
<thead>
<tr>
<th>Year</th>
<th>EBIT * (1 - tax rate)</th>
<th>Reinvestment</th>
<th>Free Cashflow to Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$7,404</td>
<td>$3,702</td>
<td>$3,702</td>
</tr>
<tr>
<td>2</td>
<td>$7,923</td>
<td>$3,961</td>
<td>$3,961</td>
</tr>
<tr>
<td>3</td>
<td>$8,477</td>
<td>$4,239</td>
<td>$4,239</td>
</tr>
<tr>
<td>4</td>
<td>$9,071</td>
<td>$4,535</td>
<td>$4,535</td>
</tr>
<tr>
<td>5</td>
<td>$9,706</td>
<td>$4,853</td>
<td>$4,853</td>
</tr>
</tbody>
</table>

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

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

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

Terminal Value10= 9,206/(.0676-.025) = 216,262

Terminal Yr
12,275
3,069
9,206

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%

Return on Capital 14.00%
Reinvestment Rate 50.00%

Unlevered Beta for Sectors: 0.9239

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%
First Principles

The Investment Decision
Invest in assets that earn a return greater than the minimum acceptable hurdle rate

The Financing Decision
Find the right kind of debt for your firm and the right mix of debt and equity to fund your operations

The Dividend Decision
If you cannot find investments that make your minimum acceptable rate, return the cash to owners of your business

The hurdle rate should reflect the riskiness of the investment and the mix of debt and equity used to fund it.

The return should reflect the magnitude and the timing of the cashflows as well as all side effects.

The optimal mix of debt and equity maximizes firm value.

The right kind of debt matches the tenor of your assets.

How much cash you can return depends upon current & potential investment opportunities.

How you choose to return cash to the owners will depend whether they prefer dividends or buybacks.

Maximize the value of the business (firm)