



Aswath Damodaran

Website for this class: <http://bit.ly/2a2S9OH>

# APPLIED CORPORATE FINANCE

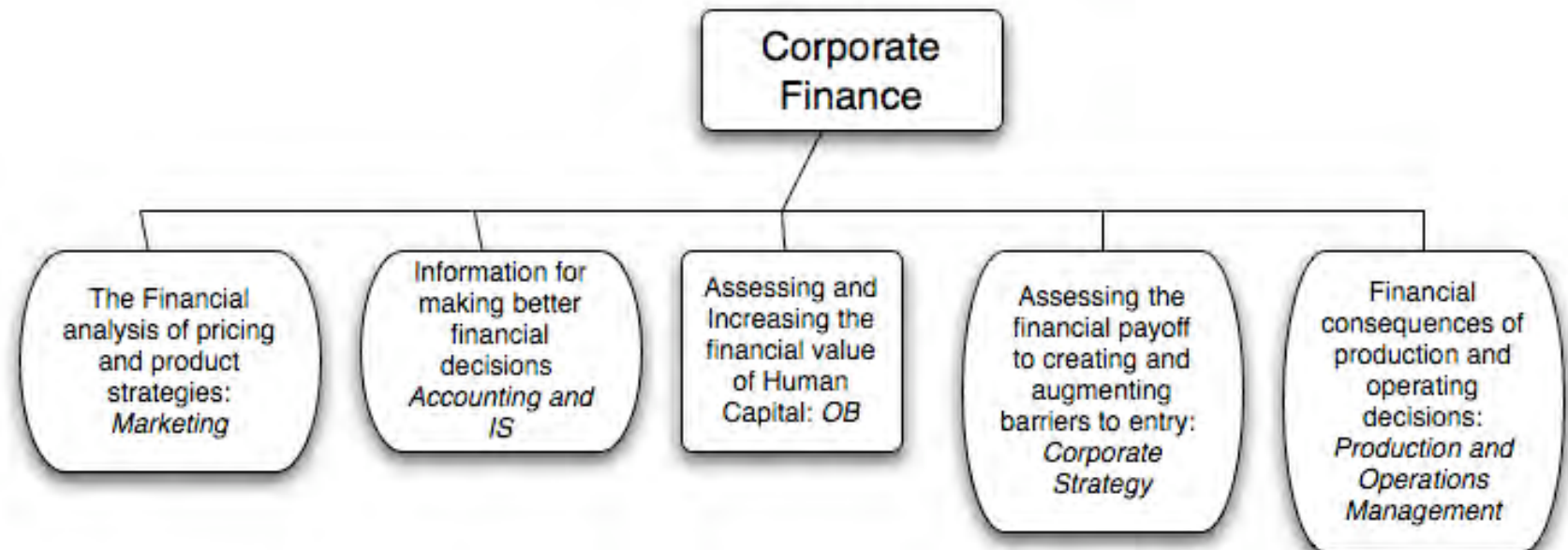
Aswath Damodaran

[www.damodaran.com](http://www.damodaran.com)

# What is corporate finance?

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- Every decision that a business makes has financial implications, and any decision which affects the finances of a business is a corporate finance decision.
- Defined broadly, everything that a business does fits under the rubric of corporate finance.



# The Traditional Accounting Balance Sheet

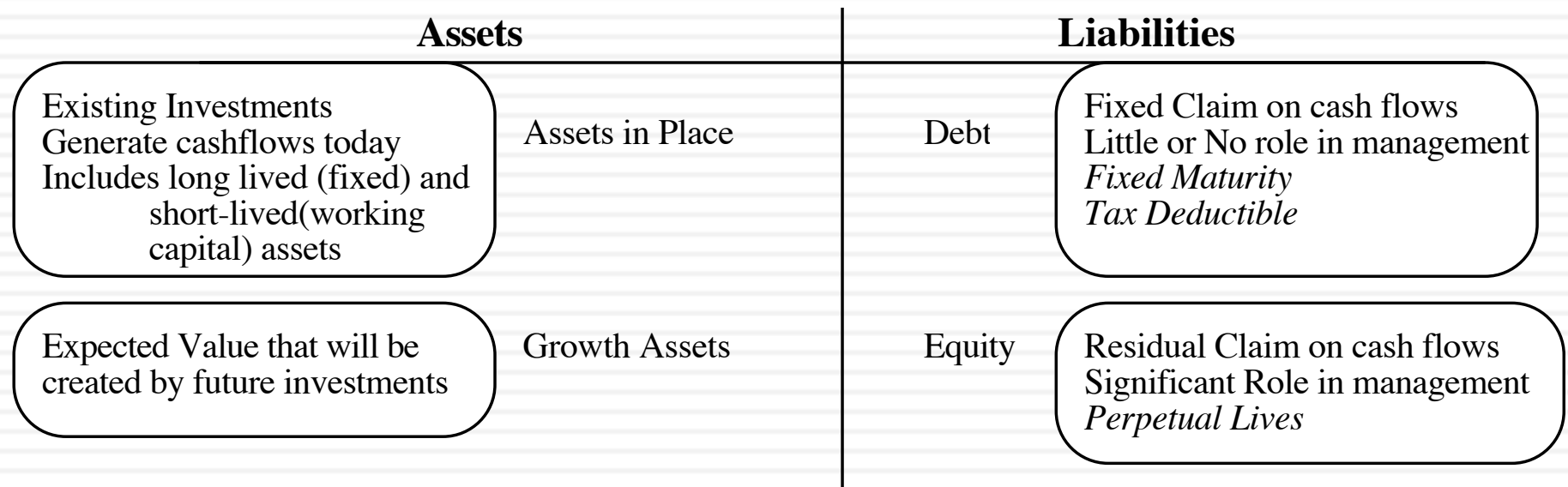
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## The Balance Sheet

Assets		Liabilities	
Long Lived Real Assets	Fixed Assets	Current Liabilities	Short-term liabilities of the firm
Short-lived Assets	Current Assets	Debt	Debt obligations of firm
Investments in securities & assets of other firms	Financial Investments	Other Liabilities	Other long-term obligations
Assets which are not physical, like patents & trademarks	Intangible Assets	Equity	Equity investment in firm

# The Financial View of the Firm

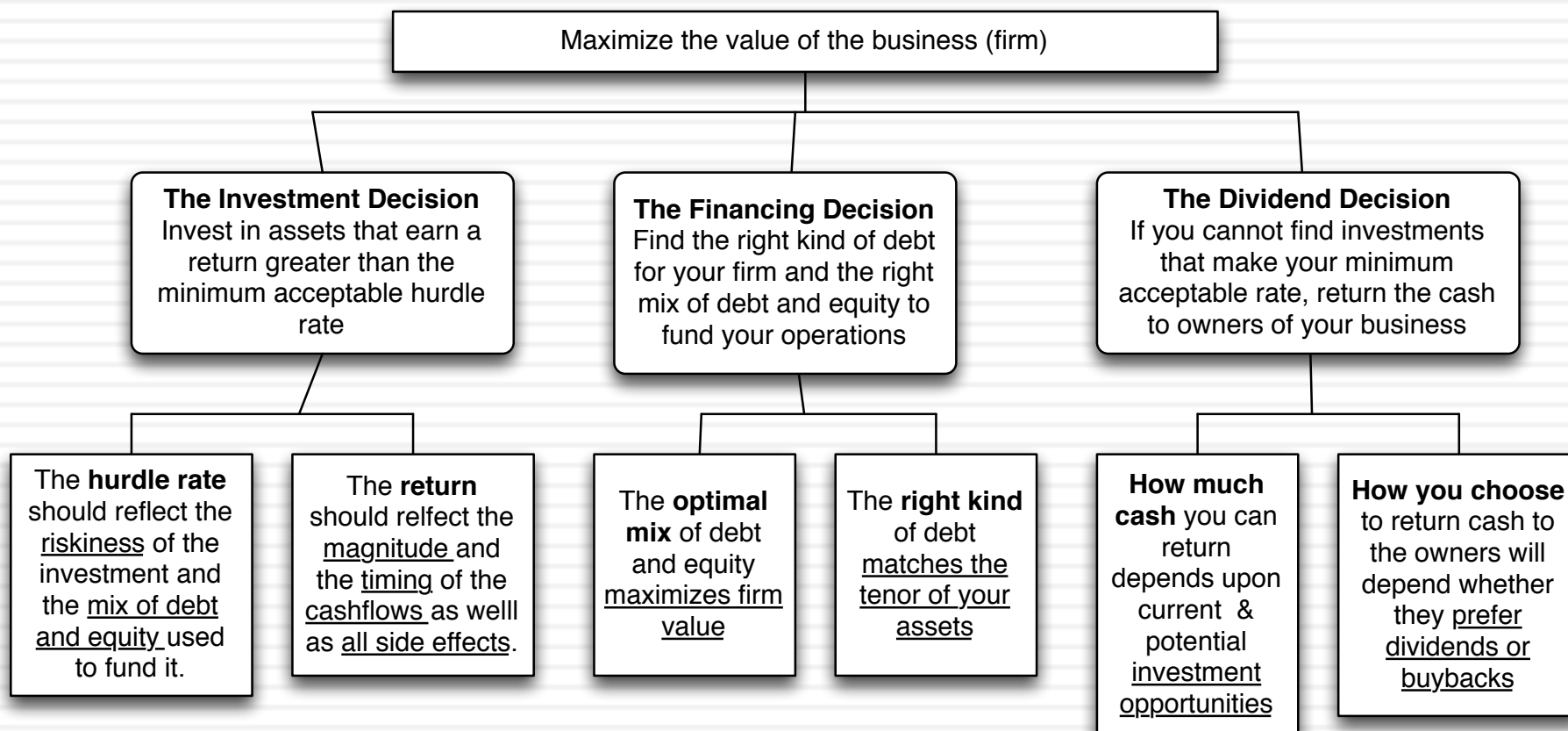
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# First Principles & The Big Picture

5



# Theme 1: Corporate finance is “common sense”

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- There is nothing earth shattering about any of the first principles that govern corporate finance. After all, arguing that taking investments that make 9% with funds that cost 10% to raise seems to be stating the obvious (the investment decision), as is noting that it is better to find a funding mix which costs 10% instead of 11% (the financing decision) or positing that if most of your investment opportunities generate returns less than your cost of funding, it is best to return the cash to the owners of the business and shrink the business.
- Shrewd business people, notwithstanding their lack of exposure to corporate finance theory, have always recognized these fundamentals and put them into practice.

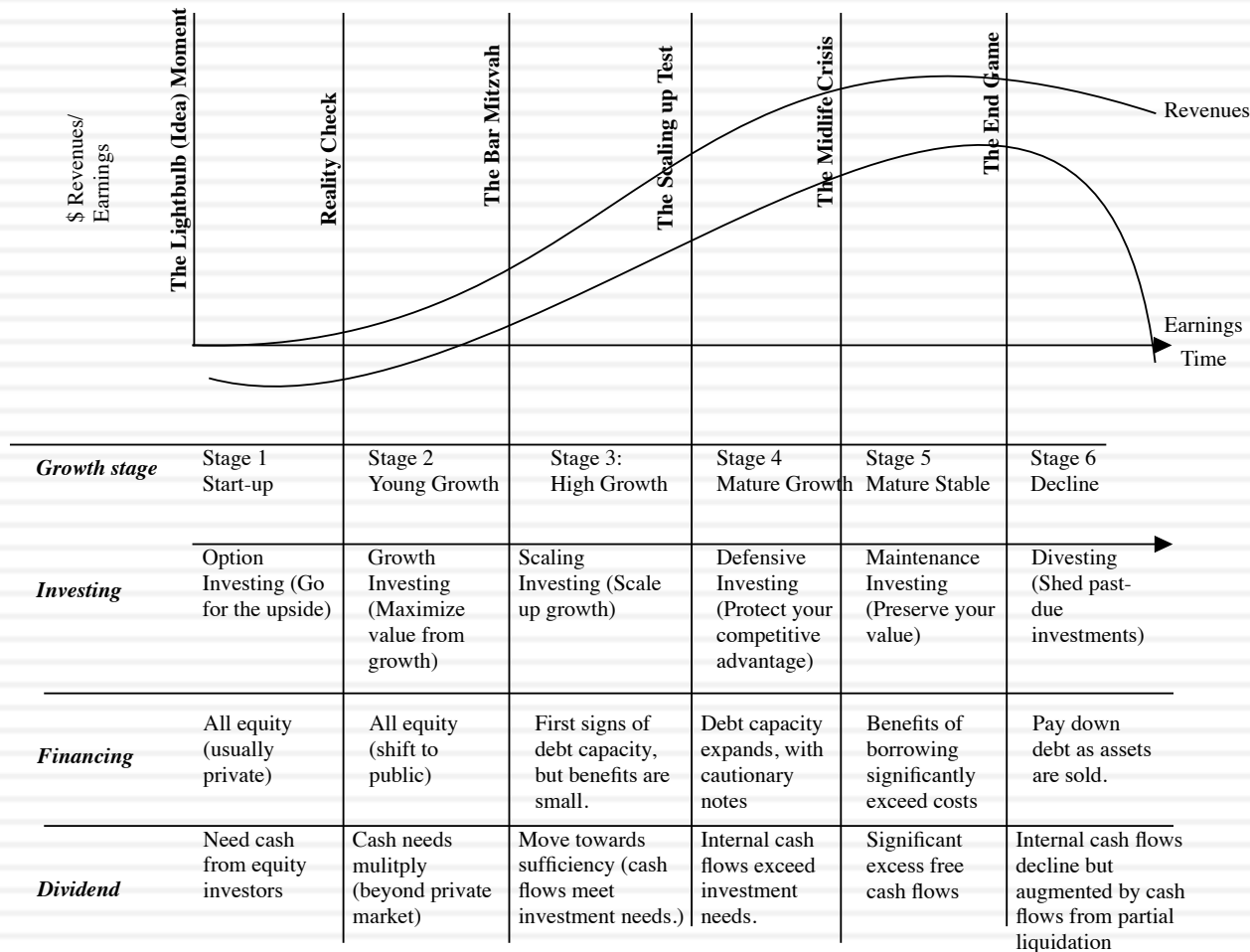
# Theme 2: Corporate finance is focused...

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- It is the focus on maximizing the value of the business that gives corporate finance its focus. As a result of this singular objective, we can
  - ▣ Choose the “right” investment decision rule to use, given a menu of such rules.
  - ▣ Determine the “right” mix of debt and equity for a specific business
  - ▣ Examine the “right” amount of cash that should be returned to the owners of a business and the “right” amount to hold back as a cash balance.
- This certitude does come at a cost. To the extent that you accept the objective of maximizing firm value, everything in corporate finance makes complete sense. If you do not, nothing will.

# Theme 3: The focus in corporate finance changes across the life cycle...

The Corporate Life Cycle



# Theme 4: Corporate finance is universal...

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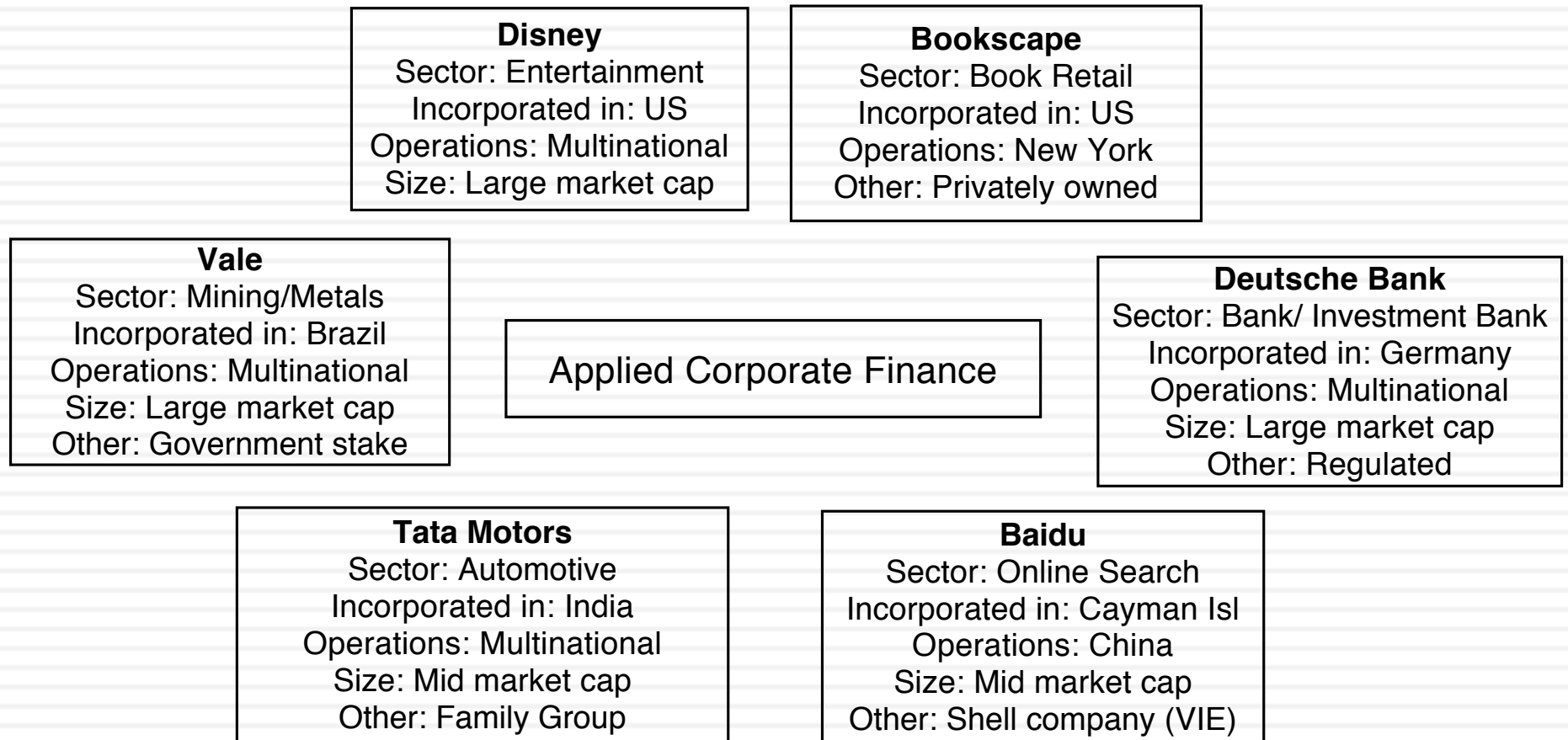
- Every business, small or large, public or private, US or emerging market, has to make investment, financing and dividend decisions.
- The objective in corporate finance for all of these businesses remains the same: maximizing value.
- While the constraints and challenges that firms face can vary dramatically across firms, the first principles do not change.
  - A publicly traded firm, with its greater access to capital markets and more diversified investor base, may have much lower costs of debt and equity than a private business, but they both should look for the financing mix that minimizes their costs of capital.
  - A firm in an emerging markets may face greater uncertainty, when assessing new investments, than a firm in a developed market, but both firms should invest only if they believe they can generate higher returns on their investments than they face as their respective (and very different) hurdle rates.

## Theme 5: If you violate first principles, you will pay a price (no matter who you are..)

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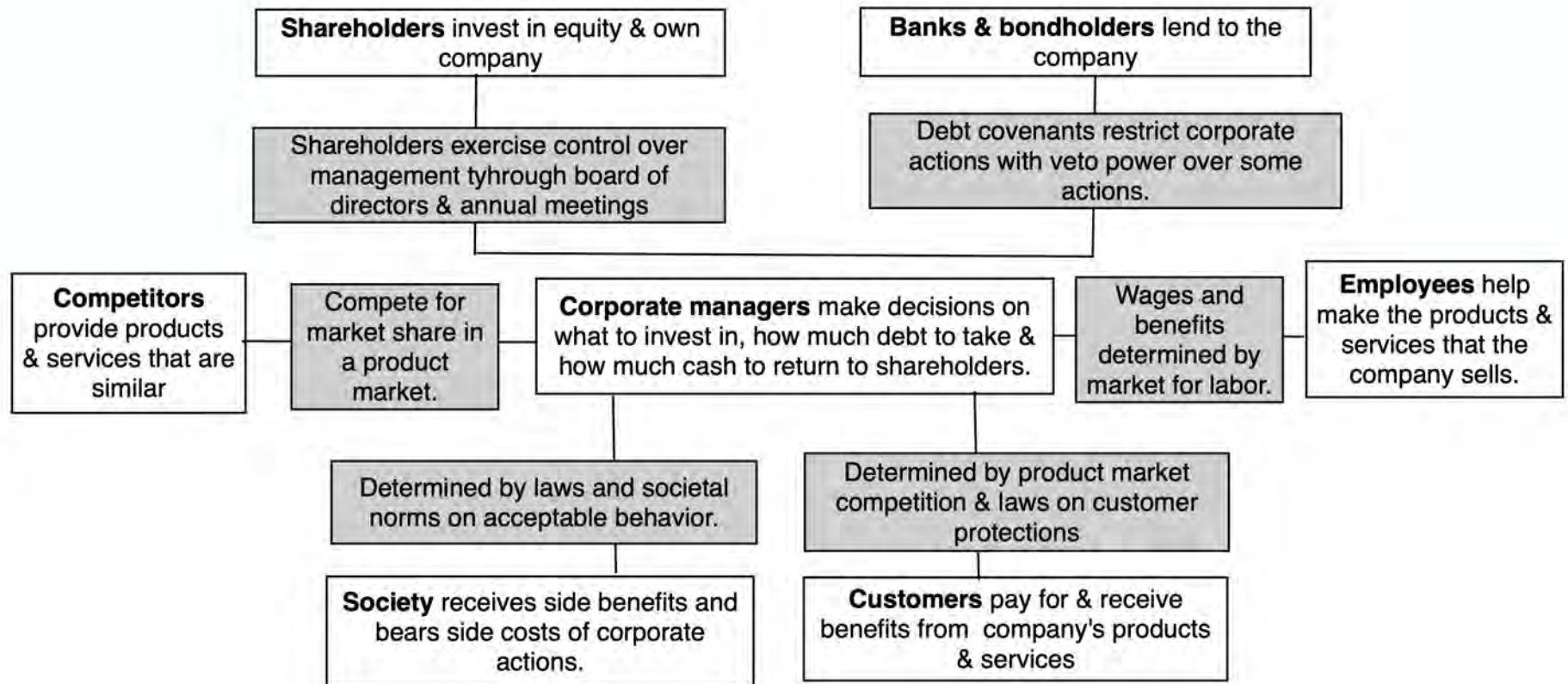
- There are some investors/analysts/managers who convince themselves that the first principles don't apply to them because of their superior education, standing or past successes, and then proceed to put into place strategies or schemes that violate first principles.
- Sooner or later, these strategies will blow up and create huge costs.
- Almost every corporate disaster or bubble has its origins in a violation of first principles.

# Theme 6: If you cannot apply it, who cares?



# The Corporate Stakeholders

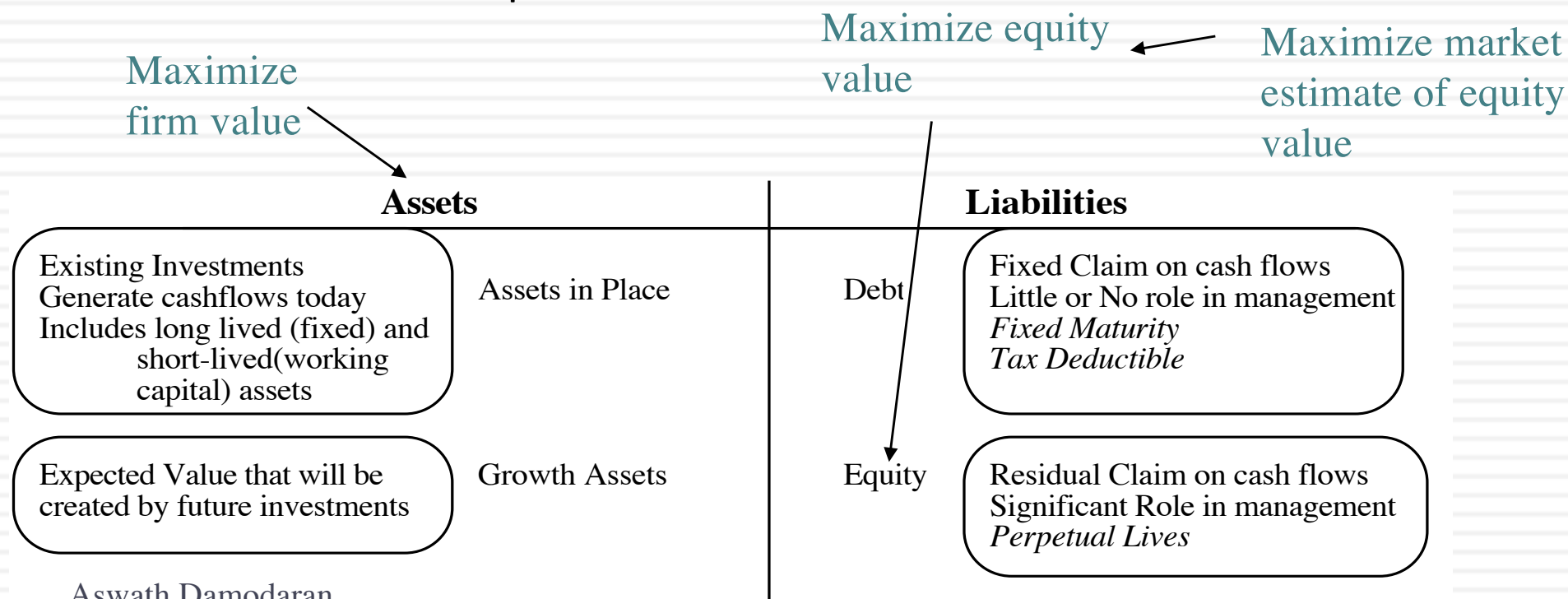
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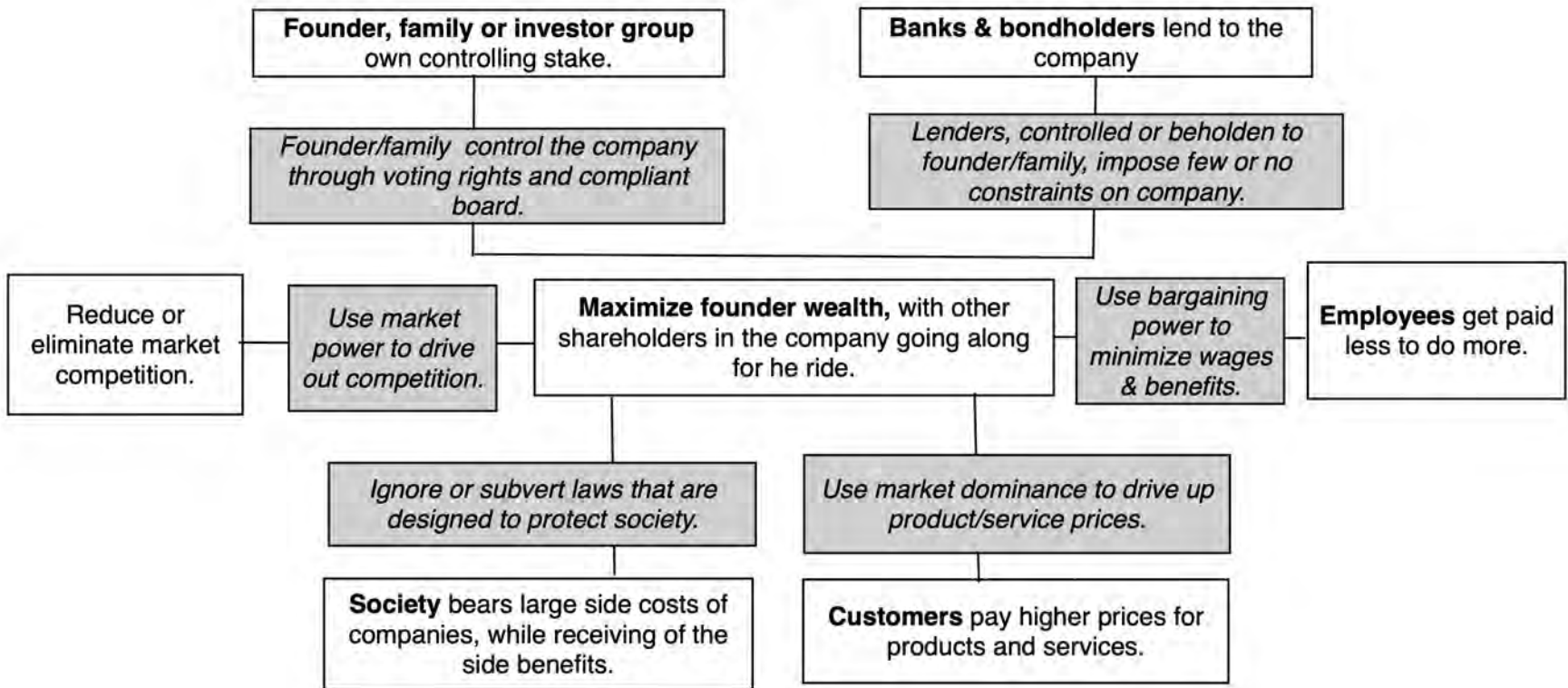
# The Objective in Decision Making

- In traditional corporate finance, the objective in decision making is to maximize the value of the firm.
- A narrower objective is to maximize stockholder wealth. When the stock is traded and markets are viewed to be efficient, the objective is to maximize the stock price.



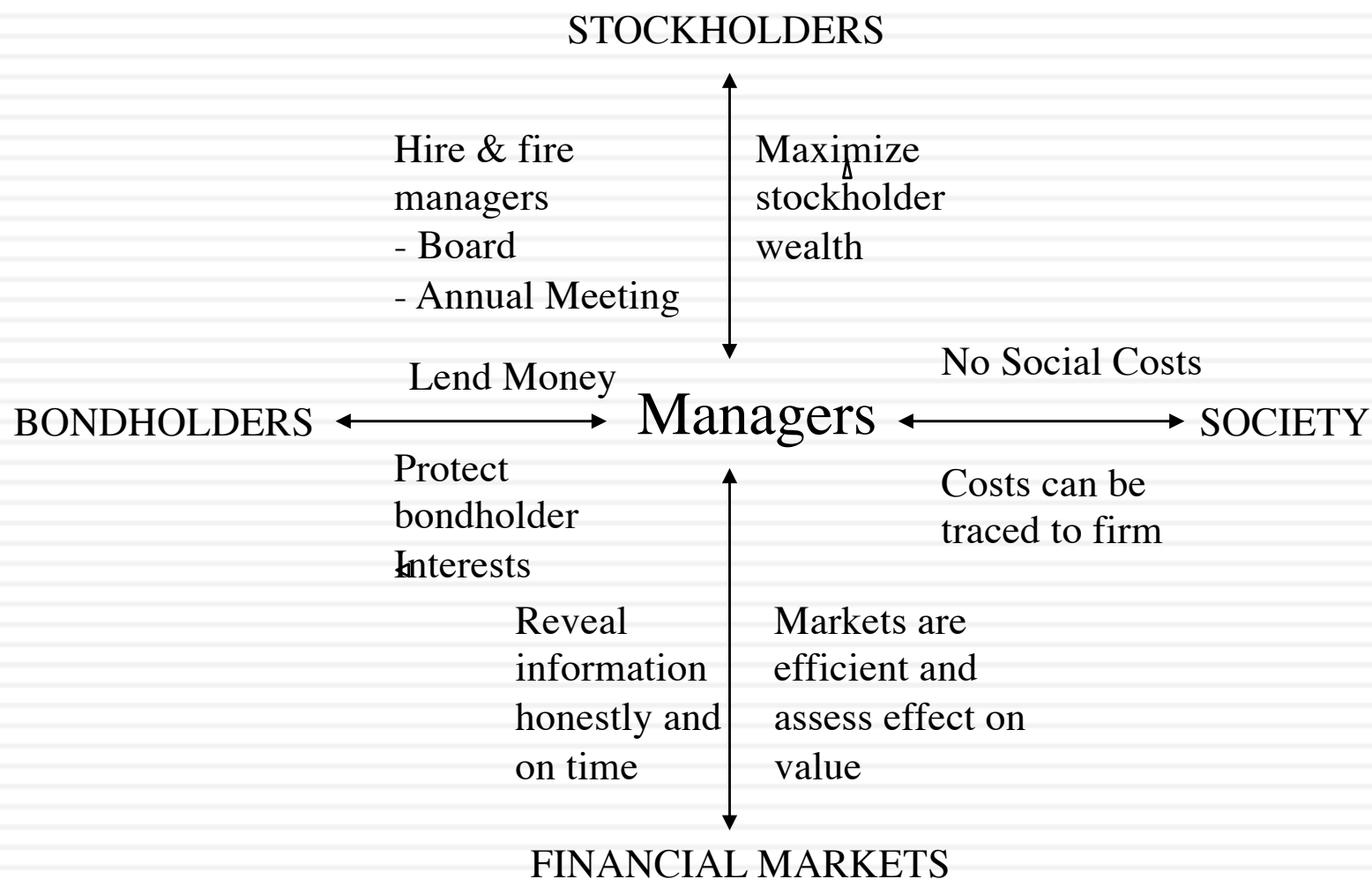
# The Strawman Version: Cutthroat Corporatism

## Cutthroat Corporatism

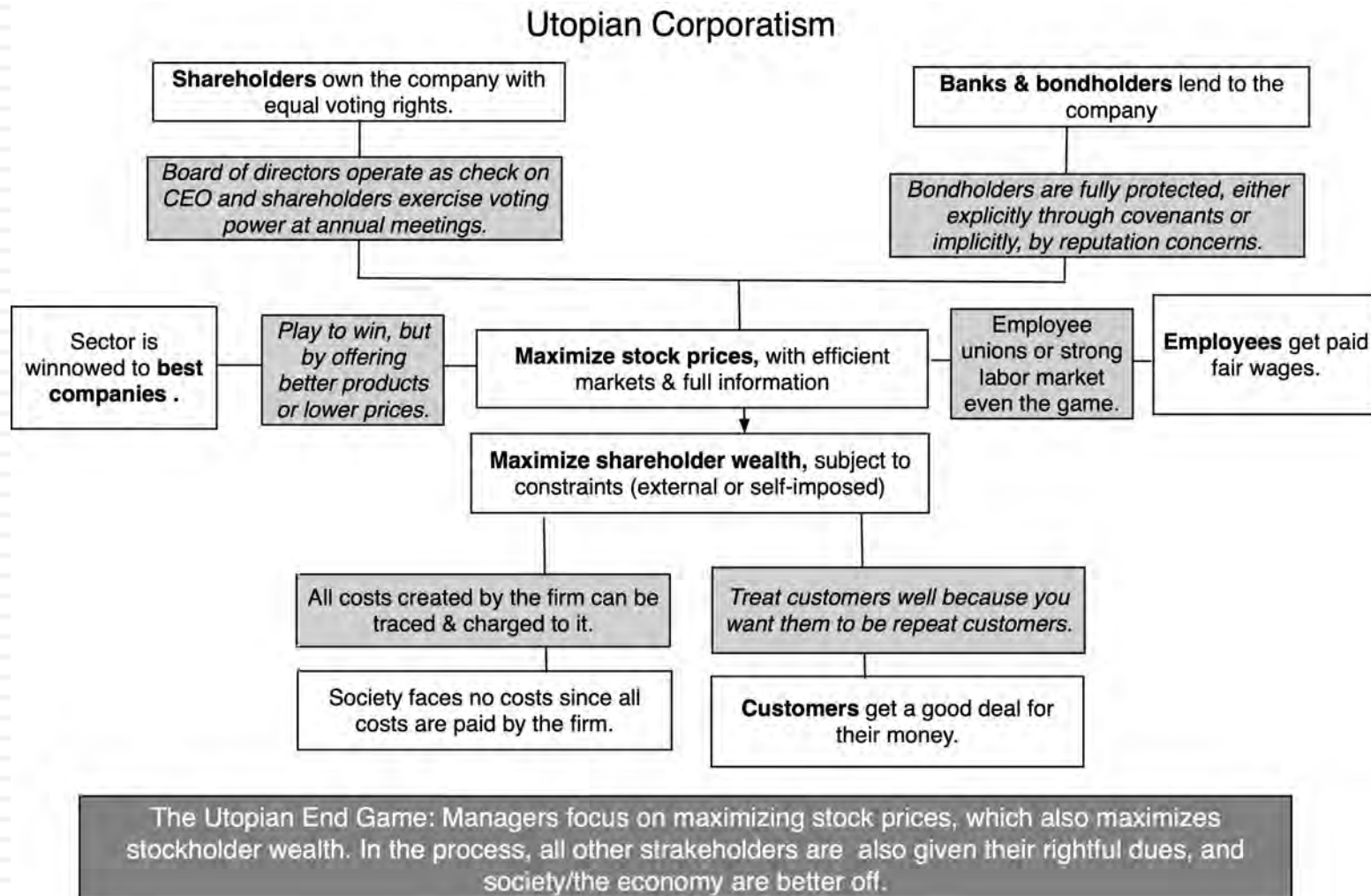


The Darwinian End Game: Winning companies dominate or monopolize their markets, exploiting customers, employees & society, while enriching their founders (and shareholders).

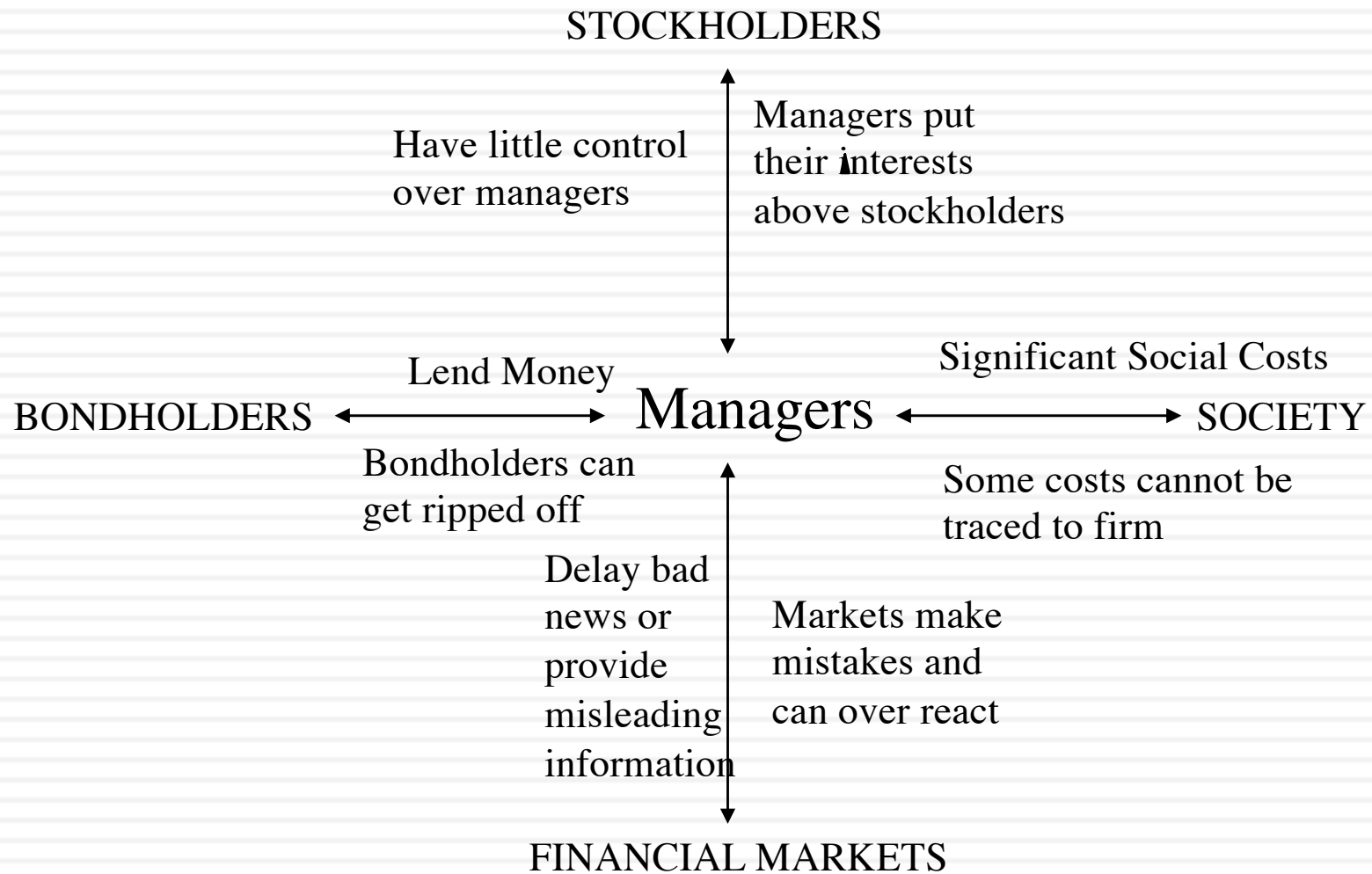
# The Classical Objective Function



# Utopian Corporatism



# What can go wrong?



# Who's on Board? The Disney Experience - 1997

**Reveta F. Bowers 1,5**  
Head of School  
Center for Early Education

**Roy E. Disney 3**  
Vice Chairman  
The Walt Disney Company

**Michael D. Eisner 3**  
Chairman and Chief Executive Officer  
The Walt Disney Company

**Stanley P. Gold 4,5**  
President and Chief Executive Officer  
Shamrock Holdings, Inc.

**Sanford M. Litvack**  
Senior Executive Vice President  
and Chief of Corporate Operations  
The Walt Disney Company

**Ignacio E. Lozano, Jr. 1,2,4**  
Editor-in-Chief, LA OPINION

**George J. Mitchell 5**  
Special Counsel  
Verner, Lipfert, Bernard, McPherson  
and Hand

**Thomas S. Murphy**  
Former Chairman  
Capital Cities/ABC, Inc.

**Richard A. Nunis**  
Chairman  
Walt Disney Attractions

**Leo J. O'Donovan, S.J.**  
President  
Georgetown University

**Michael S. Ovitz 3**  
President  
The Walt Disney Company

**Sidney Poitier 2,4**  
Chief Executive Officer  
Verdon-Cedric Productions

**Irwin E. Russell 2,4**  
Attorney at Law

**Robert A.M. Stern**  
Senior Partner Productions

**E. Cardon Walker 1**  
Former Chairman and Chief Executive Officer  
The Walt Disney Company

**Raymond L. Watson 1,2,3**  
Vice Chairman  
The Irvine Company

**Gary L. Wilson 5**  
Co-Chairman  
Northwest Airlines Corporation

1 Member of Audit Review Committee

2 Member of Compensation Committee

3 Member of Executive Committee

4 Member of Executive Performance Plan Committee

5 Member of Nominating Committee

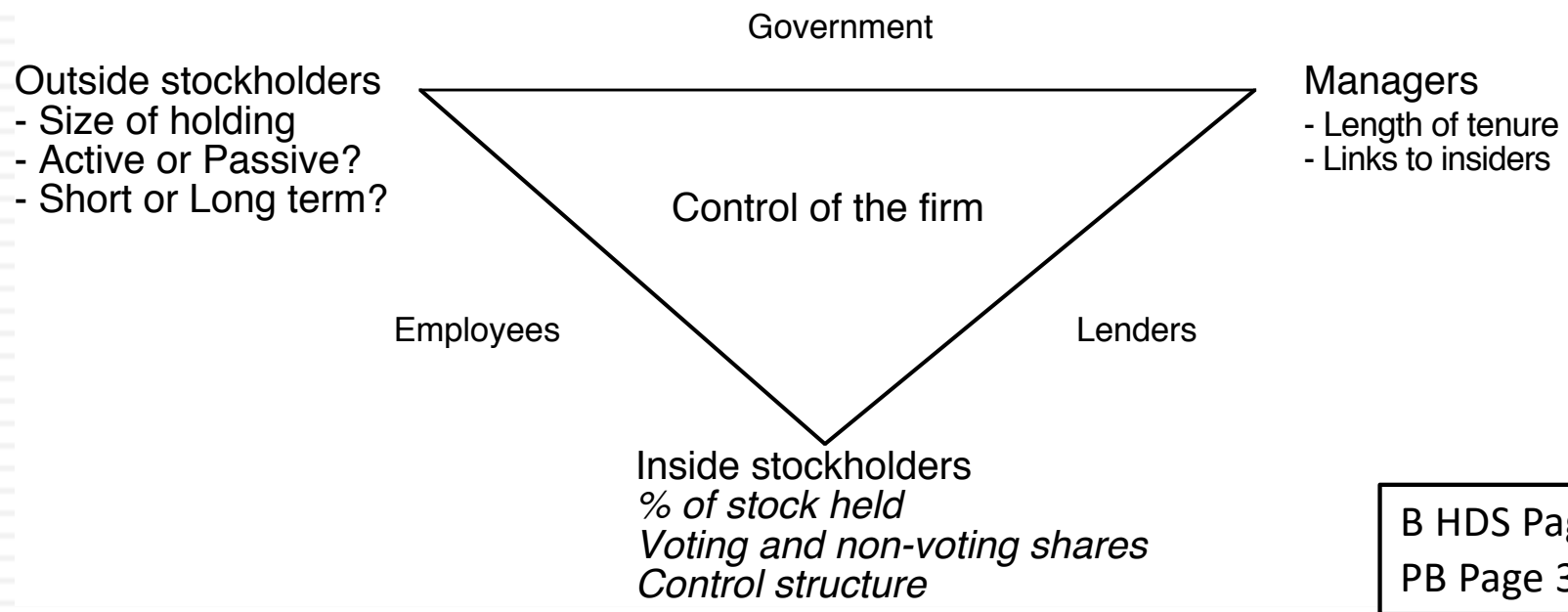
# So, what next? When the cat is idle, the mice will play ....

- When managers do not fear stockholders, they will often put their interests over stockholder interests
  - Greenmail: The (managers of ) target of a hostile takeover buy out the potential acquirer's existing stake, at a price much greater than the price paid by the raider, in return for the signing of a 'standstill' agreement.
  - Golden Parachutes: Provisions in employment contracts, that allows for the payment of a lump-sum or cash flows over a period, if managers covered by these contracts lose their jobs in a takeover.
  - Poison Pills: A security, the rights or cashflows on which are triggered by an outside event, generally a hostile takeover, is called a poison pill.
  - Shark Repellents: Anti-takeover amendments are also aimed at dissuading hostile takeovers, but differ on one very important count. They require the assent of stockholders to be instituted.
  - Overpaying on takeovers: Acquisitions often are driven by management interests rather than stockholder interests.

No stockholder approval needed..... Stockholder Approval needed

# ⌚ Application Test: Who owns/runs your firm?

- Look at: Bloomberg printout HDS for your firm
- Who are the top stockholders in your firm?
- What are the potential conflicts of interests that you see emerging from this stockholding structure?





# Case 1: Splintering of Stockholders

## Disney's top stockholders in 2003

<HELP> for explanation. dgp Equity HDS  
 Enter #<GD> to select aggregate portfolio and see detailed information

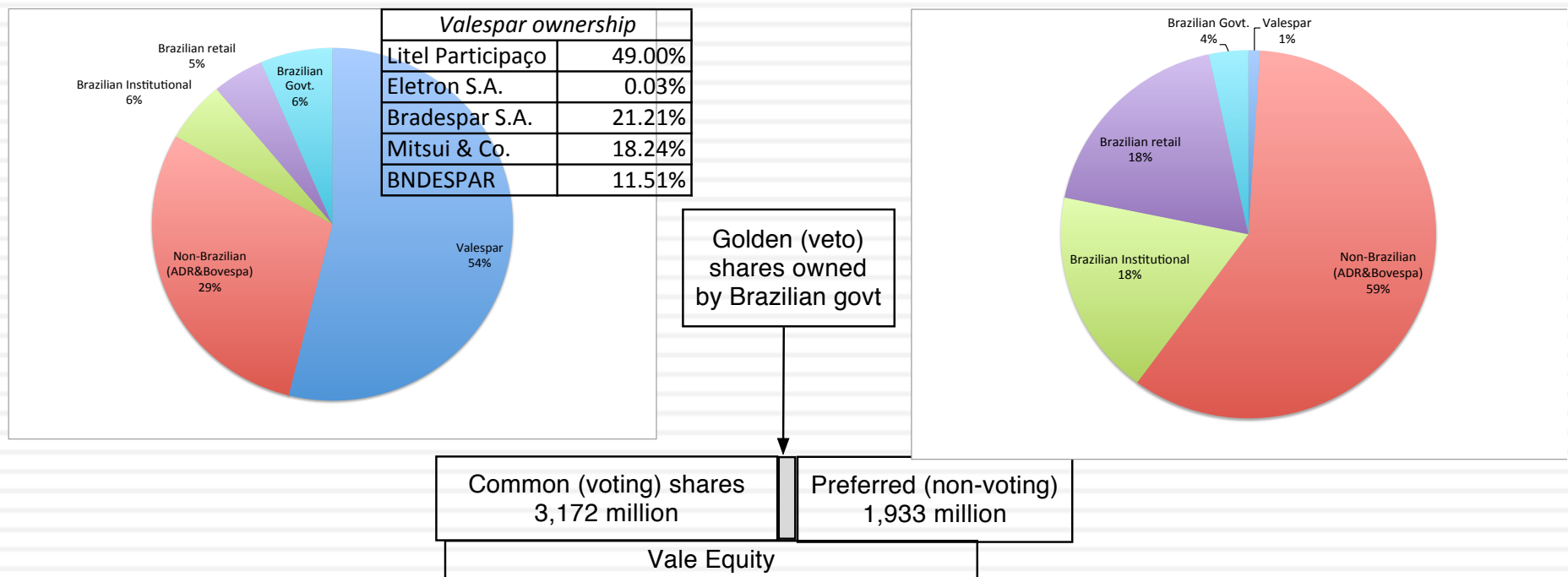
001189658224-000		HOLDINGS SEARCH		CUSIP 25468710		
DIS	US	DISNEY (WALT) CO		Page 1 / 100		
Holder name	Portfolio Name	Source	Held	Outstd	Percent Latest Filing	Change Date
1BARCLAYS GLOBAL	BARCLAYS BANK PLC	13F	83,630M	4.095	1,750M	09/02
2CITIGROUP INC	CITIGROUP INCORPORAT	13F	62,857M	3.078	4,811M	09/02
3FIDELITY MANAGEM	FIDELITY MANAGEMENT	13F	56,125M	2.748	5,992M	09/02
4STATE STREET	STATE STREET CORPORA	13F	54,635M	2.675	2,239M	09/02
5SOUTHEASTRN ASST	SOUTHEASTERN ASSET M	13F	47,333M	2.318	14,604M	09/02
6ST FARM MU AUTO	STATE FARM MUTUAL AU	13F	41,938M	2.054	120,599	09/02
7VANGUARD GROUP	VANGUARD GROUP INC	13F	34,721M	1.700	-83,839	09/02
8MELLON BANK N A	MELLON BANK CORP	13F	32,693M	1.601	957,489	09/02
9PUTNAM INVEST	PUTNAM INVESTMENT MA	13F	28,153M	1.379	-11,468M	09/02
10LORD ABBETT & CO	LORD ABBETT & CO	13F	24,541M	1.202	5,385M	09/02
11MONTAG CALDWELL	MONTAG & CALDWELL IN	13F	24,466M	1.198	-11,373M	09/02
12DEUTSCHE BANK AK	DEUTSCHE BANK AG	13F	23,239M	1.138	-5,002M	09/02
13MORGAN STANLEY	MORGAN STANLEY	13F	19,655M	0.962	3,482M	09/02
14PRICE T ROWE	T ROWE PRICE ASSOCIA	13F	19,133M	0.937	2,925M	09/02
15ROY EDWARD DISNE	n/a	PROXY	17,547M	0.859	-126,710	12/01
16AXA FINANCIAL	ALLIANCE CAPITAL MAN	13F	14,283M	0.699	69,353	09/02
17JP MORGAN CHASE	JP MORGAN CHASE & CO	13F	14,209M	0.696	-462,791	09/02
Sub-totals for current page:			599,159M	29.340		

\* Honey market directory info available. Select portfolio, then hit IP<GD>.

Australia 61 2 8777 8400 Brazil 5511 2048 4500 Europe 44 20 7330 7500 Germany 49 69 90810  
 Hong Kong 852 2577 6900 Japan 81 3 3281 8900 Singapore 65 212 1800 U.S. 1 212 318 2000 Copyright 2002 Bloomberg L.P.  
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# Case 2: Voting versus Non-voting Shares & Golden Shares: Vale



Vale has eleven members on its board of directors, ten of whom were nominated by Valepar and the board was chaired by Don Conrado, the CEO of Valepar.

# Case 3: Cross and Pyramid Holdings

## Tata Motor's top stockholders in 2013

TTMT IN Equity      25) Settings      99) Feedback      Holdings: Current

Tata Motors Ltd      ISIN INE155A01022

1) Current    2) Historical    3) Matrix    4) Ownership    5) Transactions    6) Options

Search Name    --      21) Save    22) Delete    3) Saved Search    24) Refine Search

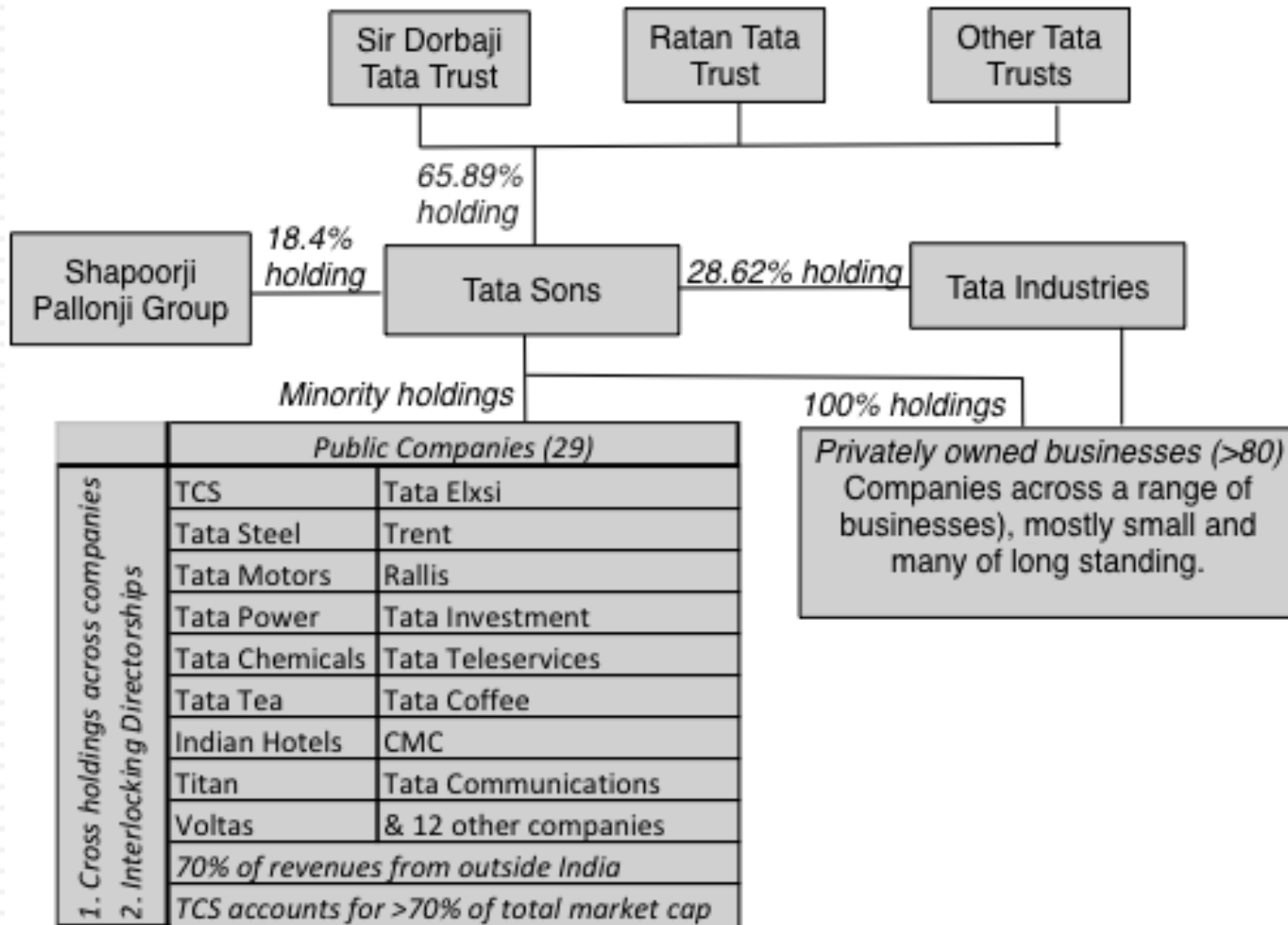
Text Search    Holder Group    All Holders    20) Export

Holder Name	Portfolio Name	Source	Opt	Amt Held	% Out	Latest Chg	File Dt
		All Sources	All				
1. TATA SONS LTD	n/a	Co File		702,333,345	26.07	0	09/30/13
2. CITIBANK NA	n/a	20F		446,246,135	16.56	0	06/30/12
3. LIFE INSURANCE CORP OF I	n/a	Co File		168,754,477	6.26	-119,728,333	09/30/13
4. TATA STEEL LTD	n/a	Co File		147,810,695	5.49	0	09/30/13
5. CAPITAL GROUP COMPANIES	n/a	ULT-AGG		97,689,911	3.63	-877,871	09/30/13
6. TATA INDUSTPIES LTD	n/a	Co File		68,436,485	2.54	0	09/30/13
7. VANGUARD GROUP INC	n/a	ULT-AGG		41,285,983	1.53	4,535,434	09/30/13
8. PRUDENTIAL PLC	n/a	ULT-AGG		34,080,063	1.26	147,814	09/30/13
9. GIC PRIVATE LIMITED	n/a	ULT-AGG		30,428,428	1.13	0	09/30/13
10. WILLIAM BLAIR & COMPANY	WILLIAM BLAIR & COMP	13F		30,093,943	1.12	3,997,149	06/30/13
11. JPMORGAN CHASE & CO	n/a	ULT-AGG		24,918,852	0.92	-2,157,750	08/31/13
12. SCHRODER INVESTMENT MGMT	Multiple Portfolios	MF-AGG		19,136,665	0.71	2,578,904	06/30/13
13. BLACKROCK	n/a	ULT-AGG		14,100,725	0.52	-265,173	10/31/13
14. NORGES BANK	Multiple Portfolios	MF-AGG		10,762,579	0.40	0	12/31/12
15. T ROWE PRICE ASSOCIATES	Multiple Portfolios	MF-AGG		10,056,366	0.37	324,353	09/30/13
16. TATA INVESTMENT COPP LTD	n/a	Co File		10,025,000	0.37	0	09/30/13
17. SBI LIFE INSURANCE CO LTD	Multiple Portfolios	MF-AGG		9,256,170	0.34	-151,323	09/30/13
18. ALLIANZ ASSET MANAGEMENT	n/a	ULT-AGG		8,129,923	0.30	2,071,551	09/30/13

% Out    76.19      Zoom    100%

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 Japan 81 3 3201 8900      Singapore 65 6212 1000      U.S. 1 212 318 2000      Copyright 2013 Bloomberg Finance L.P.  
 SN 636136 EST    GMT-5:00 G627-2830-0 04-Nov-2013 12:31:34

# But it is a benevolent family!





# Case 4: Legal rights and Corporate Structures: Baidu

- The Board: The company has six directors, one of whom is Robin Li, who is the founder/CEO of Baidu. Mr. Li also owns a majority stake of Class B shares, which have ten times the voting rights of Class A shares, granting him effective control of the company.
- The structure: Baidu is a Chinese company, but it is incorporated in the Cayman Islands, its primary stock listing is on the NASDAQ and the listed company is structured as a shell company, to get around Chinese government restrictions of foreign investors holding shares in Chinese corporations.
- The legal system: Baidu's operating counterpart in China is structured as a Variable Interest Entity (VIE), and it is unclear how much legal power the shareholders in the shell company have to enforce changes at the VIE.

# Things change.. Disney's top stockholders in 2009

**DIS** US \$ ↑ **24.2422** +.7422 D 2s EquityHDS  
 DELAY 14:27 Vol 6,135,972 Op 23.81 Z Hi 24.34 T Lo 23.8 T ValTrd 148.014m

DIS US Equity 95) Saved Searches 96) Default Settings Page 1/150 Holdings Search  
 Walt Disney Co/The CUSIP 25468710

21) Sources 22) Types 23) Countries 24) Metro Areas 25) Advanced Filters

Name Filter  Sort By **Mkt Val**

	Holder Name	Portfolio Name	Source	Mkt Val	% Out	Mkt Val Chg	File Dt
1)	JOBS STEVEN PAUL	n/a	Form 4	3.34BLN	7.46	0	5/5/06
2)	FIDELITY MANAGEMENT &	FIDELITY MANAGEMEN	13F	2.05BLN	4.58	-36.12MLN	9/30/08
3)	STATE STREET CORP	STATE STREET CORPO	13F	1.7BLN	3.79	-18.6MLN	9/30/08
4)	BARCLAYS GLOBAL INVES	BARCLAYS GLOBAL IN	13F	1.66BLN	3.70	-160.12MLN	9/30/08
5)	VANGUARD GROUP INC	VANGUARD GROUP IN	13F	1.38BLN	3.08	-6.82MLN	9/30/08
6)	SOUTHEASTERN ASSET M	SOUTHEASTERN ASSE	13F	1.12BLN	2.50	-14.03MLN	9/30/08
7)	STATE FARM MUTUAL AU	STATE FARM MUTUAL	13F	1.02BLN	2.28	0	9/30/08
8)	WELLINGTON MANAGEMEN	WELLINGTON MANAGE	13F	939.38MLN	2.09	110.6MLN	9/30/08
9)	CLEARBRIDGE ADVISORS	CLEARBRIDGE ADVISO	13F	815.91MLN	1.82	-47.04MLN	9/30/08
10)	JP MORGAN CHASE & CO	JP MORGAN CHASE &	13F	693.31MLN	1.55	-18.89MLN	9/30/08
11)	MASSACHUSETTS FINANCI	MASSACHUSETTS FINA	13F	682.16MLN	1.52	112.29MLN	9/30/08
12)	BANK OF NEW YORK MELL	BANK OF NEW YORK	13F	681.68MLN	1.52	-57.13MLN	9/30/08
13)	NORTHERN TRUST CORP	NORTHERN TRUST CO	13F	610.26MLN	1.36	-4.81MLN	9/30/08
14)	AXA	AXA	13F	486.28MLN	1.08	47.05MLN	9/30/08
15)	BLACKROCK INVESTMENT	BLACKROCK INVESTME	13F	476.12MLN	1.06	-47.11MLN	9/30/08
16)	JENNISON ASSOCIATES L	JENNISON ASSOCIATE	13F	428.85MLN	0.96	-102.77MLN	9/30/08
17)	T ROWE PRICE ASSOCIAT	T ROWE PRICE ASSOC	13F	351.61MLN	0.78	-9.94MLN	9/30/08

26) Latest Chg 27) Hist Held % Out on Page **41.12**

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 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000  
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# When traditional corporate financial theory breaks down, the solution is:

- To choose a different mechanism for corporate governance, i.e., assign the responsibility for monitoring managers to someone other than stockholders.
- To choose a different objective for the firm.
- To maximize stock price, but reduce the potential for conflict and breakdown:
  - ▣ Making managers (decision makers) and employees into stockholders
  - ▣ Protect lenders from expropriation
  - ▣ By providing information honestly and promptly to financial markets
  - ▣ Minimize social costs

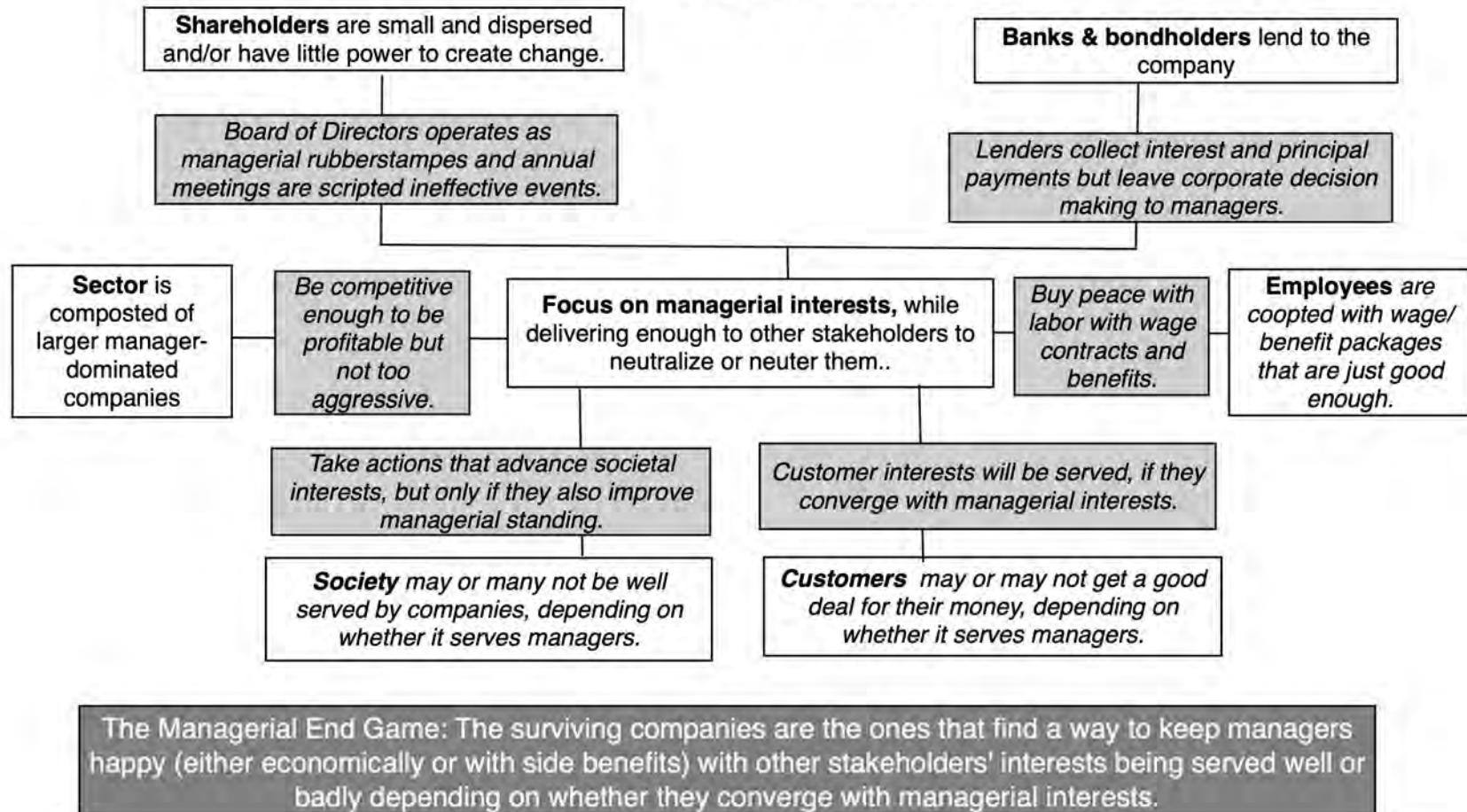
# I. An Alternative Corporate Governance System

- Germany and Japan developed a different mechanism for corporate governance, based upon corporate cross holdings.
  - In Germany, the banks form the core of this system.
  - In Japan, it is the keiretsus
  - Other Asian countries have modeled their system after Japan, with family companies forming the core of the new corporate families
- At their best, the most efficient firms in the group work at bringing the less efficient firms up to par. They provide a corporate welfare system that makes for a more stable corporate structure
- At their worst, the least efficient and poorly run firms in the group pull down the most efficient and best run firms down. The nature of the cross holdings makes its very difficult for outsiders (including investors in these firms) to figure out how well or badly the group is doing.

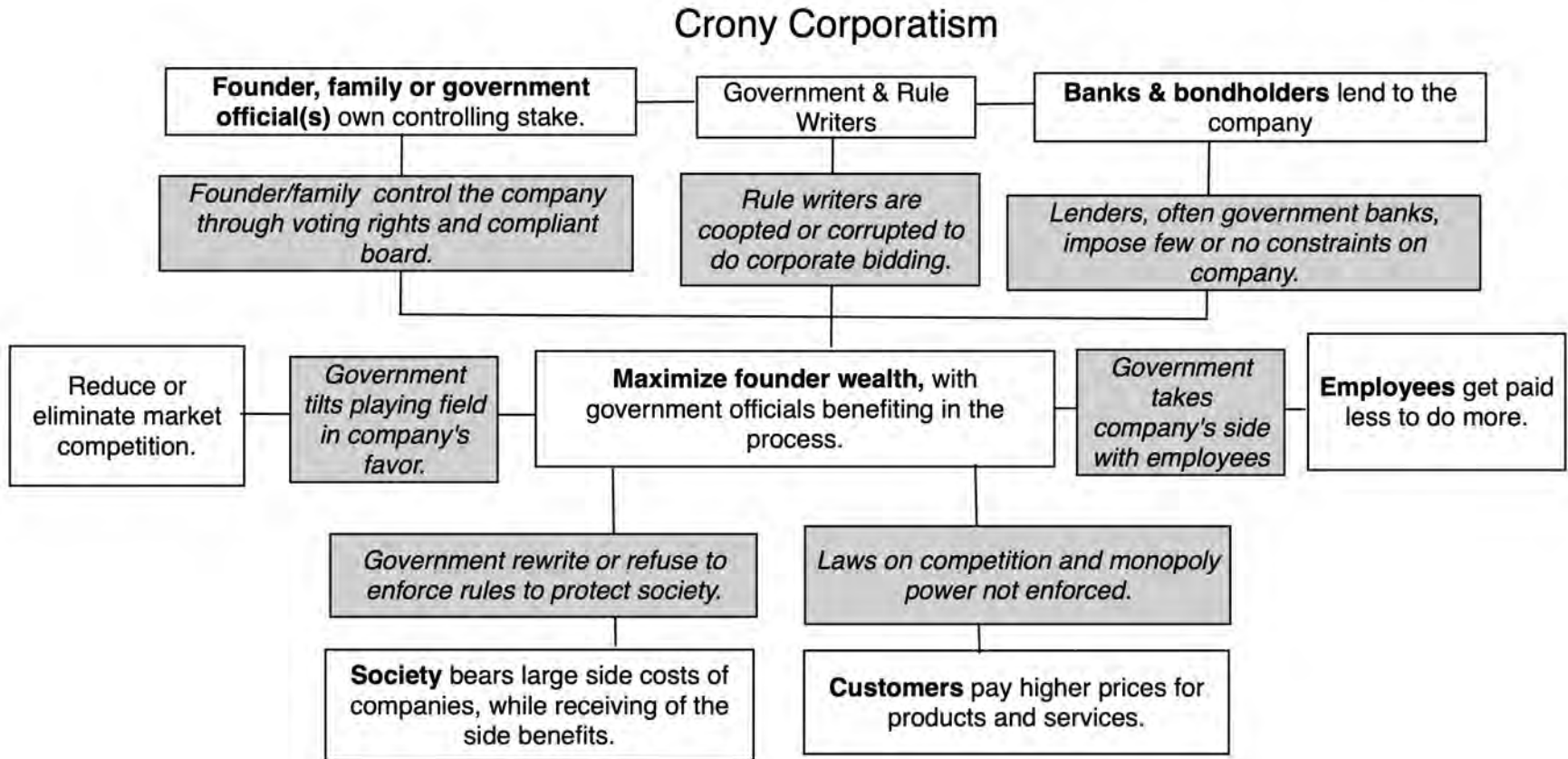


# One End game: Managerial Corporatism

## Managerial Corporatism



# A Skewed Version: Crony Corporatism



The Connections End Game: The most-politically connected companies dominate or monopolize their markets, exploiting customers, employees & society.

# Ila. Choose a Different Objective Function

- Firms can always focus on a different objective function. Examples would include
  - ▣ maximizing earnings
  - ▣ maximizing revenues
  - ▣ maximizing firm size
  - ▣ maximizing market share
  - ▣ maximizing EVA
- The key thing to remember is that these are intermediate objective functions.
  - ▣ To the degree that they are correlated with the long term health and value of the company, they work well.
  - ▣ To the degree that they do not, the firm can end up with a disaster

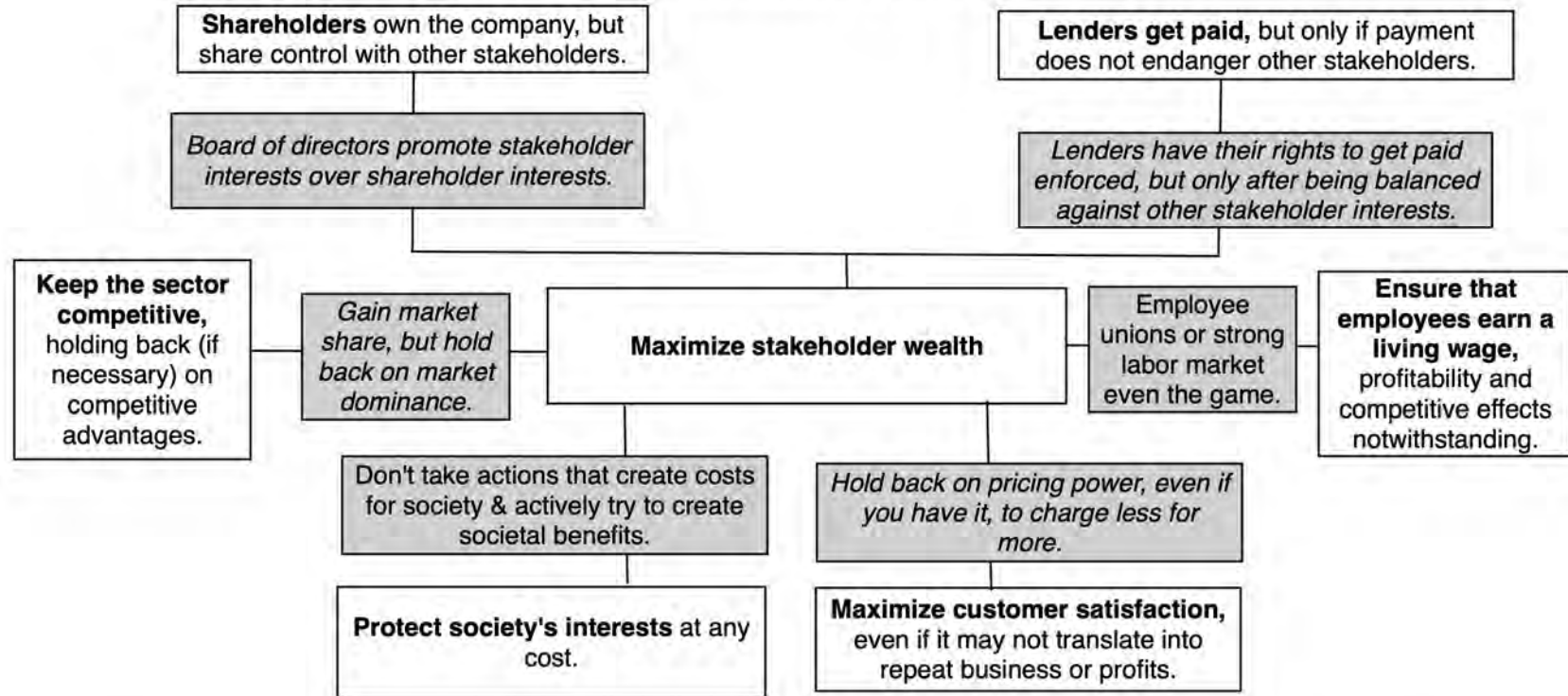
## Ib. Maximize stakeholder wealth

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- A fairness argument: To the extent that shareholder wealth maximization seems to, at least at first sight, put all other stakeholders in the back seat, it seems unfair.
- An Easy Fix? The logical response seems to be stakeholder wealth maximization, where the collective wealth of all stakeholders is maximized. That is the promise of stakeholder wealth maximization.
- Protective response: As corporations have found themselves losing the battle for public opinions, many CEOs and even some institutional investors seem to have bought into this idea.

# Confused Corporatism

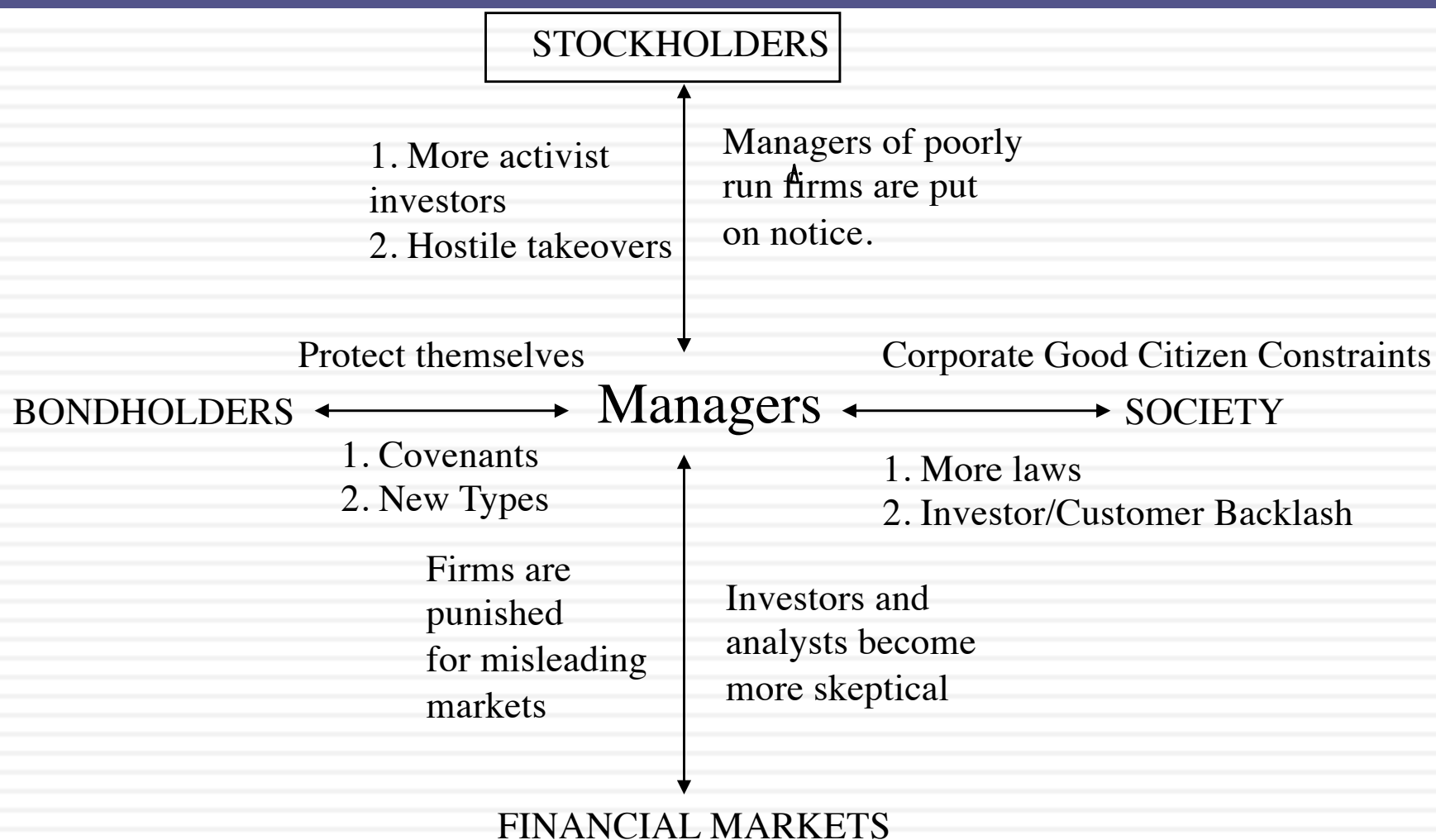
## Confused Corporatism



The Confused End Game: In the attempt to serve all stakeholders, none will be served, and there will be no accountability for managers, leading to companies that are less competitive and efficient.



# III. A Market Based Solution



# Disney: Eisner's rise & fall from grace

- In his early years at Disney, Michael Eisner brought about long-delayed changes in the company and put it on the path to being an entertainment giant that it is today. His success allowed him to consolidate power and the boards that he created were increasingly captive ones (see the 1997 board).
- In 1996, Eisner spearheaded the push to buy ABC and the board rubberstamped his decision, as they had with other major decisions. In the years following, the company ran into problems both on its ABC acquisition and on its other operations and stockholders started to get restive, especially as the stock price halved between 1998 and 2002.
- In 2003, Roy Disney and Stanley Gold resigned from the Disney board, arguing against Eisner's autocratic style.
- In early 2004, Comcast made a hostile bid for Disney and later in the year, 43% of Disney shareholders withheld their votes for Eisner's reelection to the board of directors. Following that vote, the board of directors at Disney voted unanimously to elect George Mitchell as the Chair of the board, replacing Eisner, who vowed to stay on as CEO.
- In October 2005, Eisner stepped down as CEO, to be replaced by Bob Iger.

# A Market Solution: Eisner's exit... and a new age dawns? Disney's board in 2008

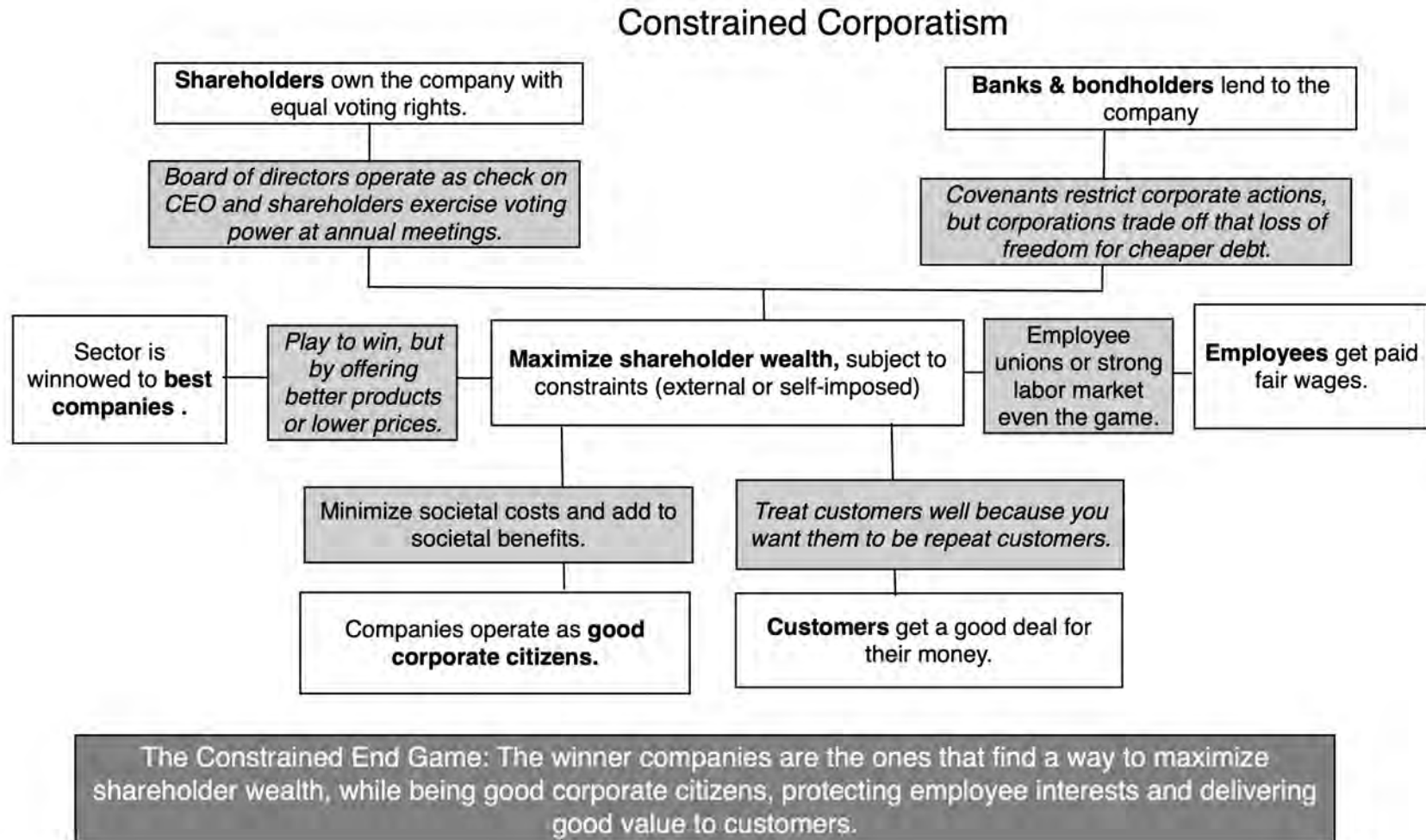
<i>Board Members</i>	<i>Occupation</i>
John E. Pepper, Jr. (Chairman)	Retired Chairman and CEO, Procter & Gamble Co.
Susan E. Arnold	President, Global Business Units, Procter & Gamble Co.
John E. Bryson	Retired Chairman and CEO, Edison International
John S. Chen	Chairman,, CEO & President, Sybase, Inc.
Judith L. Estrin	CEO, J Labs, LLC.
Robert A. Iger	CEO, Disney
Steven P. Jobs	CEO, Apple
Fred Langhammer	Chairman, Global Affairs, The Estee Lauder Companies
Aylwin B. Lewis	President and CEO, Potbelly Sandwich Works
Monica Lozano	Publisher and CEO, La Opinion
Robert W. Matschullat	Retired Vice Chairman and CFO, The Seagram Co.
Orin C. Smith	Retired President and CEO, Starbucks Corporation



# But as a CEO's tenure lengthens, does corporate governance suffer?

- While the board size has stayed compact (at twelve members), there has been only one change since 2008, with Sheryl Sandberg, COO of Facebook, replacing the deceased Steve Jobs.
- The board voted reinstate Iger as chair of the board in 2011, reversing a decision made to separate the CEO and Chair positions after the Eisner years.
  - In 2011, Iger announced his intent to step down as CEO in 2015 but Disney's board convinced Iger to stay on as CEO for an extra year, for the "the good of the company".
  - In 2016, Thomas Staggs who was considered heir apparent to Iger left Disney.
  - In 2017, Disney acquired Fox and announced that Iger's term would be extended to 2019 (and perhaps beyond) because his stewardship was essential for the merger to work.

# Constrained Corporatism

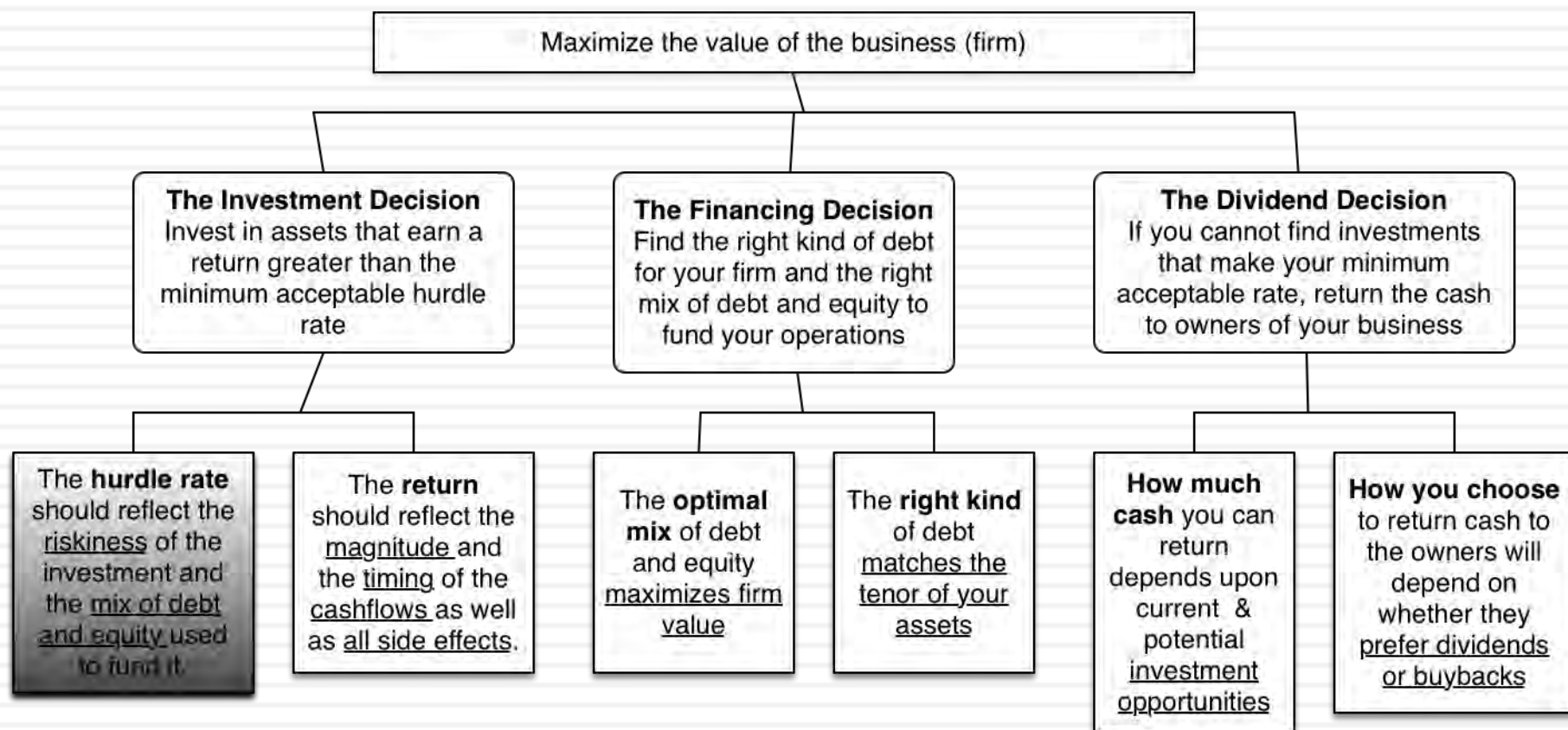




## THE INVESTMENT PRINCIPLE: RISK AND RETURN MODELS

“You cannot swing upon a rope that is attached only to your own belt.”

# First Principles



# The notion of a benchmark

- Since financial resources are finite, there is a hurdle that projects have to cross before being deemed acceptable.
- This hurdle will be higher for riskier projects than for safer projects.
- A simple representation of the hurdle rate is as follows:  
$$\text{Hurdle rate} = \text{Riskless Rate} + \text{Risk Premium}$$
- The two basic questions that every risk and return model in finance tries to answer are:
  - ▣ How do you measure risk?
  - ▣ How do you translate this risk measure into a risk premium?

# What is Risk?

- Risk, in traditional terms, is viewed as a ‘negative’. Webster’s dictionary, for instance, defines risk as “exposing to danger or hazard”. The Chinese symbols for risk, reproduced below, give a much better description of risk:

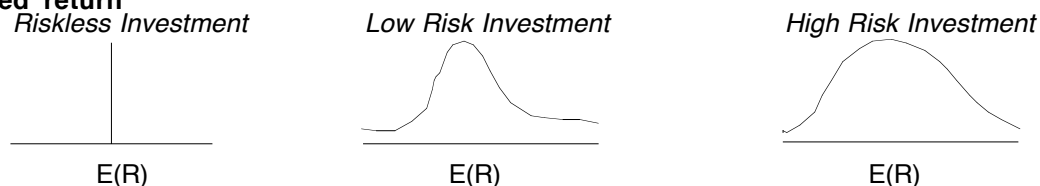
危机

- The first symbol is the symbol for “danger”, while the second is the symbol for “opportunity”, making risk a mix of danger and opportunity. You cannot have one, without the other.
- Risk is therefore neither good nor bad. It is just a fact of life. The question that businesses have to address is therefore not whether to avoid risk but how best to incorporate it into their decision making.

# Risk and Return Models in Finance

## Step 1: Defining Risk

The risk in an investment can be measured by the variance in actual returns around an expected return



## Step 2: Differentiating between Rewarded and Unrewarded Risk

*Risk that is specific to investment (Firm Specific)*

Can be diversified away in a diversified portfolio

1. each investment is a small proportion of portfolio
2. risk averages out across investments in portfolio

**The marginal investor is assumed to hold a “diversified” portfolio. Thus, only market risk will be rewarded and priced.**

*Risk that affects all investments (Market Risk)*

Cannot be diversified away since most assets are affected by it.

## Step 3: Measuring Market Risk

The CAPM	The APM	Multi-Factor Models	Proxy Models
<p>If there is</p> <ol style="list-style-type: none"> <li>1. no private information</li> <li>2. no transactions cost</li> </ol> <p>the optimal diversified portfolio includes every traded asset. Everyone will hold this <u>market portfolio</u></p> <p><b>Market Risk = Risk added by any investment to the market portfolio:</b></p>	<p>If there are no arbitrage opportunities then the market risk of any asset must be captured by betas relative to factors that affect all investments.</p> <p><b>Market Risk = Risk exposures of any asset to market factors</b></p>	<p>Since market risk affects most or all investments, it must come from macro economic factors.</p> <p><b>Market Risk = Risk exposures of any asset to macro economic factors.</b></p>	<p>In an efficient market, differences in returns across long periods must be due to market risk differences. Looking for variables correlated with returns should then give us proxies for this risk.</p> <p><b>Market Risk = Captured by the Proxy Variable(s)</b></p>
Beta of asset relative to Market portfolio (from a regression)	Betas of asset relative to unspecified market factors (from a factor analysis)	Betas of assets relative to specified macro economic factors (from a regression)	Equation relating returns to proxy variables (from a regression)



# Limitations of the CAPM

1. The model makes unrealistic assumptions
2. The parameters of the model cannot be estimated precisely
  - Definition of a market index
  - Firm may have changed during the 'estimation' period'
3. The model does not work well
  - If the model is right, there should be
    - a linear relationship between returns and betas
    - the only variable that should explain returns is betas
  - The reality is that
    - the relationship between betas and returns is weak
    - Other variables (size, price/book value) seem to explain differences in returns better.



# The Marginal Investor

- The who: The marginal investor is the investor who affects prices at the margin. To do so, that investor needs to not only trade the equity in the company, but to do so in large quantities.
- Following up, the marginal investor in a company will
  - ▣ Be a "large" shareholder in the company
  - ▣ Trade that shareholding (rather than being forced to hold the shares for control or other reasons).
- Why we care: For a central assumption in risk and return models in finance to hold, i.e., that the only risk that we incorporate in hurdle rates is the risk that we cannot diversify away, the marginal investor has to be diversified.

# Gauging the marginal investor: Disney in 2013

DIS US Equity    25) Settings    99) Feedback    Holdings: Current  
Walt Disney Co/The    CUSIP 25468710

1) Current    2) Historical    3) Matrix    4) Ownership    5) Transactions    6) Options

Search Name --    21) Save    22) Delete    3) Saved Search    24) Refine Search

Text Search    Holder Group    All Holders    20) Export

Holder Name	Portfolio Name	Source	Opt	Amt Held	% Out	Latest Chg File Dt
		All Sources	All			
1. LAURENE POWELL JOBS TRU	n/a	PROXY		130,844,544	7.32	0 01/07/13
2. BLACKROCK	n/a	ULT-AGG		93,837,994	5.25	-494,298 09/24/13
3. VANGUARD GROUP INC	n/a	ULT-AGG		80,163,479	4.49	1,183,628 06/30/13
4. STATE STREET CORP	n/a	ULT-AGG		77,799,514	4.35	2,893,171 09/24/13
5. CAPITAL GROUP COMPANIES	n/a	ULT-AGG		62,014,410	3.47	36,689,294 06/30/13
6. FMR LLC	n/a	ULT-AGG		59,453,225	3.33	-1,495,596 06/30/13
7. SUN LIFE FINANCIAL INC	n/a	ULT-AGG		55,699,112	3.12	-1,422,694 06/30/13
8. STATE FARM MUTUAL AUTO I	STATE FARM MUTUAL AU	13F		42,206,018	2.36	0 06/30/13
9. LUCAS JR GEORGE W	n/a	Co File		37,076,679	2.08	0 02/06/13
10. BANK OF NEW YORK MELLON	BANK OF NEW YORK MEL	13F		30,293,150	1.70	-127,337 06/30/13
11. NORTHERN TRUST CORPORAT	NORTHERN TRUST CORP	13F		28,465,082	1.59	224,418 06/30/13
12. T ROWE PRICE ASSOCIATES	T ROWE PRICE ASSOCIA	13F		25,834,722	1.45	-3,332,832 06/30/13
13. WELLINGTON MANAGEMENT C	WELLINGTON MANAGEME	13F		24,292,691	1.36	-4,191,722 06/30/13
14. JENNISON ASSOCIATES LLC	JENNISON ASSOCIATES	13F		16,644,863	0.93	2,408,938 06/30/13
15. JP MORGAN	n/a	ULT-AGG		15,073,679	0.84	1,496,290 06/30/13
16. NORGES BANK	NORGES BANK	13F		14,991,213	0.84	0 12/31/12
17. DAVIS SELECTED ADVISERS L	DAVIS SELECTED ADVISE	13F		12,938,299	0.72	-2,546,616 06/30/13
18. GEODE CAPITAL MANAGEMEN	GEODE CAPITAL MANAGE	13F		12,441,353	0.70	233,702 06/30/13

Loading .....    % Out 79.75    Zoom - 100%

# ⌚ Application Test: Who is the marginal investor in your firm?

- Looking at the breakdown of stockholders in your firm, consider whether the marginal investor is
  - ▣ An institutional investor
  - ▣ An individual investor
  - ▣ An insider

[B DES Page 3](#)  
[PB Page 13](#)

# Inputs required to use the CAPM -

- The capital asset pricing model yields the following expected return:
  - $\text{Expected Return} = \text{Riskfree Rate} + \text{Beta} * (\text{Expected Return on the Market Portfolio} - \text{Riskfree Rate})$
- To use the model we need three inputs:
  - a. The current risk-free rate
  - b. The expected market risk premium (the premium expected for investing in risky assets (market portfolio) over the riskless asset)
  - c. The beta of the asset being analyzed.

# I. A Riskfree Rate

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- On a riskfree asset, the actual return is equal to the expected return. Therefore, there is no variance around the expected return. For an investment to be riskfree, then, it has to have
  - ▣ No default risk
  - ▣ No reinvestment risk
- 1. Time horizon matters: Thus, the riskfree rates in valuation will depend upon when the cash flow is expected to occur and will vary across time.
- 2. Not all government securities are riskfree: Some governments face default risk and the rates on bonds issued by them will not be riskfree.
- The conventional practice of estimating riskfree rates is to use the government bond rate, with the government being the one that is in control of issuing that currency. **In November 2013**, for instance, the rate on a ten-year US treasury bond (2.75%) is used as the risk free rate in US dollars.

# What if there is no default-free entity?

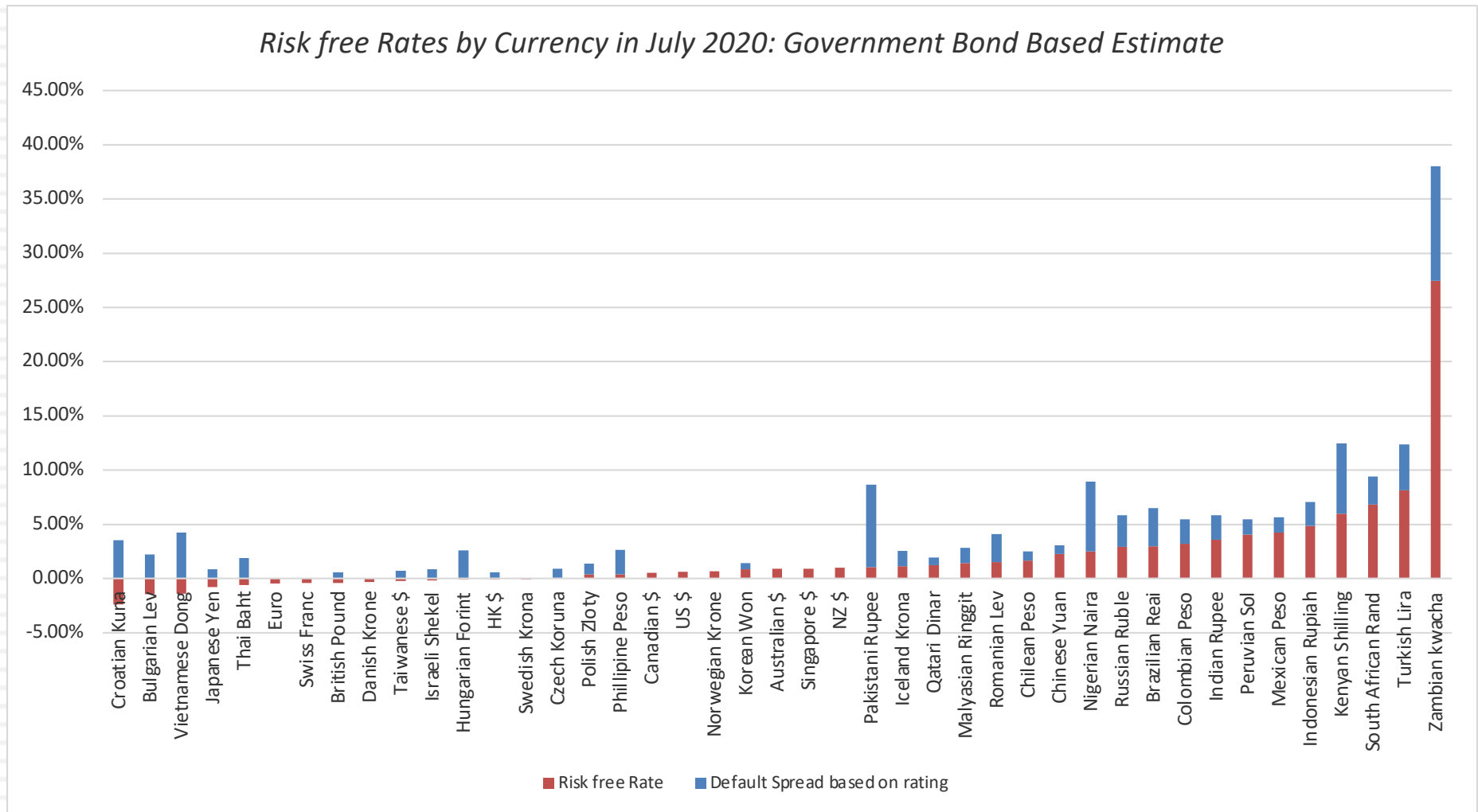
## Risk free rates in November 2013

PB Page 14-21

- If the government is perceived to have default risk, the government bond rate will have a default spread component in it and not be riskfree. There are three choices we have, when this is the case.
  - **Adjust the local currency government borrowing rate for default risk** to get a riskless local currency rate.
    - In November 2013, the Indian government rupee bond rate was 8.82%. the local currency rating from Moody's was Baa3 and the default spread for a Baa3 rated country bond was 2.25%.  
Riskfree rate in Rupees =  $8.82\% - 2.25\% = 6.57\%$
  - **Do the analysis in an alternate currency**, where getting the riskfree rate is easier. With Vale in 2013, we could chose to do the analysis in US dollars (rather than estimate a riskfree rate in R\$). The riskfree rate is then the US treasury bond rate.
  - **Do your analysis in real terms**, in which case the riskfree rate has to be a real riskfree rate. The inflation-indexed treasury rate is a measure of a real riskfree rate.

# Risk free rates by currency: July 2020

*Risk free Rates by Currency in July 2020: Government Bond Based Estimate*



## II. Equity Risk Premium

- The risk premium is the premium that investors demand for investing in an average risk investment, relative to the risk free rate.
- As a general proposition, this premium should be
  - ▣ increase with the risk aversion of the investors in that market
  - ▣ increase with the riskiness of the “average” risk investment



# What is your risk premium?

- Assume that stocks are the only risky assets and that you are offered two investment options:
  - a riskless investment (say a Government Security), on which you can make 3%
  - a mutual fund of all stocks, on which the returns are uncertain
- How much of an expected return would you demand to shift your money from the riskless asset to the mutual fund?
  - a. Less than 3%
  - b. Between 3 - 5%
  - c. Between 5 - 7%
  - d. Between 7 -9%
  - e. Between 9%- 11%
  - f. More than 11%

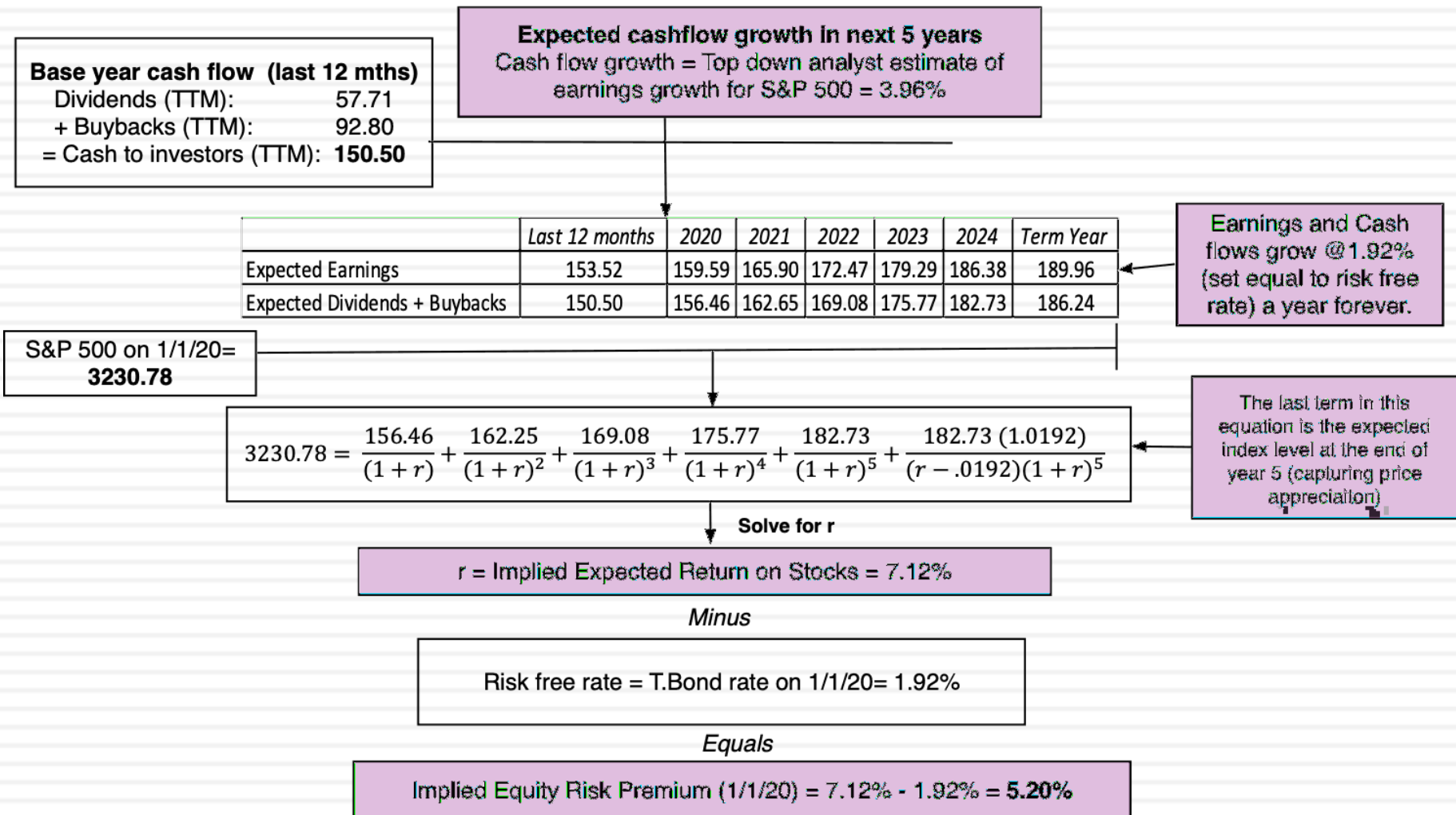
# ERP: A Historical Snapshot

	Arithmetic Average		Geometric Average	
	Stocks - T. Bills	Stocks - T. Bonds	Stocks - T. Bills	Stocks - T. Bonds
1928-2019	8.18%	6.43%	6.35%	4.83%
Std Error	2.08%	2.20%		
1970-2019	7.26%	4.50%	5.93%	3.52%
Std Error	2.38%	2.73%		
2010-2019	13.51%	9.67%	12.93%	9.31%
Std Error	3.85%	4.87%		

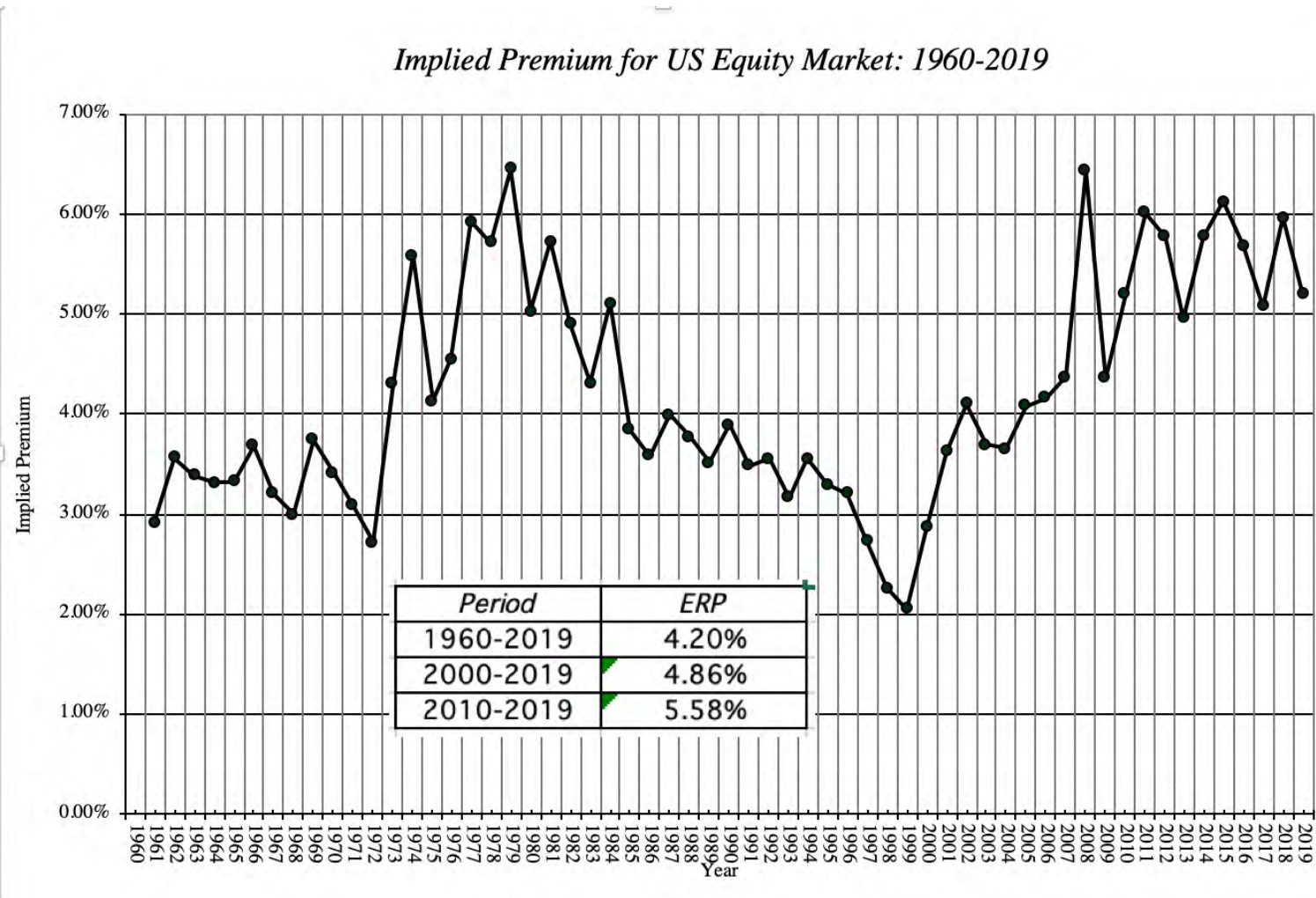
Historical  
premium  
for the US

- If you are going to use a historical risk premium, make it
  - ▣ Long term (because of the standard error)
  - ▣ Consistent with your risk free rate
  - ▣ A “compounded” average
- No matter which estimate you use, recognize that it is backward looking, is noisy and may reflect selection bias.

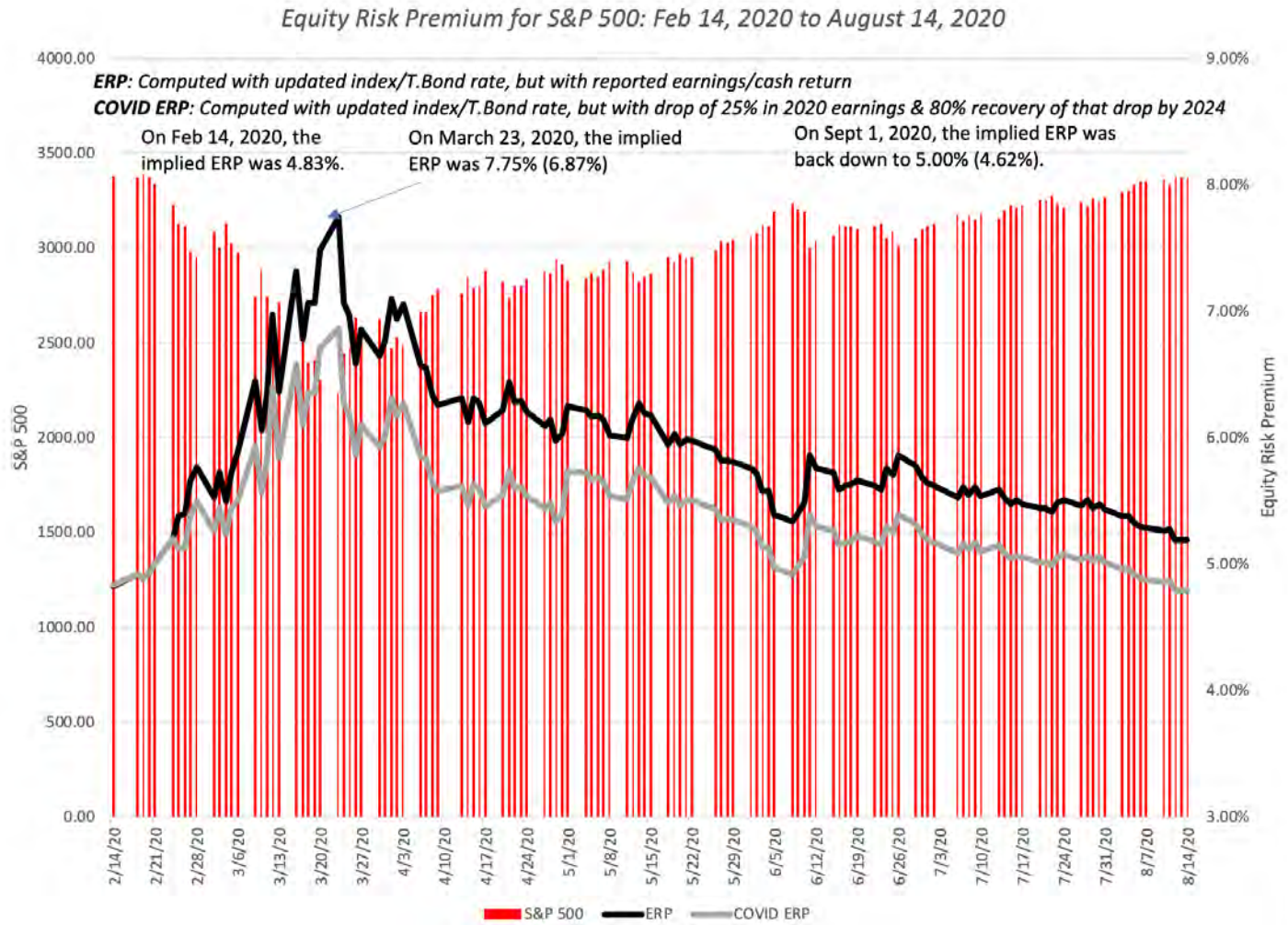
# An Implied ERP



# Implied Premiums in the US: 1960-2019



# The Price of Equity Risk: COVID



# The bottom line on Equity Risk Premiums in November 2013

- Mature Markets: In November 2013, the number that we chose to use as the equity risk premium for all mature markets was 5.5%. This was set equal to the implied premium at that point in time and it was much higher than the historical risk premium of 4.20% prevailing then (1928-2012 period).

	Arithmetic Average		Geometric Average	
	Stocks - T. Bills	Stocks - T. Bonds	Stocks - T. Bills	Stocks - T. Bonds
1928-2012	7.65%	5.88%	5.74%	4.20%
	2.20%	2.33%		
1962-2012	5.93%	3.91%	4.60%	2.93%
	2.38%	2.66%		
2002-2012	7.06%	3.08%	5.38%	1.71%
	5.82%	8.11%		

- For emerging markets, the historical data option is not useful, since most of these markets have too short a history to compute a risk premium. The implied premium can be computed, but some of the inputs (especially growth) are tough to get.

# Country Risk: Look at a country's bond rating and default spreads as a start – Brazil in November 2013

- In this approach, the country equity risk premium is set equal to the default spread for the country, estimated in one of three ways. In November 2013, for Brazil, this would have yielded three numbers:
  - The default spread on a dollar denominated bond issued by the country. (In November 2013, that spread was 5.25% for the Brazilian \$ bond)
  - The sovereign CDS spread for the country. In November 2013, the ten year CDS spread for Brazil was 2.59%.
  - The default spread based on the local currency rating for the country. Brazil's sovereign local currency rating is Baa3 and the default spread for a Baa3 rated sovereign was about 2.00% in November 2013.
- Many analysts add this default spread to the US risk premium to come up with a risk premium for a country. This would yield a risk premium of 7.50% for Brazil, if we use 5.50% as the US risk premium (in November 2013) and the default spread based on the rating.



# Beyond the default spread

- Country ratings measure default risk. While default risk premiums and equity risk premiums are highly correlated, one would expect equity spreads to be higher than debt spreads.
- Another is to multiply the bond default spread by the relative volatility of stock and bond prices in that market. Using this approach for Brazil in November 2013, you would get:
  - Country Equity risk premium = Default spread on country bond\*  $\frac{\sigma_{\text{Equity}}}{\sigma_{\text{Country Bond}}}$ 
    - Standard Deviation in Bovespa (Equity) = 21%
    - Standard Deviation in Brazil government bond = 14%
    - Default spread on Brazilian \$ bond = 2.00%
  - Brazil Country Risk Premium = 2.00% (21%/14%) = 3.00%
  - Brazil Total ERP = Mature Market Premium + CRP = 5.5% + 3.00% = 8.50%

# ERP : Nov 2013

Andorra	7.45%	1.95%	Liechtenstein	5.50%	0.00%
Austria	5.50%	0.00%	Luxembourg	5.50%	0.00%
Belgium	6.70%	1.20%	Malta	7.45%	1.95%
Cyprus	22.00%	16.50%	Netherlands	5.50%	0.00%
Denmark	5.50%	0.00%	Norway	5.50%	0.00%
Finland	5.50%	0.00%	Portugal	10.90%	5.40%
France	5.95%	0.45%	Spain	8.88%	3.38%
Germany	5.50%	0.00%	Sweden	5.50%	0.00%
Greece	15.63%	10.13%	Switzerland	5.50%	0.00%
Iceland	8.88%	3.38%	Turkey	8.88%	3.38%
Ireland	9.63%	4.13%	United Kingdom	5.95%	0.45%
Italy	8.50%	3.00%	<b>Western Europe</b>	<b>6.72%</b>	<b>1.22%</b>

Albania	12.25%	6.75%
Armenia	10.23%	4.73%
Azerbaijan	8.88%	3.38%
Belarus	15.63%	10.13%
Bosnia	15.63%	10.13%
Bulgaria	8.50%	3.00%
Croatia	9.63%	4.13%
Czech Republic	6.93%	1.43%
Estonia	6.93%	1.43%
Georgia	10.90%	5.40%
Hungary	9.63%	4.13%
Kazakhstan	8.50%	3.00%
Latvia	8.50%	3.00%
Lithuania	8.05%	2.55%
Macedonia	10.90%	5.40%
Moldova	15.63%	10.13%
Montenegro	10.90%	5.40%
Poland	7.15%	1.65%
Romania	8.88%	3.38%
Russia	8.05%	2.55%
Serbia	10.90%	5.40%
Slovakia	7.15%	1.65%
Slovenia	9.63%	4.13%
Ukraine	15.63%	10.13%
<b>E. Europe &amp; Russia</b>	<b>8.60%</b>	<b>3.10%</b>

Bangladesh	10.90%	5.40%
Cambodia	13.75%	8.25%
China	6.94%	1.44%
Fiji	12.25%	6.75%
Hong Kong	5.95%	0.45%
India	9.10%	3.60%
Indonesia	8.88%	3.38%
Japan	6.70%	1.20%
Korea	6.70%	1.20%
Macao	6.70%	1.20%
Malaysia	7.45%	1.95%
Mauritius	8.05%	2.55%
Mongolia	12.25%	6.75%
Pakistan	17.50%	12.00%
Papua NG	12.25%	6.75%
Philippines	9.63%	4.13%
Singapore	5.50%	0.00%
Sri Lanka	12.25%	6.75%
Taiwan	6.70%	1.20%
Thailand	8.05%	2.55%
Vietnam	13.75%	8.25%
<b>Asia</b>	<b>7.27%</b>	<b>1.77%</b>

Canada	5.50%	0.00%
United States of America	5.50%	0.00%
<b>North America</b>	<b>5.50%</b>	<b>0.00%</b>

Country	TRP	CRP
Angola	10.90%	5.40%
Benin	13.75%	8.25%
Botswana	7.15%	1.65%
Burkina Faso	13.75%	8.25%
Cameroon	13.75%	8.25%
Cape Verde	12.25%	6.75%
Egypt	17.50%	12.00%
Gabon	10.90%	5.40%
Ghana	12.25%	6.75%
Kenya	12.25%	6.75%
Morocco	9.63%	4.13%
Mozambique	12.25%	6.75%
Namibia	8.88%	3.38%
Nigeria	10.90%	5.40%
Rwanda	13.75%	8.25%
Senegal	12.25%	6.75%
South Africa	8.05%	2.55%
Tunisia	10.23%	4.73%
Uganda	12.25%	6.75%
Zambia	12.25%	6.75%
<b>Africa</b>	<b>11.22%</b>	<b>5.82%</b>

Bahrain	8.05%	2.55%
Israel	6.93%	1.43%
Jordan	12.25%	6.75%
Kuwait	6.40%	0.90%
Lebanon	12.25%	6.75%
Oman	6.93%	1.43%
Qatar	6.40%	0.90%
Saudi Arabia	6.70%	1.20%
United Arab Emirates	6.40%	0.90%
<b>Middle East</b>	<b>6.88%</b>	<b>1.38%</b>

Australia	5.50%	0.00%
Cook Islands	12.25%	6.75%
New Zealand	5.50%	0.00%
<b>Australia &amp; NZ</b>	<b>5.50%</b>	<b>0.00%</b>

Argentina	15.63%	10.13%
Belize	19.75%	14.25%
Bolivia	10.90%	5.40%
Brazil	8.50%	3.00%
Chile	6.70%	1.20%
Colombia	8.88%	3.38%
Costa Rica	8.88%	3.38%
Ecuador	17.50%	12.00%
El Salvador	10.90%	5.40%
Guatemala	9.63%	4.13%
Honduras	13.75%	8.25%
Mexico	8.05%	2.55%
Nicaragua	15.63%	10.13%
Panama	8.50%	3.00%
Paraguay	10.90%	5.40%
Peru	8.50%	3.00%
Suriname	10.90%	5.40%
Uruguay	8.88%	3.38%
Venezuela	12.25%	6.75%
<b>Latin America</b>	<b>9.44%</b>	<b>3.94%</b>

Black #: Total ERP  
 Red #: Country risk premium  
 AVG: GDP weighted average

# Estimating ERP for Disney: November 2013

- Incorporation: The conventional practice on equity risk premiums is to estimate an ERP based upon where a company is incorporated. Thus, the cost of equity for Disney would be computed based on the US equity risk premium, because it is a US company, and the Brazilian ERP would be used for Vale, because it is a Brazilian company.
- Operations: The more sensible practice on equity risk premium is to estimate an ERP based upon where a company operates. For Disney in 2013:

<i>Region/ Country</i>	<i>Proportion of Disney's Revenues</i>	<i>ERP</i>
US& Canada	82.01%	5.50%
Europe	11.64%	6.72%
Asia-Pacific	6.02%	7.27%
Latin America	0.33%	9.44%
<b>Disney</b>	<b>100.00%</b>	<b>5.76%</b>

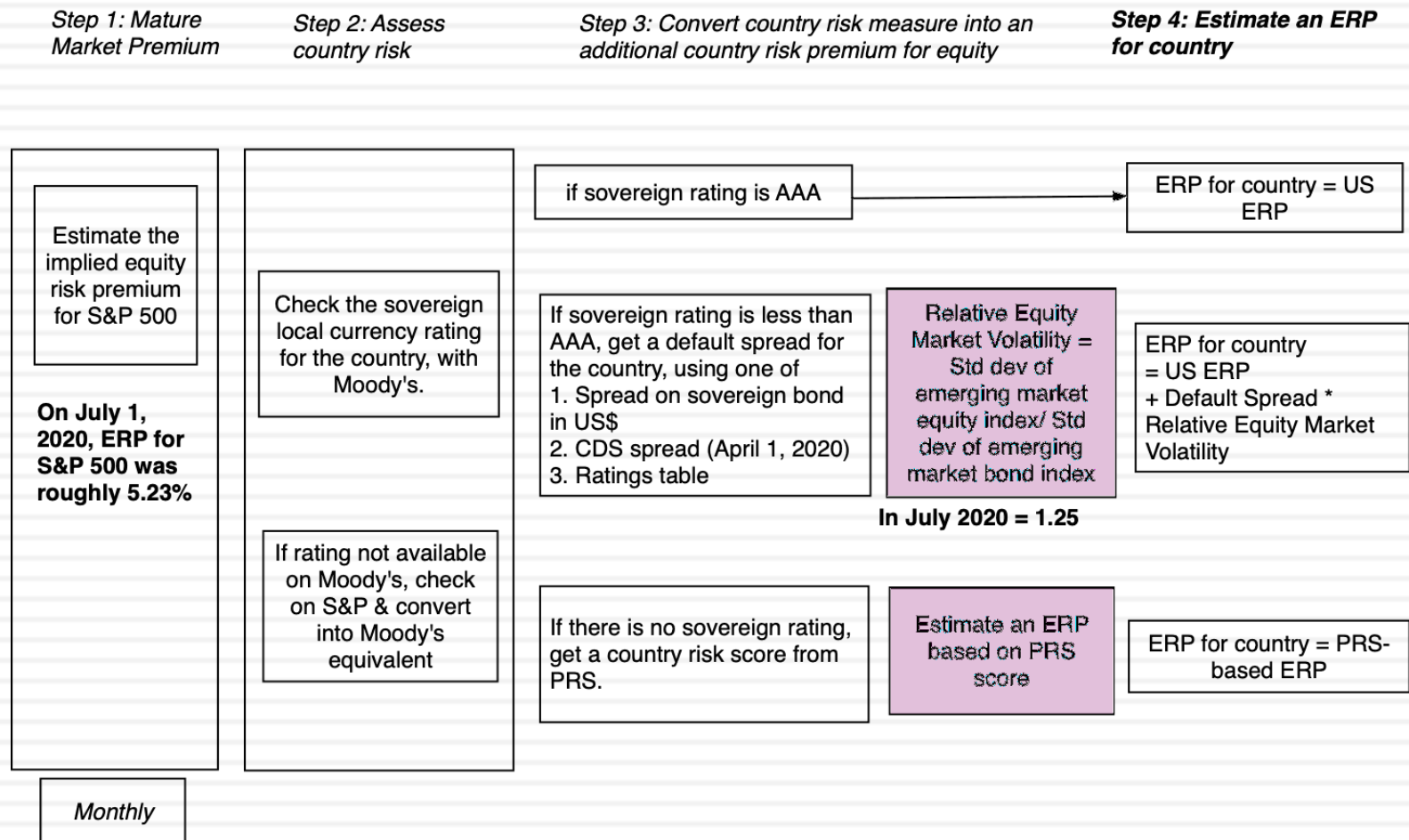
# ERP for the Rest: November 2013

In November 2013,  
the mature market  
premium used was  
5.5%

<i>Company</i>	<i>Region/ Country</i>	<i>Weight</i>	<i>ERP</i>
Bookscape	United States	100%	5.50%
Vale	US & Canada	4.90%	5.50%
	Brazil	16.90%	8.50%
	Rest of Latin America	1.70%	10.09%
	China	37.00%	6.94%
	Japan	10.30%	6.70%
	Rest of Asia	8.50%	8.61%
	Europe	17.20%	6.72%
	Rest of World	3.50%	10.06%
	Company	100.00%	7.38%
Tata Motors	India	23.90%	9.10%
	China	23.60%	6.94%
	UK	11.90%	5.95%
	United States	10.00%	5.50%
	Mainland Europe	11.70%	6.85%
	Rest of World	18.90%	6.98%
	Company	100.00%	7.19%
Baidu	China	100%	6.94%
Deutsche Bank	Germany	35.93%	5.50%
	North America	24.72%	5.50%
	Rest of Europe	28.67%	7.02%
	Asia-Pacific	10.68%	7.27%
	South America	0.00%	9.44%
	Company	100.00%	6.12%

# A Template for Estimating the ERP: July 1, 2020

## ERP Estimation Procedure - July 1, 2020





ERP : July 1, 2020

Andorra	7.08%	9.49%	8.03%	Italy	7.37%	10.04%	8.46%
Austria	5.59%	6.74%	5.81%	Jersey	5.89%	7.30%	6.12%
Belgium	5.80%	7.12%	6.12%	Liechtenstein	5.20%	6.01%	5.23%
Cyprus	8.16%	11.51%	9.64%	Luxembourg	5.20%	6.01%	5.23%
Denmark	5.20%	6.01%	5.23%	Malta	6.04%	7.56%	6.48%
Finland	5.59%	6.74%	5.81%	Netherlands	5.20%	6.01%	5.23%
France	5.69%	6.92%	5.96%	Norway	5.20%	6.01%	5.23%
Germany	5.20%	6.01%	5.23%	Portugal	7.37%	10.04%	8.46%
Greece	9.64%	14.25%	11.84%	Spain	6.77%	8.93%	7.58%
Guernsey	6.77%	8.93%	6.12%	Sweden	5.20%	6.01%	5.23%
Iceland	6.04%	7.56%	6.48%	Switzerland	5.20%	6.01%	5.23%
Ireland	6.04%	7.56%	6.48%	Turkey	9.64%	14.25%	11.84%
Isle of Man	5.69%	6.92%	5.96%	United Kingdom	5.69%	6.92%	5.96%

Country	1/20	4/20	7/20
Angola	11.62%	17.91%	14.79%
Benin	10.63%	16.08%	13.32%
Botswana	6.04%	7.56%	6.48%
Burkina Faso	10.63%	16.08%	13.32%
Cameroon	10.63%	16.08%	13.32%
Cape Verde	10.63%	16.08%	13.32%
Congo (DR)	12.59%	19.73%	16.25%
Congo (Rep)	14.08%	22.49%	18.46%
Côte d'Ivoire	8.75%	12.60%	10.52%
Egypt	10.63%	16.08%	13.32%
Ethiopia	9.64%	14.25%	13.32%
Gabon	12.59%	19.73%	16.25%
Ghana	11.62%	17.91%	14.79%
Kenya	10.63%	16.08%	13.32%
Mali	11.62%	17.91%	14.79%
Morocco	7.66%	10.58%	8.90%
Mozambique	14.08%	22.49%	18.46%
Namibia	8.16%	11.51%	9.64%
Niger	11.62%	17.91%	14.79%
Nigeria	10.63%	16.08%	13.32%
Rwanda	10.63%	16.08%	13.32%
Senegal	8.75%	12.60%	10.52%
South Africa	7.37%	10.58%	8.90%
Swaziland	10.63%	16.08%	13.32%
Tanzania	9.64%	14.25%	11.84%
Togo	11.62%	17.91%	14.79%
Tunisia	10.63%	16.08%	13.32%
Uganda	10.63%	16.08%	13.32%
Zambia	14.08%	27.97%	22.86%

Canada	5.20%	6.01%	5.23%
United States	5.20%	6.01%	5.23%

Argentina	14.08%	27.97%	22.86%
Belize	11.62%	17.91%	16.25%
Bolivia	8.75%	14.25%	11.84%
Brazil	8.16%	11.51%	9.64%
Chile	5.89%	7.30%	6.26%
Colombia	7.08%	9.49%	8.03%
Costa Rica	9.64%	16.08%	13.32%
Ecuador	11.62%	24.30%	19.92%
El Salvador	11.62%	17.91%	14.79%
Guatemala	7.66%	10.58%	8.90%
Honduras	9.64%	14.25%	11.84%
Mexico	6.38%	8.21%	7.58%
Nicaragua	10.63%	17.91%	14.79%
Panama	6.77%	8.93%	7.58%
Paraguay	7.66%	10.58%	8.90%
Peru	6.38%	8.21%	6.99%
Suriname	10.63%	16.08%	14.79%
Uruguay	7.08%	9.49%	8.03%
Venezuela	22.89%	29.46%	27.14%

Albania	9.64%	14.25%	11.84%
Armenia	8.75%	12.60%	10.52%
Azerbaijan	8.16%	11.51%	9.64%
Belarus	11.62%	17.91%	14.79%
Bosnia and Herzegovina	11.62%	17.91%	14.79%
Bulgaria	7.08%	9.49%	8.03%
Croatia	8.16%	11.51%	9.64%
Czech Republic	5.80%	7.12%	6.12%
Estonia	5.89%	7.30%	6.26%
Georgia	8.16%	11.51%	9.64%
Hungary	7.37%	10.04%	8.46%
Kazakhstan	7.37%	10.04%	8.46%
Kyrgyzstan	10.63%	16.08%	13.32%
Latvia	6.38%	8.21%	6.99%
Lithuania	6.38%	8.21%	6.99%
Macedonia	8.75%	12.60%	10.52%
Moldova	11.62%	17.91%	14.79%
Montenegro	9.64%	14.25%	11.84%
Poland	6.04%	7.56%	6.48%
Romania	7.37%	10.04%	8.46%
Russia	7.37%	10.04%	8.46%
Serbia	8.75%	12.60%	10.52%
Slovakia	6.04%	7.56%	6.48%
Slovenia	6.77%	8.93%	7.58%
Tajikistan	11.62%	17.91%	14.79%
Ukraine	12.59%	19.73%	14.79%
Uzbekistan	9.64%	14.25%	11.84%

Abu Dhabi	5.69%	6.92%	5.96%
Bahrain	10.63%	16.08%	13.32%
Iraq	12.59%	19.73%	16.25%
Israel	5.89%	7.30%	6.26%
Jordan	9.64%	14.25%	11.84%
Kuwait	5.69%	6.92%	5.96%
Lebanon	14.08%	27.97%	22.86%
Oman	7.66%	11.51%	10.52%
Qatar	5.80%	7.12%	6.12%
Ras Al Khaimah (Emirate of)	12.59%	19.73%	6.48%
Saudi Arabia	5.89%	7.30%	6.26%
Sharjah	6.38%	9.49%	8.03%
United Arab Emirates	5.69%	6.92%	5.96%

Region	Weighted Average: ERP
Africa	12.42%
Asia	6.78%
Australia & New Zealand	5.23%
Caribbean	13.37%
Central and South America	10.70%
Eastern Europe & Russia	8.42%
Middle East	7.70%
North America	5.23%
Western Europe	6.44%
Global	6.76%

Country	PRS	1-Jan	1-Apr	1-Jul
Algeria	55	11.62%	17.91%	22.86%
Brunei	80	5.59%	6.74%	6.48%
Gambia	63.5	11.62%	17.91%	14.79%
Guinea	54	15.06%	24.30%	22.86%
Guinea-Bissau	62	11.62%	17.91%	16.25%
Guyana	65	11.62%	17.91%	13.32%
Haiti	54.5	14.08%	22.49%	22.86%
Iran	58.5	11.62%	17.91%	18.46%
Korea, D.P.R.	50.3	17.03%	27.97%	22.86%
Liberia	53.5	21.71%	31.93%	22.86%
Libya	58.3	8.16%	11.51%	18.46%
Madagascar	63	10.63%	16.08%	14.79%
Malawi	57.8	11.62%	17.91%	18.46%
Myanmar	62.8	11.62%	17.91%	14.79%
Sierra Leone	59	15.06%	24.30%	18.46%
Somalia	50.5	17.03%	27.97%	22.86%
Sudan	36.3	21.71%	31.93%	27.14%
Syria	53.8	17.03%	27.97%	22.86%
Yemen, Republic	50	17.03%	27.97%	27.14%
Zimbabwe	51.3	17.03%	27.97%	22.86%

Bangladesh	8.75%	12.60%	10.52%
Cambodia	10.63%	16.08%	13.32%
China	5.89%	7.30%	6.26%
Fiji	8.75%	12.60%	10.52%
Hong Kong	5.69%	7.12%	6.12%
India	7.08%	9.49%	8.46%
Indonesia	7.08%	9.49%	8.03%
Japan	5.89%	7.30%	6.26%
Korea	5.69%	6.92%	5.96%
Laos	NA	8.21%	6.99%
Macao	5.80%	7.12%	6.12%
Malaysia	6.38%	8.21%	6.99%
Maldives	10.63%	16.08%	14.79%
Mauritius	6.77%	8.93%	7.58%
Mongolia	11.62%	17.91%	14.79%
Pakistan	11.62%	17.91%	14.79%
Papua New Guinea	10.63%	16.08%	13.32%
Philippines	7.08%	9.49%	8.03%
Singapore	5.20%	6.01%	5.23%
Solomon Islands	11.62%	17.91%	14.79%
Sri Lanka	10.63%	16.08%	13.32%
Taiwan	5.80%	7.12%	6.12%
Thailand	6.77%	8.93%	7.58%
Vietnam	8.75%	12.60%	10.52%

Australia	5.20%	6.01%	5.23%
Cook Islands	9.64%	14.25%	11.84%
New Zealand	5.20%	6.01%	5.23%

Blue: ERP on 7/1/20  
 Red: ERP on 4/1/20  
 Green: ERP on 1/1/20

# ⌚ Application Test: Estimating a Market Risk Premium

- For your company, get the geographical breakdown of revenues in the most recent year. Based upon this revenue breakdown and the most recent country risk premiums, estimate the equity risk premium that you would use for your company.
- This computation was based entirely on revenues. With your company, what concerns would you have about your estimate being too high or too low?

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# III. The Beta

- The beta of a stock (asset) measures its exposure to market risk, i.e., the risk that cannot be diversified away by the marginal investors. It is therefore a measure of exposure to broad macroeconomic risk factors.
- The beta of a stock is standardized around one.
  - A beta that is greater than one indicates above-average risk
  - A beta that is close to one indicates average risk
  - A beta less than one indicates below average risk
  - A beta below zero is a indication of a market risk reducing investment
- Implications:
  - The weighted average beta of stocks in any market (even the most risky ones) is one. Thus, beta cannot carry the weight of country risk.
  - A stock can be risky and have a low beta, if most of the risk in the stock is firm-specific risk.

# Measuring Beta

- The standard procedure is to regress stock returns ( $R_j$ ) against market returns ( $R_m$ ):

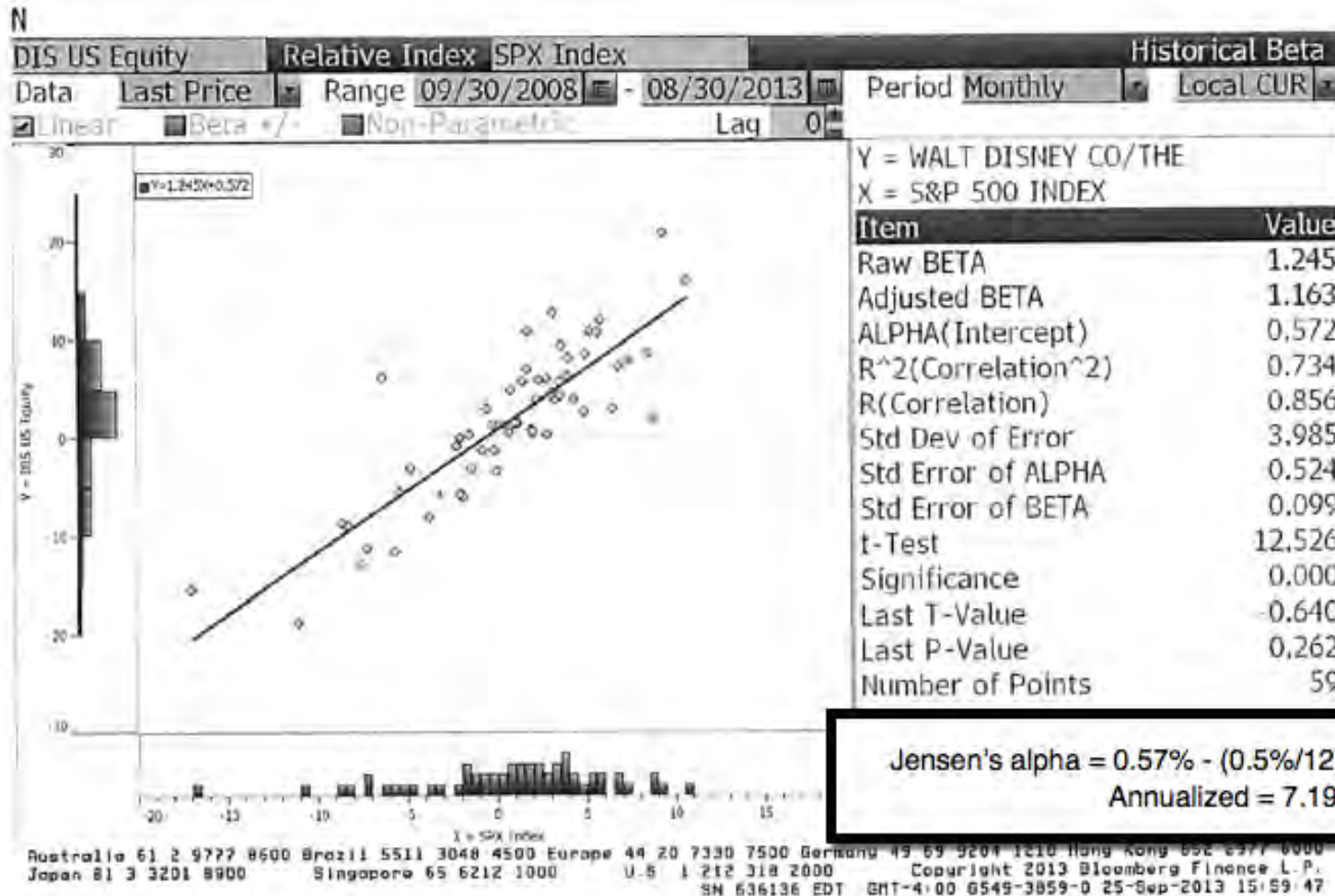
$$R_j = a + b R_m$$

- Risk measure: The slope of the regression ( $b$ ) corresponds to the beta of the stock, and measures the riskiness of the stock. The regression yields a range on the beta that can be computed from the standard error of the beta estimate.
  - Plus (minus) one standard errors: 67% confidence interval
  - Plus (minus) two standard errors: 95% confidence interval
- Performance measure: The intercept ( $a$ ) of the regression is a measure of how well or badly the stock performed during the period of the regression, after adjusting for risk and market performance. If the regression is run with raw returns, the intercept has to be compared to  $R_f (1 - \text{Beta})$  to measure what's called **Jensen's alpha ( $a - R_f (1 - \text{Beta})$ )**
  - $a > R_f (1 - b)$  : Positive Jensen's alpha = Stock did better than expected during regression period
  - $a = R_f (1 - b)$  : Zero Jensen's alpha = Stock did as wellr than expected during regression period
  - $a < R_f (1 - b)$  : Negative Jensen's alpha = Stock did worse than expected during regression period
- Risk source: The R squared ( $R^2$ ) of the regression provides an estimate of the proportion of the risk (variance) of a firm that can be attributed to market risk.

# Setting up for the Estimation

- Decide on an estimation period
  - ▣ Services use periods ranging from 2 to 5 years for the regression
  - ▣ Longer estimation period provides more data, but firms change.
  - ▣ Shorter periods can be affected more easily by significant firm-specific event that occurred during the period.
- Decide on a return interval - daily, weekly, monthly
  - ▣ Shorter intervals yield more observations, but suffer from more noise.
  - ▣ Noise is created by stocks not trading and biases all betas towards one.
- Estimate returns (including dividends) on stock
  - ▣  $\text{Return} = (\text{Price}_{\text{End}} - \text{Price}_{\text{Beginning}} + \text{Dividends}_{\text{Period}}) / \text{Price}_{\text{Beginning}}$
  - ▣ Included dividends only in ex-dividend month
- Choose a market index, and estimate returns (inclusive of dividends) on the index for each interval for the period.

# Disney: Beta Regression



The risk free rate used in the Jensen's alpha is the average, short term risk free rate during the period of the regression.

# Estimating Expected Returns for Disney in November 2013

- Inputs to the expected return calculation
  - ▣ Disney's Beta = 1.25
  - ▣ Riskfree Rate = 2.75% (U.S. ten-year T.Bond rate in November 2013)
  - ▣ Risk Premium = 5.76% (Based on Disney's operating exposure)

$$\begin{aligned}\text{Expected Return} &= \text{Riskfree Rate} + \text{Beta} (\text{Risk Premium}) \\ &= 2.75\% + 1.25 (5.76\%) = 9.95\%\end{aligned}$$

# Use to a Potential Investor in Disney

- As a potential investor in Disney, what does this expected return of 9.95% tell you?
  - This is the return that I can expect to make in the long term on Disney, if the stock is correctly priced and the CAPM is the right model for risk,
  - This is the return that I need to make on Disney in the long term to break even on my investment in the stock
  - Both
- Assume now that you are an active investor and that your research suggests that an investment in Disney will yield 12.5% a year for the next 5 years. Based upon the expected return of 9.95%, you would
  - Buy the stock
  - Sell the stock

# How managers use this expected return

- Managers at Disney
  - need to make at least 9.95% as a return for their equity investors to break even.
  - this is the hurdle rate for projects, when the investment is analyzed from an equity standpoint
- In other words, Disney's cost of equity is 9.95%.
- What is the cost of not delivering this cost of equity?



# The problem with regression betas

- They are backward looking: By definition, a regression beta is backward looking because it is computed based upon past returns. Consequently, if a company's business mix or financial leverage has changed during the regression period, the regression beta (even if well estimated) is no longer operational.
- They are subject to manipulation: Changing the market index used, the time period of the regression or even the return intervals (daily, weekly, monthly) can yield very different regression output.
- They are noisy: A regression slope (which is what we use as a beta) comes with a standard error, and if you regress a stock against a broad enough index, the regression beta should have a high standard error (it is a feature, not a bug)>

# Beta: Exploring Fundamentals

Beta > 2	Bulgari: 2.45
Beta between 1 and 2	Qwest Communications: 1.85
	Microsoft: 1.25
	GE: 1.15
Beta < 1	Exxon Mobil: 0.70
	Altria (Philip Morris): 0.60
Beta < 0	Harmony Gold Mining: -0.15

# Determinant 1: Product Type

- Industry Effects: The beta value for a firm depends upon the sensitivity of the demand for its products and services and of its costs to macroeconomic factors that affect the overall market.
  - ▣ Cyclical companies have higher betas than non-cyclical firms
  - ▣ Firms which sell more discretionary products will have higher betas than firms that sell less discretionary products

# Determinant 2: Operating Leverage Effects

- Operating leverage refers to the proportion of the total costs of the firm that are fixed.
- Other things remaining equal, higher operating leverage results in greater earnings variability which in turn results in higher betas.

# Measuring Disney's Operating Leverage: 1987- 2013

Year	Net Sales	% Change in Sales	EBIT	% Change in EBIT	
1987	\$2,877		\$756		
1988	\$3,438	19.50%	\$848	12.17%	
1989	\$4,594	33.62%	\$1,177	38.80%	
1990	\$5,844	27.21%	\$1,368	16.23%	
1991	\$6,182	5.78%	\$1,124	-17.84%	
1992	\$7,504	21.38%	\$1,287	14.50%	
1993	\$8,529	13.66%	\$1,560	21.21%	
1994	\$10,055	17.89%	\$1,804	15.64%	
1995	\$12,112	20.46%	\$2,262	25.39%	
1996	\$18,739	54.71%	\$3,024	33.69%	
1997	\$22,473	19.93%	\$3,945	30.46%	
1998	\$22,976	2.24%	\$3,843	-2.59%	
1999	\$23,435	2.00%	\$3,580	-6.84%	
2000	\$25,418	8.46%	\$2,525	-29.47%	
2001	\$25,172	-0.97%	\$2,832	12.16%	
2002	\$25,329	0.62%	\$2,384	-15.82%	
2003	\$27,061	6.84%	\$2,713	13.80%	
2004	\$30,752	13.64%	\$4,048	49.21%	
2005	\$31,944	3.88%	\$4,107	1.46%	
2006	\$33,747	5.64%	\$5,355	30.39%	
2007	\$35,510	5.22%	\$6,829	27.53%	
2008	\$37,843	6.57%	\$7,404	8.42%	
2009	\$36,149	-4.48%	\$5,697	-23.06%	
2010	\$38,063	5.29%	\$6,726	18.06%	
2011	\$40,893	7.44%	\$7,781	15.69%	
2012	\$42,278	3.39%	\$8,863	13.91%	
2013	\$45,041	6.54%	\$9,450	6.62%	
<b>Average: 87-13</b>		<b>11.79%</b>		<b>11.91%</b>	<b>11.91/11.79 =1.01</b>
<b>Average: 96-13</b>		<b>8.16%</b>		<b>10.20%</b>	<b>10.20/8.16 =1.25</b>

Average across entertainment companies = 1.35

Given Disney's operating leverage measures (1.01 or 1.25), would you expect Disney to have a higher or a lower beta than other entertainment companies?

- a.Higher
- b.Lower
- c.No effect

# Determinant 3: Financial Leverage

- As firms borrow, they create fixed costs (interest payments) that make their earnings to equity investors more volatile.
- This increased earnings volatility which increases the equity beta.
- The beta of equity alone can be written as a function of the unlevered beta and the debt-equity ratio
- $\beta_L = \beta_U (1 + ((1-t)D/E))$   
where
  - $\beta_L$  = Levered or Equity Beta      $D/E$  = Market value Debt to equity ratio
  - $\beta_U$  = Unlevered or Asset Beta      $t$  = Marginal tax rate
- Earlier, we estimated the beta for Disney from a regression. Was that beta a levered or unlevered beta?
  - a. Levered
  - b. Unlevered

# Effects of leverage on betas: Disney

- The regression beta for Disney is 1.25. This beta is a levered beta (because it is based on stock prices, which reflect leverage) and the leverage implicit in the beta estimate is the average market debt equity ratio during the period of the regression (2008 to 2013)
- The average debt equity ratio during this period was 19.44%.
- The unlevered beta for Disney can then be estimated (using a marginal tax rate of 36.1%)  
= Current Beta / (1 + (1 - tax rate) (Average Debt/Equity))  
= 1.25 / (1 + (1 - 0.361)(0.1944))= 1.1119



# Disney : Beta and Financial Leverage

<i>Debt to Capital</i>	<i>Debt/Equity Ratio</i>	<i>Beta</i>	<i>Effect of Leverage</i>
0.00%	0.00%	1.11	0.00
10.00%	11.11%	1.1908	0.08
20.00%	25.00%	1.29	0.18
30.00%	42.86%	1.42	0.30
40.00%	66.67%	1.59	0.47
50.00%	100.00%	1.82	0.71
60.00%	150.00%	2.18	1.07
70.00%	233.33%	2.77	1.66
80.00%	400.00%	3.95	2.84
90.00%	900.00%	7.51	6.39

# Betas are weighted Averages

- The beta of a portfolio is always the market-value weighted average of the betas of the individual investments in that portfolio.
- Thus,
  - the beta of a mutual fund is the weighted average of the betas of the stocks and other investment in that portfolio
  - the beta of a firm after a merger is the market-value weighted average of the betas of the companies involved in the merger.

# Bottom-up versus Top-down Beta

- The top-down beta for a firm comes from a regression
- The bottom up beta can be estimated by doing the following:
  - ▣ Find out the businesses that a firm operates in
  - ▣ Find the unlevered betas of other firms in these businesses
  - ▣ Take a weighted (by sales or operating income) average of these unlevered betas
  - ▣ Lever up using the firm's debt/equity ratio
- The bottom up beta is a better estimate than the top down beta for the following reasons
  - ▣ The standard error of the beta estimate will be much lower
  - ▣ The betas can reflect the current (and even expected future) mix of businesses that the firm is in rather than the historical mix

# Disney's businesses: The financial breakdown (from 2013 annual report)

<i>Business</i>	<i>Revenues</i>	<i>Operating Income</i>	<i>D&amp;A</i>	<i>EBITDA</i>	<i>S, G &amp; A Costs</i>	<i>Cap Ex</i>	<i>Identifiable Assets</i>
Media Networks	\$20,356	\$6,818	\$251	\$7,069	\$2,768	\$263	\$28,627
Parks & Resorts	\$14,087	\$2,220	\$1,370	\$3,590	\$1,960	\$2,110	\$22,056
Studio Entertainment	\$5,979	\$661	\$161	\$822	\$2,145	\$78	\$14,750
Consumer Products	\$3,555	\$1,112	\$146	\$1,258	\$731	\$45	\$7,506
Interactive	\$1,064	-\$87	\$44	-\$43	\$449	\$13	\$2,311

# Unlevered Betas for businesses

Unlevered Beta  
 $(1 - \text{Cash} / \text{Firm Value})$

<i>Business</i>	<i>Comparable firms</i>	<i>Sample size</i>	<i>Median Beta</i>	<i>Median D/E</i>	<i>Median Tax rate</i>	<i>Company Unlevered Beta</i>	<i>Median Cash/ Firm Value</i>	<i>Business Unlevered Beta</i>
Media Networks	US firms in broadcasting business	26	1.43	71.09%	40.00%	1.0024	2.80%	1.0313
Parks & Resorts	Global firms in amusement park business	20	0.87	46.76%	35.67%	0.6677	4.95%	0.7024
Studio Entertainment	US movie firms	10	1.24	27.06%	40.00%	1.0668	2.96%	1.0993
Consumer Products	Global firms in toys/games production & retail	44	0.74	29.53%	25.00%	0.6034	10.64%	0.6752
Interactive	Global computer gaming firms	33	1.03	3.26%	34.55%	1.0085	17.25%	1.2187

# Disney's unlevered beta: Operations & Entire Company

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

Disney has \$3.93 billion in cash, invested in close to riskless assets (with a beta of zero).  
You can compute an unlevered beta for Disney as a company (inclusive of cash):

$$\beta_{\text{Disney}} = \beta_{\text{Operating Assets}} \frac{\text{Value}_{\text{Operating Assets}}}{(\text{Value}_{\text{Operating Assets}} + \text{Value}_{\text{Cash}})} + \beta_{\text{Cash}} \frac{\text{Value}_{\text{Cash}}}{(\text{Value}_{\text{Operating Assets}} + \text{Value}_{\text{Cash}})}$$

$$= 0.9239 \left( \frac{135,132}{(135,132 + 3,931)} \right) + 0.00 \left( \frac{3,931}{(135,132 + 3,931)} \right) = 0.8978$$

# The levered beta: Disney and its divisions

- To estimate the debt ratios for division, we allocate Disney's total debt (\$15,961 million) to its divisions based on identifiable assets.

<i>Business</i>	<i>Identifiable assets (2013)</i>	<i>Proportion of debt</i>	<i>Value of business</i>	<i>Allocated debt</i>	<i>Estimated equity</i>	<i>D/E ratio</i>
Media Networks	\$28,627	38.04%	\$66,580	\$6,072	\$60,508	10.03%
Parks & Resorts	\$22,056	29.31%	\$45,683	\$4,678	\$41,005	11.41%
Studio Entertainment	\$14,750	19.60%	\$18,234	\$3,129	\$15,106	20.71%
Consumer Products	\$7,506	9.97%	\$2,952	\$1,592	\$1,359	117.11%
Interactive	\$2,311	3.07%	\$1,684	\$490	\$1,194	41.07%
Disney	\$75,250	100.00%		\$15,961	\$121,878	13.10%

- We use the allocated debt to compute D/E ratios and levered betas.

<i>Business</i>	<i>Unlevered beta</i>	<i>Value of business</i>	<i>D/E ratio</i>	<i>Levered beta</i>	<i>Cost of Equity</i>
Media Networks	1.0313	\$66,580	10.03%	1.0975	9.07%
Parks & Resorts	0.7024	\$45,683	11.41%	0.7537	7.09%
Studio Entertainment	1.0993	\$18,234	20.71%	1.2448	9.92%
Consumer Products	0.6752	\$2,952	117.11%	1.1805	9.55%
Interactive	1.2187	\$1,684	41.07%	1.5385	11.61%
Disney Operations	0.9239	\$135,132	13.10%	1.0012	8.52%



# Discussion Issue

- Assume now that you are the CFO of Disney. The head of the movie business has come to you with a new big budget movie that he would like you to fund. He claims that his analysis of the movie indicates that it will generate a return on equity of 9.5%. Would you fund it?
  - a. Yes. It is higher than the cost of equity for Disney as a company
  - b. No. It is lower than the cost of equity for the movie business.
- What are the broader implications of your choice?

# Estimating Bottom Up Betas & Costs of Equity: Vale

<i>Business</i>	<i>Sample</i>	<i>Sample size</i>	<i>Unlevered beta of business</i>	<i>Revenues</i>	<i>Peer Group EV/Sales</i>	<i>Value of Business</i>	<i>Proportion of Vale</i>
Metals & Mining	Global firms in metals & mining, Market cap>\$1 billion	48	0.86	\$9,013	1.97	\$17,739	16.65%
Iron Ore	Global firms in iron ore	78	0.83	\$32,717	2.48	\$81,188	76.20%
Fertilizers	Global specialty chemical firms	693	0.99	\$3,777	1.52	\$5,741	5.39%
Logistics	Global transportation firms	223	0.75	\$1,644	1.14	\$1,874	1.76%
<i>Vale Operations</i>			<i>0.8440</i>	<i>\$47,151</i>		<i>\$106,543</i>	<i>100.00%</i>

Business	Unlevered beta	D/E ratio	Levered beta	Risk free rate	ERP	Cost of Equity
Metals & Mining	0.86	54.99%	1.1657	2.75%	7.38%	11.35%
Iron Ore	0.83	54.99%	1.1358	2.75%	7.38%	11.13%
Fertilizers	0.99	54.99%	1.3493	2.75%	7.38%	12.70%
Logistics	0.75	54.99%	1.0222	2.75%	7.38%	10.29%
Vale Operations	0.84	54.99%	1.1503	2.75%	7.38%	11.23%

# Vale: Cost of Equity Calculation – in nominal \$R

- To convert a discount rate in one currency to another, all you need are expected inflation rates in the two currencies.

$$(1 + \$ \text{ Cost of Equity}) \frac{(1 + \text{Inflation Rate}_{\text{Brazil}})}{(1 + \text{Inflation Rate}_{\text{US}})} - 1$$

- From US \$ to R\$: If we use 2% as the inflation rate in US dollars and 9% as the inflation ratio in Brazil, we can convert Vale's US dollar cost of equity of 11.23% to a \$R cost of equity:

$$\begin{aligned} \text{Cost of Equity}_{\text{Nominal RS}} &= (1 + \text{Cost of Equity}_{\text{US \$}}) \frac{(1 + \text{Expected Inflation}_{\text{RS}})}{(1 + \text{Expected Inflation}_{\text{US \$}})} - 1 \\ &= (1.1123) \frac{(1.09)}{(1.02)} - 1 = 18.87\% \end{aligned}$$

- Alternatively, you can compute a cost of equity, starting with the \$R riskfree rate of 10.18%.

$$\text{Cost of Equity in } \$R = 10.18\% + 1.15 (7.38\%) = 18.67\%$$

# Bottom up Betas and Costs of Equity: Deutsche Bank

- We break Deutsche Bank down into two businesses – commercial and investment banking.

<i>Business</i>	<i>Sample used</i>	<i>Sample size</i>	<i>Median Levered Beta</i>	<i>Deutsche Net Revenues in 2012</i>	<i>Proportion</i>
Banking	European diversified banks	84	1.0665	19,019 mil €	54.86%
Investment Banking	Global investment banks	58	1.2550	15,648 mil €	45.14%
Deutsche Bank			1.1516	34,667 mil €	

- We do not unlever or relever betas, because estimating debt and equity for banks is an exercise in futility.

<i>Business</i>	<i>Beta</i>	<i>Cost of Equity</i>
Commercial banking	1.0665	$1.75\% + 1.0665(6.12\%) = 8.28\%$
Investment Banking	1.2550	$1.75\% + 1.2550(6.12\%) = 9.44\%$
Deutsche Bank	1.1516	$1.75\% + 1.1516(6.12\%) = 8.80\%$

# Estimating Betas for Non-Traded Assets

- The conventional approaches of estimating betas from regressions do not work for assets that are not traded. There are no stock prices or historical returns that can be used to compute regression betas.
- There are two ways in which betas can be estimated for non-traded assets
  - ▣ Using comparable firms
  - ▣ Using accounting earnings

# Using comparable firms to estimate beta for Bookscape

<i>Company Name</i>	<i>Industry</i>	<i>Market Capitalization</i>	<i>Levered Beta</i>	<i>Marginal tax rate</i>	<i>Gross D/E ratio</i>	<i>Cash/Firm Value</i>	<i>R<sup>2</sup></i>
Red Giant Entertainment	Publishing	\$2.13	0.69	40.00%	0.00%	0.05%	0.1300
CTM Media Holdings	Publishing	\$25.20	1.04	40.00%	17.83%	33.68%	0.1800
Books-A-Million	Book Stores	\$38.60	1.42	40.00%	556.55%	4.14%	0.1900
Dex Media	Publishing	\$90.50	4.92	40.00%	3190.39%	7.86%	0.2200
Martha Stewart Living	Publishing	\$187.70	1.11	40.00%	19.89%	15.86%	0.3500
Barnes & Noble	Book Stores	\$939.30	0.11	40.00%	164.54%	3.22%	0.2600
Scholastic Corporation	Publishing	\$953.80	1.08	40.00%	21.41%	1.36%	0.2750
John Wiley	Publishing	\$2,931.40	0.81	40.00%	29.58%	5.00%	0.3150
Washington Post	Publishing	\$4,833.20	0.68	40.00%	21.04%	16.04%	0.2680
News Corporation	Publishing	\$10,280.40	0.49	40.00%	8.73%	24.05%	0.2300
Thomson Reuters	Publishing	\$31,653.80	0.62	40.00%	26.38%	1.68%	0.2680
<b>Average</b>			<b>1.1796</b>	<b>40.00%</b>	<b>368.76%</b>	<b>10.27%</b>	<b>0.2442</b>
<b>Median</b>			<b>0.8130</b>	<b>40.00%</b>	<b>21.41%</b>	<b>5.00%</b>	<b>0.2600</b>

Unlevered beta for book company =  $0.8130 / (1 + (1 - .4) (.2141)) = 0.7205$

Unlevered beta for book business =  $0.7205 / (1 - .05) = 0.7584$



# Estimating Bookscape Levered Beta and Cost of Equity

- Because the debt/equity ratios used in computing levered betas are market debt equity ratios, and the only debt equity ratio we can compute for Bookscape is a book value debt equity ratio, we have assumed that Bookscape is close to the book industry median market debt to equity ratio of 21.41 percent.
- Using a marginal tax rate of 40 percent for Bookscape, we get a levered beta of 0.8558.  
Levered beta for Bookscape =  $0.7584[1 + (1 - 0.40) (0.2141)] = 0.8558$
- Using a riskfree rate of 2.75% (US treasury bond rate) and an equity risk premium of 5.5%:  
Cost of Equity =  $2.75\% + 0.8558 (5.5\%) = 7.46\%$

# Total Risk versus Market Risk

- Adjust the beta to reflect total risk rather than market risk. This adjustment is a relatively simple one, since the R squared of the regression measures the proportion of the risk that is market risk.
  - ▣ Total Beta = Market Beta / Correlation of the sector with the market
- In the Bookscape example, where the market beta is 0.8558 and the average R-squared of the comparable publicly traded firms is 26.00%; the correlation with the market is 50.99%.

$$\frac{\text{Market Beta}}{\sqrt{\text{R squared}}} = \frac{0.8558}{.5099} = 1.6783$$

- ▣ Total Cost of Equity = 2.75 + 1.6783 (5.5%) = 11.98%

# ⌚ Application Test: Estimating a Bottom-up Beta

- Based upon the business or businesses that your firm is in right now, and its current financial leverage, estimate the bottom-up unlevered beta for your firm.
- Data Source: You can get a listing of unlevered betas by industry on my web site by going to updated data.

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# From Cost of Equity to Cost of Capital

- The cost of capital is a composite cost to the firm of raising financing to fund its projects.
- In addition to equity, firms can raise capital from debt

# What is debt?

- General Rule: Debt generally has the following characteristics:
  - ▣ Commitment to make fixed payments in the future
  - ▣ The fixed payments are tax deductible
  - ▣ Failure to make the payments can lead to either default or loss of control of the firm to the party to whom payments are due.
- As a consequence, debt should include
  - ▣ Any interest-bearing liability, whether short term or long term.
  - ▣ Any lease obligation, whether operating or capital.

# Estimating the Cost of Debt

- If the firm has bonds outstanding, and the bonds are traded, the yield to maturity on a long-term, straight (no special features) bond can be used as the interest rate.
- If the firm is rated, use the rating and a typical default spread on bonds with that rating to estimate the cost of debt.
- If the firm is not rated,
  - ▣ and it has recently borrowed long term from a bank, use the interest rate on the borrowing or
  - ▣ estimate a synthetic rating for the company, and use the synthetic rating to arrive at a default spread and a cost of debt
- The cost of debt has to be estimated in the same currency as the cost of equity and the cash flows in the valuation.



# The easy route: Outsourcing the measurement of default risk

- For those firms that have bond ratings from global ratings agencies, I used those ratings:

Company	S&P Rating	Risk-Free Rate	Default Spread	Cost of Debt
Disney	A	2.75% (US \$)	1.00%	3.75%
Deutsche Bank	A	1.75% (Euros)	1.00%	2.75%
Vale	A-	2.75% (US \$)	1.30%	4.05%

- If you want to estimate Vale's cost of debt in \$R terms, we can again use the differential inflation approach we used for the cost of equity:

$$\begin{aligned}\text{Cost of debt}_{RS} &= (1 + \text{Cost of debt}_{US\$}) \frac{(1 + \text{Expected Inflation}_{RS})}{(1 + \text{Expected Inflation}_{US\$})} - 1 \\ &= (1.0405) \frac{(1.09)}{(1.02)} - 1 = 11.19\%\end{aligned}$$

# A more general route: Estimating Synthetic Ratings

- The rating for a firm can be estimated using the financial characteristics of the firm. In its simplest form, we can use just the interest coverage ratio:

$$\text{Interest Coverage Ratio} = \text{EBIT} / \text{Interest Expenses}$$

- For the four non-financial service companies, we obtain the following:

Company	Operating income	Interest Expense	Interest coverage ratio
Disney	\$10,023	\$444	22.57
Vale	\$15,667	\$1,342	11.67
Tata Motors	Rs 166,605	Rs 36,972	4.51
Baidu	CY 11,193	CY 472	23.72
Bookscape	\$2,536	\$492	5.16

# Interest Coverage Ratios, Ratings and Default Spreads- November 2013

<i>Large cap (&gt;\$5 billion)</i>	<i>Small cap or risky (&lt;\$5 billion)</i>	<i>Rating is (S&amp;P/ Moody's)</i>	<i>Spread (11/13)</i>
>8.50	>12.5	Aaa/AAA	0.40%
6.5-8.5	9.5-12.5	Aa2/AA	0.70%
5.5-6.5	7.5-9.5	A1/A+	0.85%
4.25-5.5	6-7.5	A2/A	1.00%
3-4.25	4.5-6	A3/A-	1.30%
2.5-3	4-4.5	Baa2/BBB	2.00%
2.25-2.5	3.5-4	Ba1/BB+	3.00%
2-2.25	3-3.5	Ba2/BB	4.00%
1.75-2.25	2.5-3	B1/B+	5.50%
1.5-1.75	2-2.5	B2/B	6.50%
1.25-1.5	1.5-2	B3/B-	7.25%
0.8-1.25	1.25-1.5	Caa/CCC	8.75%
0.65-0.8	0.8-1.25	Ca2/CC	9.50%
0.2-0.65	0.5-0.8	C2/C	10.50%
<0.2	<0.5	D2/D	12.00%

Disney: Large cap, developed	22.57	→	AAA
Vale: Large cap, emerging	11.67	→	AA
Tata Motors: Large cap, Emerging	4.51	→	A-
Baidu: Small cap, Emerging	23.72	→	AAA
Bookscape: Small cap, private	5.16	→	A-

# Estimating Cost of Debt

- For Bookscape, we will use the synthetic rating (A-) to estimate the cost of debt:
  - ▣ Default Spread based upon A- rating = 1.30%
  - ▣ Pre-tax cost of debt = Riskfree Rate + Default Spread = 2.75% + 1.30% = 4.05%
  - ▣ After-tax cost of debt = Pre-tax cost of debt (1- tax rate) = 4.05% (1-.40) = 2.43%
- For the three publicly traded firms that are rated in our sample, we will use the actual bond ratings to estimate the costs of debt.

Company	S&P Rating	Risk-Free Rate	Default Spread	Cost of Debt	Tax Rate	After-Tax Cost of Debt
Disney	A	2.75% (US \$)	1.00%	3.75%	36.1%	2.40%
Deutsche Bank	A	1.75% (Euros)	1.00%	2.75%	29.48%	1.94%
Vale	A-	2.75% (US \$)	1.30%	4.05%	34%	2.67%

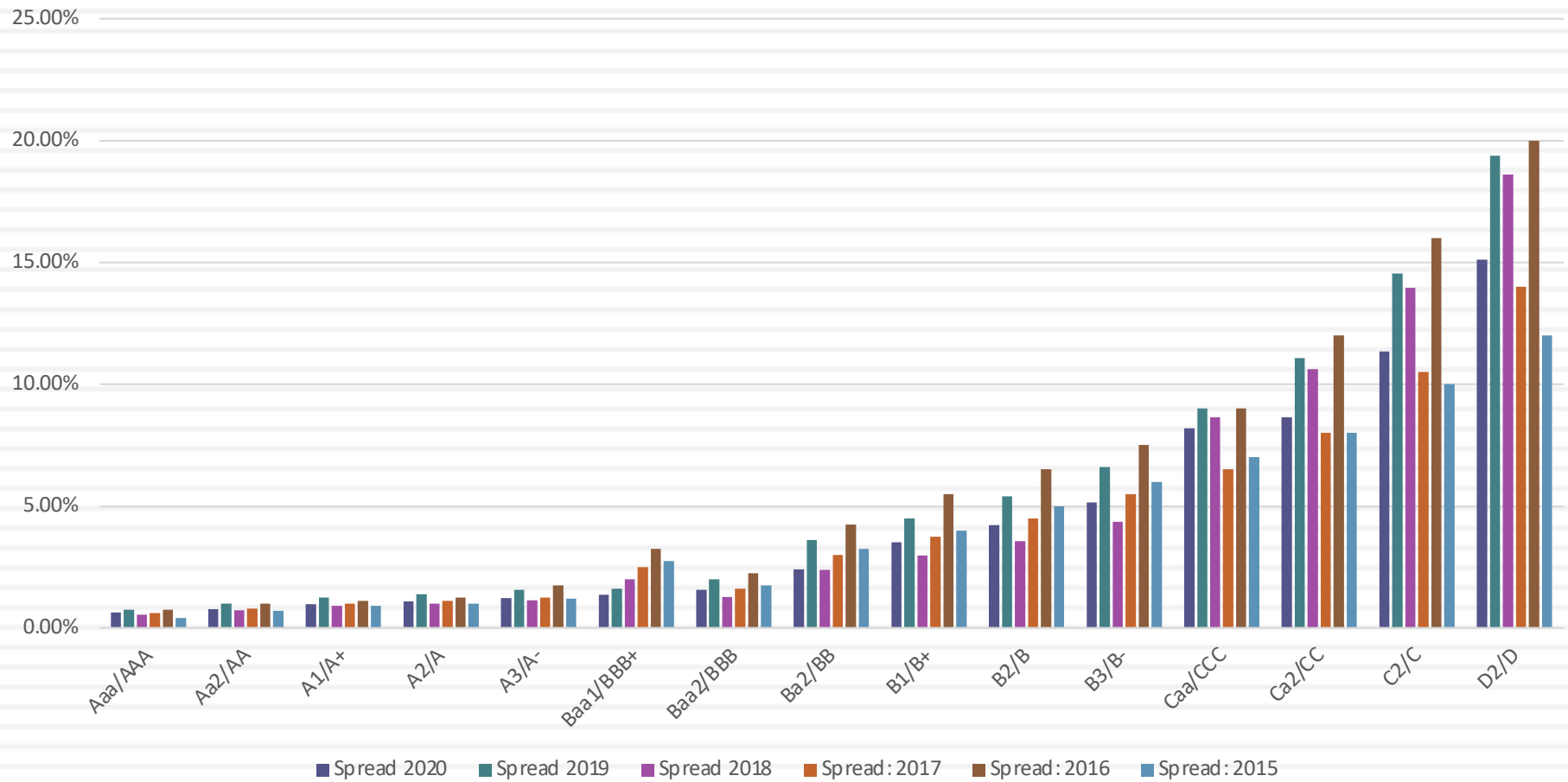
- For Tata Motors, we have a rating of AA- from CRISIL, an Indian bond-rating firm, that measures only company risk. Using that rating:

$$\begin{aligned} \text{Cost of debt}_{\text{TMT}} &= \text{Risk free rate}_{\text{Rupees}} + \text{Default spread}_{\text{India}} + \text{Default spread}_{\text{TMT}} \\ &= 6.57\% + 2.25\% + 0.70\% = 9.62\% \end{aligned}$$

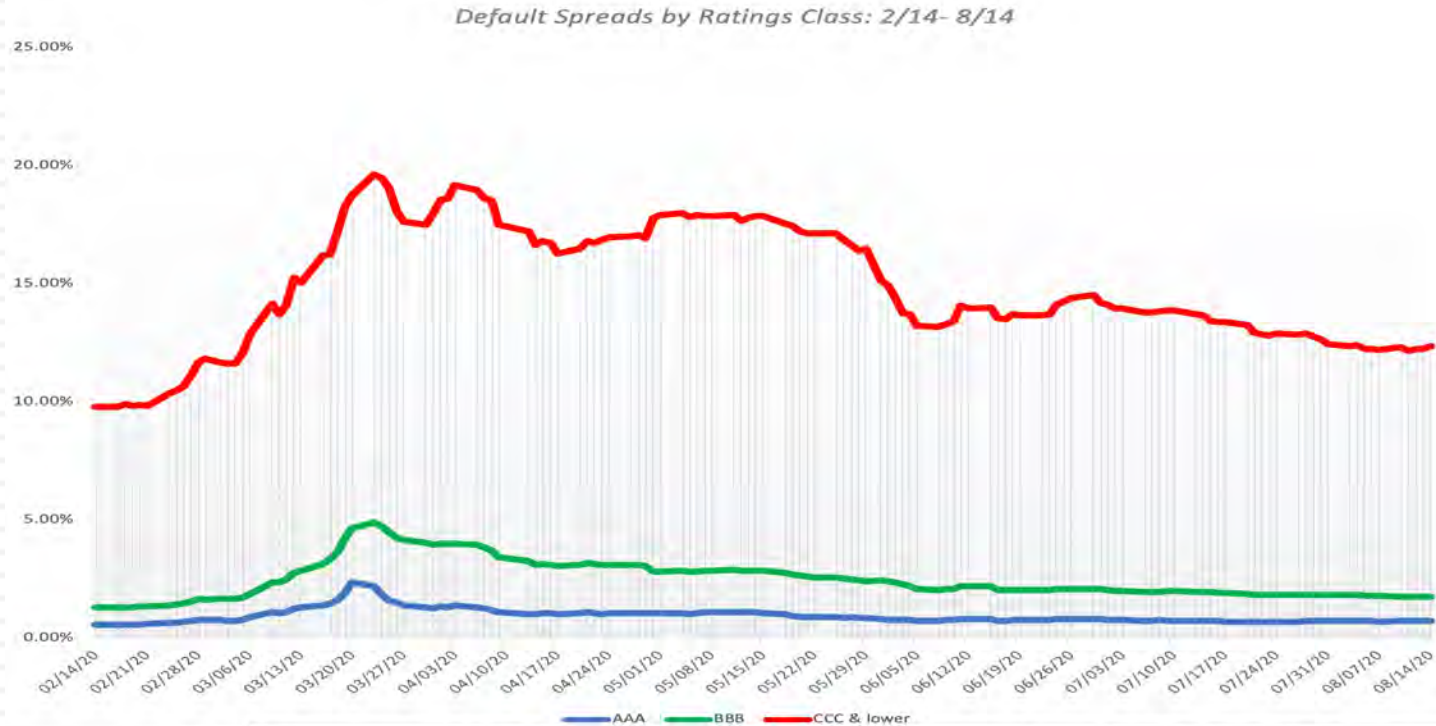
$$\text{After-tax cost of debt} = 9.62\% (1-.3245) = 6.50\%$$

# Default Spreads – January 2020

Corporate Default Spreads over time



# The Price of Bond Market Risk: The COVID effect



S&P Bond Rating	Yields and Spreads on Corporates						Change in default spread		
	Spread over 10-yr Treasury			Yield on Corporate			2/14-3/20	3/20-8/14	2/14 -8/14
	2/14/20	3/20/20	8/14/20	2/14/20	3/20/20	8/14/20			
AAA	0.69%	1.43%	0.74%	2.28%	2.35%	1.45%	0.74%	-0.69%	0.05%
AA	0.72%	2.64%	0.76%	2.31%	3.56%	1.47%	1.92%	-1.88%	0.04%
A	0.80%	3.15%	0.91%	2.39%	4.07%	1.62%	2.35%	-2.24%	0.11%
BBB	1.33%	3.73%	1.68%	2.92%	4.65%	2.39%	2.40%	-2.05%	0.35%
BB	1.93%	7.45%	3.42%	3.52%	8.37%	4.13%	5.52%	-4.03%	1.49%
B	3.40%	10.74%	5.11%	4.99%	11.66%	5.82%	7.34%	-5.63%	1.71%
CCC or lower	9.65%	17.81%	11.89%	11.24%	18.73%	12.60%	8.16%	-5.92%	2.24%

# Application Test: Estimating a Cost of Debt

- Based upon your firm's current earnings before interest and taxes, its interest expenses, estimate
  - ▣ An interest coverage ratio for your firm
  - ▣ A synthetic rating for your firm (use the tables from prior pages)
  - ▣ A pre-tax cost of debt for your firm
  - ▣ An after-tax cost of debt for your firm

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# Weights for Cost of Capital Calculation

- The weights used in the cost of capital computation should be market values.
- There are three specious arguments used against market value
  - Book value is more reliable than market value because it is not as volatile: While it is true that book value does not change as much as market value, this is more a reflection of weakness than strength
  - Using book value rather than market value is a more conservative approach to estimating debt ratios: For most companies, using book values will yield a lower cost of capital than using market value weights.
  - Since accounting returns are computed based upon book value, consistency requires the use of book value in computing cost of capital: While it may seem consistent to use book values for both accounting return and cost of capital calculations, it does not make economic sense.
- In practical terms, estimating the market value of equity should be easy for a publicly traded firm, but some or all of the debt at most companies is not traded. As a consequence, most practitioners use the book value of debt as a proxy for the market value of debt.

# Disney: From book value to market value for interest bearing debt...

- In Disney's 2013 financial statements, the debt due over time was footnoted.

Time due	Amount due	Weight	Weight *Maturity
0.5	\$1,452	11.96%	0.06
2	\$1,300	10.71%	0.21
3	\$1,500	12.36%	0.37
4	\$2,650	21.83%	0.87
6	\$500	4.12%	0.25
8	\$1,362	11.22%	0.9
9	\$1,400	11.53%	1.04
19	\$500	4.12%	0.78
26	\$25	0.21%	0.05
28	\$950	7.83%	2.19
29	\$500	4.12%	1.19
	\$12,139		7.92

- Disney's total debt due, in book value terms, on the balance sheet is \$14,288 million and the total interest expense for the year was \$349 million. Using 3.75% as the pre-tax cost of debt:

- Estimated MV of Disney Debt = 
$$349 \left[ \frac{1 - \frac{1}{(1.0375)^{7.92}}}{.0375} \right] + \frac{14,288}{(1.0375)^{7.92}} = \$13,028 \text{ million}$$

# Operating Leases at Disney

- The “debt value” of operating leases is the present value of the lease payments, at a rate that reflects their risk, usually the pre-tax cost of debt.
- The pre-tax cost of debt at Disney is 3.75%.

Year	Commitment	Present Value @3.75%
1	\$507.00	\$488.67
2	\$422.00	\$392.05
3	\$342.00	\$306.24
4	\$272.00	\$234.76
5	\$217.00	\$180.52
6-10	\$356.80	\$1,330.69
Debt value of leases		\$2,932.93

Disney reported \$1,784 million in commitments after year 5. Given that their average commitment over the first 5 years, we assumed 5 years @ \$356.8 million each.

- Debt outstanding at Disney = \$13,028 + \$ 2,933= \$15,961 million

# Application Test: Estimating Market Value

- Estimate the
  - ▣ Market value of equity at your firm and Book Value of equity
  - ▣ Market value of debt and book value of debt (If you cannot find the average maturity of your debt, use 3 years):  
Remember to capitalize the value of operating leases and add them on to both the book value and the market value of debt.
- Estimate the
  - ▣ Weights for equity and debt based upon market value
  - ▣ Weights for equity and debt based upon book value

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# Current Cost of Capital: Disney

## □ Equity

■ Cost of Equity = Riskfree rate + Beta \* Risk Premium  
= 2.75% + 1.0013 (5.76%) = 8.52%

■ Market Value of Equity = \$121,878 million

■ Equity/(Debt+Equity) = 88.42%

## □ Debt

■ After-tax Cost of debt = (Riskfree rate + Default Spread) (1-t)  
= (2.75%+1%) (1-.361) = 2.40%

■ Market Value of Debt = \$13,028+ \$2933 = \$ 15,961 million

■ Debt/(Debt +Equity) = 11.58%

□ Cost of Capital = 8.52%(.8842)+ 2.40%(.1158) = 7.81%

# Divisional Costs of Capital: Disney and Vale

## Disney

	Cost of equity	Cost of debt	Marginal tax rate	After-tax cost of debt	Debt ratio	Cost of capital
Media Networks	9.07%	3.75%	36.10%	2.40%	9.12%	8.46%
Parks & Resorts	7.09%	3.75%	36.10%	2.40%	10.24%	6.61%
Studio Entertainment	9.92%	3.75%	36.10%	2.40%	17.16%	8.63%
Consumer Products	9.55%	3.75%	36.10%	2.40%	53.94%	5.69%
Interactive	11.65%	3.75%	36.10%	2.40%	29.11%	8.96%
Disney Operations	8.52%	3.75%	36.10%	2.40%	11.58%	7.81%

## Vale

<i>Business</i>	<i>Cost of equity</i>	<i>After-tax cost of debt</i>	<i>Debt ratio</i>	<i>Cost of capital (in US\$)</i>	<i>Cost of capital (in \$R)</i>
Metals & Mining	11.35%	2.67%	35.48%	8.27%	15.70%
Iron Ore	11.13%	2.67%	35.48%	8.13%	15.55%
Fertilizers	12.70%	2.67%	35.48%	9.14%	16.63%
Logistics	10.29%	2.67%	35.48%	7.59%	14.97%
Vale Operations	11.23%	2.67%	35.48%	8.20%	15.62%

# Costs of Capital: Tata Motors, Baidu and Bookscape

- To estimate the costs of capital for Tata Motors in Indian rupees:

$$\text{Cost of capital} = 14.49\% (1 - .2928) + 6.50\% (.2928) = 12.15\%$$

- For Baidu, we follow the same path to estimate a cost of equity in Chinese RMB:

$$\text{Cost of capital} = 12.91\% (1 - .0523) + 3.45\% (.0523) = 12.42\%$$

- For Bookscape, the cost of capital is different depending on whether you look at market or total beta:

	Cost of equity	Pre-tax Cost of debt	After-tax cost of debt	D/(D+E)	Cost of capital
Market Beta	7.46%	4.05%	2.43%	17.63%	6.57%
Total Beta	11.98%	4.05%	2.43%	17.63%	10.30%



# Choosing a Hurdle Rate

- Either the cost of equity or the cost of capital can be used as a hurdle rate, depending upon whether the returns measured are to equity investors or to all claimholders on the firm (capital)
- If returns are measured to equity investors, the appropriate hurdle rate is the cost of equity.
- If returns are measured to capital (or the firm), the appropriate hurdle rate is the cost of capital.



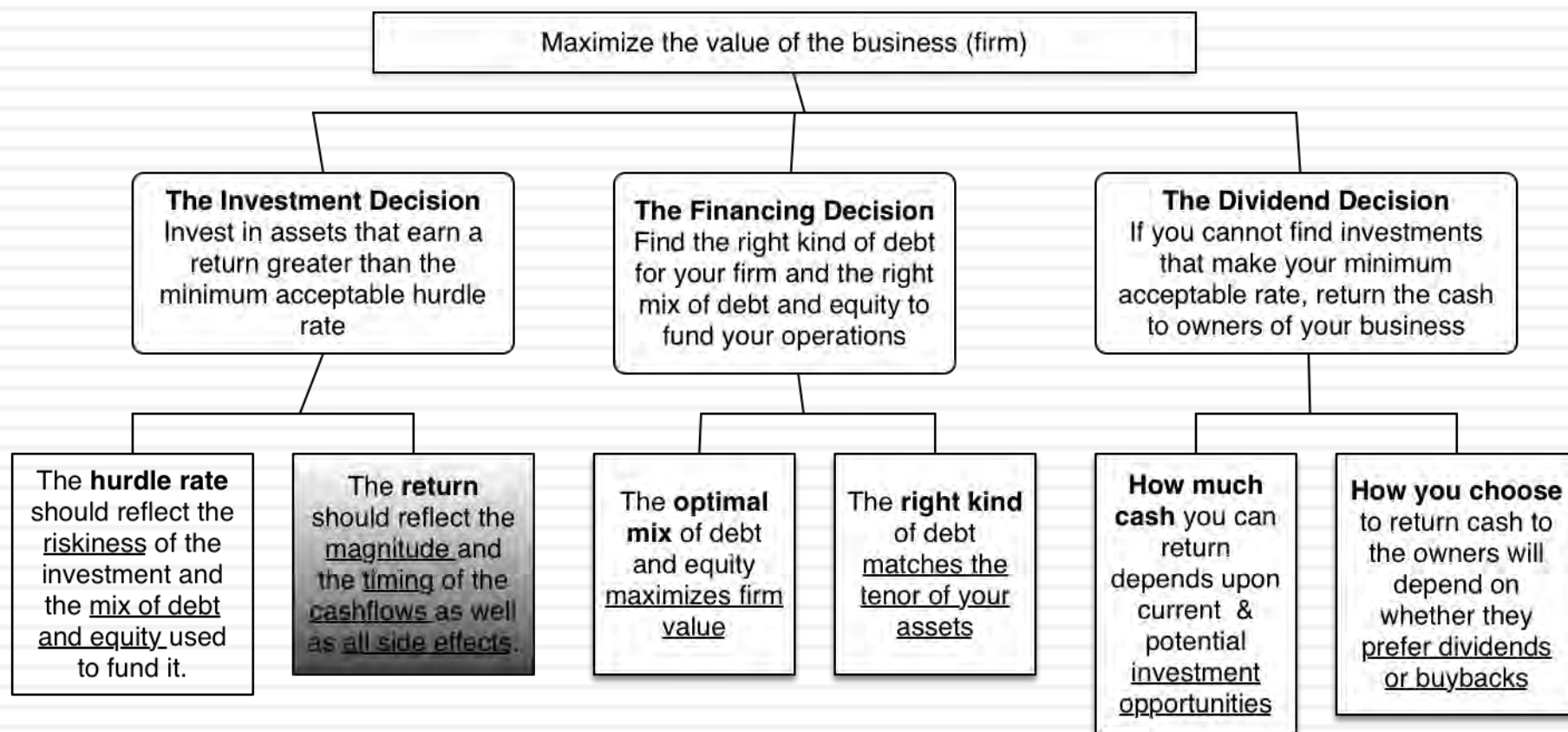
Aswath Damodaran

# MEASURING INVESTMENT RETURNS

“Show me the money”

from Jerry Maguire

# First Principles



# Measures of return: earnings versus cash flows

- Principles Governing Accounting Earnings Measurement
  - Accrual Accounting: Show revenues when products and services are sold or provided, not when they are paid for. Show expenses associated with these revenues rather than cash expenses.
  - Operating versus Capital Expenditures: Only expenses associated with creating revenues in the current period should be treated as operating expenses. Expenses that create benefits over several periods are written off over multiple periods (as depreciation or amortization)
- To get from accounting earnings to cash flows:
  - you have to add back non-cash expenses (like depreciation)
  - you have to subtract out cash outflows which are not expensed (such as capital expenditures)
  - you have to make accrual revenues and expenses into cash revenues and expenses (by considering changes in working capital).

# Measuring Returns Right: The Basic Principles

- Use cash flows rather than earnings. You cannot spend earnings.
- Use “incremental” cash flows relating to the investment decision, i.e., cashflows that occur as a consequence of the decision, rather than total cash flows.
- Use “time weighted” returns, i.e., value cash flows that occur earlier more than cash flows that occur later.

**The Return Mantra: “Time-weighted, Incremental Cash Flow Return”**

# Earnings versus Cash Flows: A Disney Theme Park

- The theme parks to be built near Rio, modeled on Euro Disney in Paris and Disney World in Orlando.
- The complex will include a “Magic Kingdom” to be constructed, beginning immediately, and becoming operational at the beginning of the second year, and a second theme park modeled on Epcot Center at Orlando to be constructed in the second and third year and becoming operational at the beginning of the fourth year.
- The earnings and cash flows are estimated in nominal U.S. Dollars.

# Key Assumptions on Start Up and Construction

- Disney has already spent \$0.5 Billion researching the proposal and getting the necessary licenses for the park; none of this investment can be recovered if the park is not built. This expenditure has been capitalized and will be depreciated straight line over ten years to a salvage value of zero.
- Disney will face substantial construction costs, if it chooses to build the theme parks.
  - The cost of constructing Magic Kingdom will be \$3 billion, with \$ 2 billion to be spent right now, and \$1 Billion to be spent one year from now.
  - The cost of constructing Epcot II will be \$ 1.5 billion, with \$ 1 billion to be spent at the end of the second year and \$0.5 billion at the end of the third year.
  - These investments will be depreciated based upon a depreciation schedule in the tax code, where depreciation will be different each year.



# Accounting Earnings on Project

	0	1	2	3	4	5	6	7	8	9	10
Magic Kingdom - Revenues		\$0	\$1,000	\$1,400	\$1,700	\$2,000	\$2,200	\$2,420	\$2,662	\$2,928	\$2,987
Epcot Rio - Revenues		\$0	\$0	\$0	\$300	\$500	\$550	\$605	\$666	\$732	\$747
Resort & Properties - Revenues		\$0	\$250	\$350	\$500	\$625	\$688	\$756	\$832	\$915	\$933
<b>Total Revenues</b>			<b>\$1,250</b>	<b>\$1,750</b>	<b>\$2,500</b>	<b>\$3,125</b>	<b>\$3,438</b>	<b>\$3,781</b>	<b>\$4,159</b>	<b>\$4,575</b>	<b>\$4,667</b>
Magic Kingdom – Direct Expenses		\$0	\$600	\$840	\$1,020	\$1,200	\$1,320	\$1,452	\$1,597	\$1,757	\$1,792
Epcot Rio – Direct Expenses		\$0	\$0	\$0	\$180	\$300	\$330	\$363	\$399	\$439	\$448
Resort & Property – Direct Expenses		\$0	\$188	\$263	\$375	\$469	\$516	\$567	\$624	\$686	\$700
<b>Total Direct Expenses</b>			<b>\$788</b>	<b>\$1,103</b>	<b>\$1,575</b>	<b>\$1,969</b>	<b>\$2,166</b>	<b>\$2,382</b>	<b>\$2,620</b>	<b>\$2,882</b>	<b>\$2,940</b>
Depreciation & Amortization		\$50	\$425	\$469	\$444	\$372	\$367	\$364	\$364	\$366	\$368
Allocated G&A Costs		\$0	\$188	\$263	\$375	\$469	\$516	\$567	\$624	\$686	\$700
<b>Operating Income</b>		<b>-\$50</b>	<b>-\$150</b>	<b>-\$84</b>	<b>\$106</b>	<b>\$315</b>	<b>\$389</b>	<b>\$467</b>	<b>\$551</b>	<b>\$641</b>	<b>\$658</b>
Taxes		-\$18	-\$54	-\$30	\$38	\$114	\$141	\$169	\$199	\$231	\$238
<b>Operating Income after Taxes</b>		<b>-\$32</b>	<b>-\$96</b>	<b>-\$54</b>	<b>\$68</b>	<b>\$202</b>	<b>\$249</b>	<b>\$299</b>	<b>\$352</b>	<b>\$410</b>	<b>\$421</b>

Direct expenses: 60% of revenues for theme parks, 75% of revenues for resort properties

Allocated G&A: Company G&A allocated to project, based on projected revenues. Two thirds of expense is fixed, rest is variable.

Taxes: Based on marginal tax rate of 36.1%

# And the Accounting View of Return

Year	After-tax Operating Income	BV of pre-project investment	BV of fixed assets	BV of Working capital	BV of Capital	Average BV of Capital	ROC(a)	ROC(b)
0		500	2000	0	\$2,500			
1	-\$32	\$450	\$3,000	\$0	\$3,450	\$2,975	-1.07%	-1.28%
2	-\$96	\$400	\$3,813	\$63	\$4,275	\$3,863	-2.48%	-2.78%
3	-\$54	\$350	\$4,145	\$88	\$4,582	\$4,429	-1.22%	-1.26%
4	\$68	\$300	\$4,027	\$125	\$4,452	\$4,517	1.50%	1.48%
5	\$202	\$250	\$3,962	\$156	\$4,368	\$4,410	4.57%	4.53%
6	\$249	\$200	\$3,931	\$172	\$4,302	\$4,335	5.74%	5.69%
7	\$299	\$150	\$3,931	\$189	\$4,270	\$4,286	6.97%	6.94%
8	\$352	\$100	\$3,946	\$208	\$4,254	\$4,262	8.26%	8.24%
9	\$410	\$50	\$3,978	\$229	\$4,257	\$4,255	9.62%	9.63%
10	\$421	\$0	\$4,010	\$233	\$4,243	\$4,250	9.90%	9.89%
Average							4.18%	4.11%

- (a) Based upon book capital at the start of each year
- (b) Based upon average book capital over the year

# Estimating a hurdle rate for Rio Disney

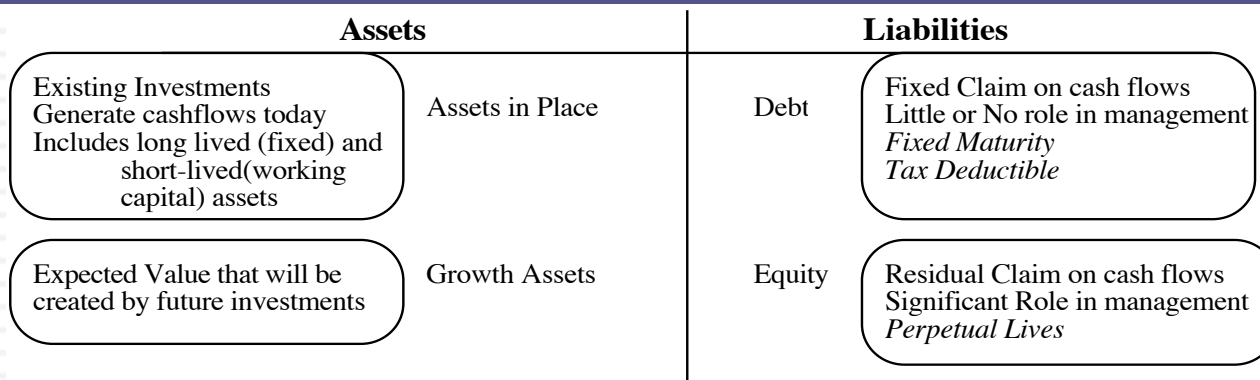
- We did estimate a cost of capital of 6.61% for the Disney theme park business, using a bottom-up levered beta of 0.7537 for the business.
- This cost of equity may not adequately reflect the additional risk associated with the theme park being in an emerging market.
- The only concern we would have with using this cost of equity for this project is that it may not adequately reflect the additional risk associated with the theme park being in an emerging market (Brazil). We first computed the Brazil country risk premium (by multiplying the default spread for Brazil by the relative equity market volatility) and then re-estimated the cost of equity:
  - Country risk premium for Brazil = 5.5% + 3% = 8.5%
  - Cost of Equity in US\$ = 2.75% + 0.7537 (8.5%) = 9.16%
- Using this estimate of the cost of equity, Disney's theme park debt ratio of 10.24% and its after-tax cost of debt of 2.40% (see chapter 4), we can estimate the cost of capital for the project:
  - Cost of Capital in US\$ = 9.16% (0.8976) + 2.40% (0.1024) = 8.46%

# Would lead us to conclude that...

- Do not invest in this park. The return on capital of 4.18% is lower than the cost of capital for theme parks of 8.46%; This would suggest that the project should not be taken.
- Given that we have computed the average over an arbitrary period of 10 years, while the theme park itself would have a life greater than 10 years, would you feel comfortable with this conclusion?
  - ▣ Yes
  - ▣ No

# A Tangent: From New to Existing Investments: ROC for the entire firm

How “good” are the existing investments of the firm?



Measuring ROC for existing investments..

Company	EBIT (1-t)	BV of Debt	BV of Equity	Cash	BV of Capital	Return on Capital	Cost of Capital	ROC - Cost of Capital
Disney	\$6,920	\$16,328	\$41,958	\$3,387	\$54,899	12.61%	7.81%	4.80%
Vale	\$12,432	\$49,246	\$75,974	\$5,818	\$119,402	10.41%	8.20%	2.22%
Baidu	¥9,111	¥13,561	¥27,215	¥10,456	¥30,320	30.05%	12.42%	17.63%
Tata Motors	120,905₹	471,489₹	330,056₹	225,562₹	575,983₹	20.99%	11.44%	9.55%
Bookscape	\$1,775	\$12,136	\$8,250	\$1,250	\$19,136	9.28%	10.30%	-1.02%

# The cash flow view of this project..

	0	1	2	3	4	5	6	7	8	9	10
After-tax Operating Income		-\$32	-\$96	-\$54	\$68	\$202	\$249	\$299	\$352	\$410	\$421
+ Depreciation & Amortization	\$0	\$50	\$425	\$469	\$444	\$372	\$367	\$364	\$364	\$366	\$368
- Capital Expenditures	\$2,500	\$1,000	\$1,188	\$752	\$276	\$258	\$285	\$314	\$330	\$347	\$350
- Change in non-cash Work Capital		\$0	\$63	\$25	\$38	\$31	\$16	\$17	\$19	\$21	\$5
Cashflow to firm	(\$2,500)	(\$982)	(\$921)	(\$361)	\$198	\$285	\$314	\$332	\$367	\$407	\$434

To get from income to cash flow, we

- I. added back all non-cash charges such as depreciation. Tax benefits:

	1	2	3	4	5	6	7	8	9	10
Depreciation	\$50	\$425	\$469	\$444	\$372	\$367	\$364	\$364	\$366	\$368
Tax Benefits from Depreciation	\$18	\$153	\$169	\$160	\$134	\$132	\$132	\$132	\$132	\$133

- II. subtracted out the capital expenditures
- III. subtracted out the change in non-cash working capital

# The incremental cash flows on the project

	0	1	2	3	4	5	6	7	8	9	10
After-tax Operating Income		-\$32	-\$96	-\$54	\$68	\$202	\$249	\$299	\$352	\$410	\$421
+ Depreciation & Amortization	\$0	\$50	\$425	\$469	\$444	\$372	\$367	\$364	\$364	\$366	\$368
- Capital Expenditures	\$2,500	\$1,000	\$1,188	\$752	\$276	\$258	\$285	\$314	\$330	\$347	\$350
- Change in non-cash Working Capital		\$0	\$63	\$25	\$38	\$31	\$16	\$17	\$19	\$21	\$5
Cashflow to firm	(\$2,500)	(\$982)	(\$921)	(\$361)	\$198	\$285	\$314	\$332	\$367	\$407	\$434
+ Pre-project investment (sunk)	\$500										
- Pre-project Depreciation * tax rate		\$18	\$18	\$18	\$18	\$18	\$18	\$18	\$18	\$18	\$18
+ Non-incremental Allocated Expense (1-t)		\$0	\$80	\$112	\$160	\$200	\$220	\$242	\$266	\$292	\$298
Incremental Cash flow to the firm	(\$2,000)	(\$1,000)	(\$860)	(\$267)	\$340	\$467	\$516	\$555	\$615	\$681	\$715

\$ 500 million has already been spent & \$ 50 million in depreciation will exist anyway

2/3rd of allocated G&A is fixed.  
Add back this amount (1-t)  
Tax rate = 36.1%



# To Time-Weighted Cash Flows

- Net Present Value (NPV): The net present value is the sum of the present values of all cash flows from the project (including initial investment).
  - ▣ NPV = Sum of the present values of all cash flows on the project, including the initial investment, with the cash flows being discounted at the appropriate hurdle rate (cost of capital, if cash flow is cash flow to the firm, and cost of equity, if cash flow is to equity investors)
  - ▣ Decision Rule: Accept if  $NPV > 0$
- Internal Rate of Return (IRR): The internal rate of return is the discount rate that sets the net present value equal to zero. It is the percentage rate of return, based upon incremental time-weighted cash flows.
  - ▣ Decision Rule: Accept if  $IRR > \text{hurdle rate}$

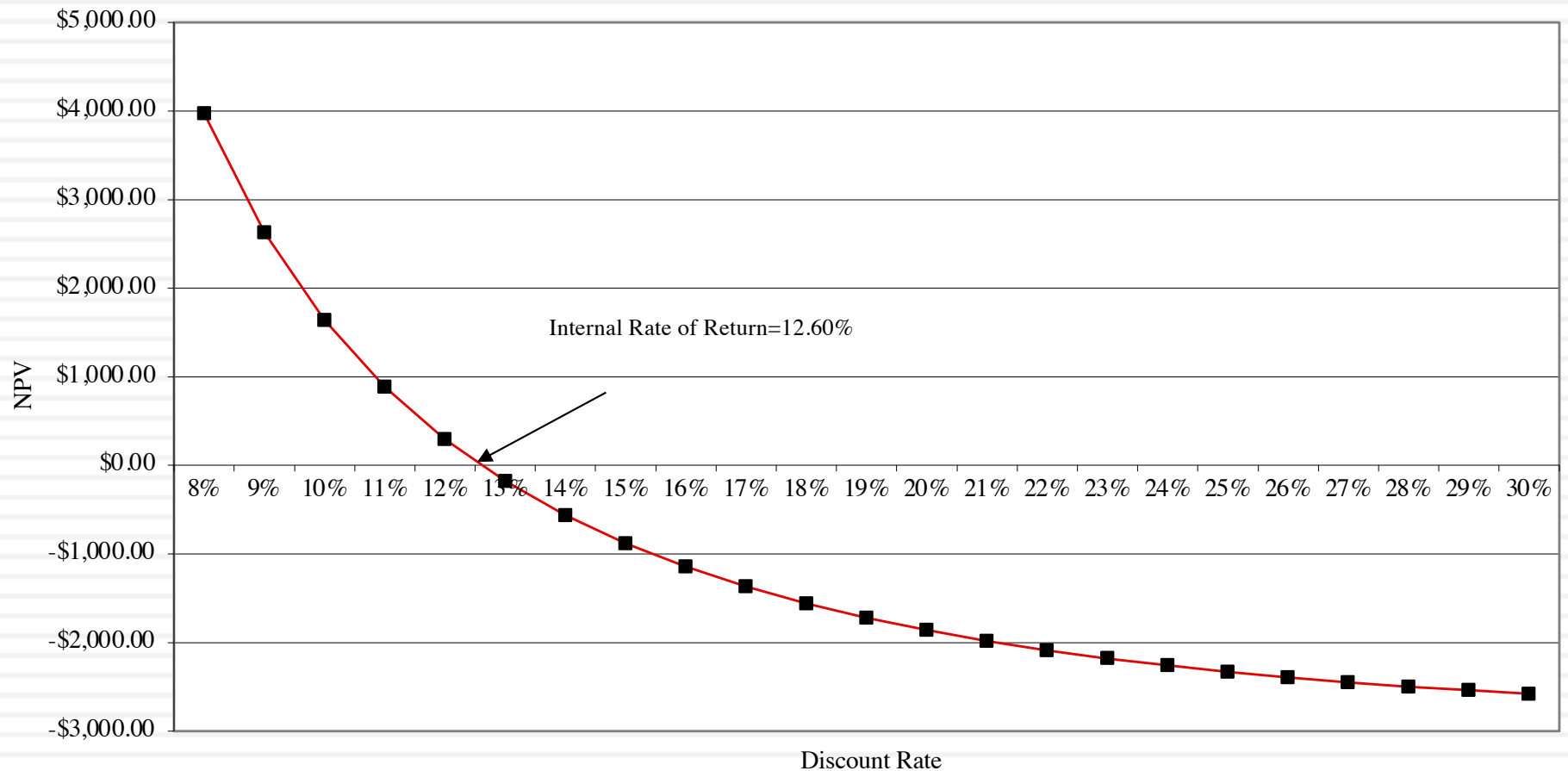
# Closure on Cash Flows

- In a project with a finite and short life, you would need to compute a salvage value, which is the expected proceeds from selling all of the investment in the project at the end of the project life. It is usually set equal to book value of fixed assets and working capital
- In a project with an infinite or very long life, we compute cash flows for a reasonable period, and then compute a terminal value for this project, which is the present value of all cash flows that occur after the estimation period ends..
- Assuming the project lasts forever, and that cash flows after year 10 grow 2% (the inflation rate) forever, the present value at the end of year 10 of cash flows after that can be written as:
  - Terminal Value in year 10=  $CF \text{ in year } 11 / (\text{Cost of Capital} - \text{Growth Rate})$   
 $= 715 (1.02) / (.0846 - .02) = \$ 11,275 \text{ million}$

# Which yields a NPV of..

Year	Annual Cashflo	Terminal Value	Present Value
0	-\$2,000		-\$2,000
1	-\$1,000		-\$922
2	-\$859		-\$730
3	-\$267		-\$210
4	\$340		\$246
5	\$466		\$311
6	\$516		\$317
7	\$555		\$314
8	\$615		\$321
9	\$681		\$328
10	\$715	\$11,275	\$5,321
			\$3,296

# The IRR of this project



# Does the currency matter?

- The analysis was done in dollars. Would the conclusions have been any different if we had done the analysis in Brazilian Reais?
  - a. Yes
  - b. No

# Disney Theme Park: \$R NPV

Expected Exchange Rate<sub>t</sub>  
 = Exchange Rate today \* (1.09/1.02)<sup>t</sup>

Discount at \$R cost of capital  
 = (1.0846) (1.09/1.02) - 1 = 15.91%

Year	Cashflow (\$)	\$R/\$	Cashflow (\$R)	Present Value
0	-R\$ 2,000.00	R\$ 2.35	-R\$ 4,700.00	-R\$ 4,700.00
1	-R\$ 1,000.00	R\$ 2.51	-R\$ 2,511.27	-R\$ 2,166.62
2	-R\$ 859.03	R\$ 2.68	-R\$ 2,305.29	-R\$ 1,715.95
3	-R\$ 267.39	R\$ 2.87	-R\$ 766.82	-R\$ 492.45
4	R\$ 340.22	R\$ 3.06	R\$ 1,042.63	R\$ 577.68
5	R\$ 466.33	R\$ 3.27	R\$ 1,527.21	R\$ 730.03
6	R\$ 516.42	R\$ 3.50	R\$ 1,807.31	R\$ 745.36
7	R\$ 555.08	R\$ 3.74	R\$ 2,075.89	R\$ 738.63
8	R\$ 614.95	R\$ 4.00	R\$ 2,457.65	R\$ 754.45
9	R\$ 681.46	R\$ 4.27	R\$ 2,910.36	R\$ 770.81
10	R\$ 11,989.85	R\$ 4.56	R\$ 54,719.84	R\$ 12,503.50
				R\$ 7,745.43

NPV = R\$ 7,745/2.35= \$ 3,296 Million  
 NPV is equal to NPV in dollar terms

# Uncertainty in Project Analysis: What can we do?

- Based on our expected cash flows and the estimated cost of capital, the proposed theme park looks like a very good investment for Disney. Which of the following may affect your assessment of value?
  - a. Revenues may be over estimated (crowds may be smaller and spend less)
  - b. Actual costs may be higher than estimated costs
  - c. Tax rates may go up
  - d. Interest rates may rise
  - e. Risk premiums and default spreads may increase
  - f. All of the above
- How would you respond to this uncertainty?
  - a. Will wait for the uncertainty to be resolved
  - b. Will not take the investment
  - c. Ignore it.
  - d. Other



# One simplistic solution: See how quickly you can get your money back...

- If your biggest fear is losing the billions that you invested in the project, one simple measure that you can compute is the number of years it will take you to get your money back.

Year	Cash Flow	Cumulated CF	PV of Cash Flow	Cumulated DCF
0	-\$2,000	-\$2,000	-\$2,000	-\$2,000
1	-\$1,000	-\$3,000	-\$922	-\$2,922
2	-\$859	-\$3,859	-\$730	-\$3,652
3	-\$267	-\$4,126	-\$210	-\$3,862
4	\$340	-\$3,786	\$246	-\$3,616
5	\$466	-\$3,320	\$311	-\$3,305
6	\$516	-\$2,803	\$317	-\$2,988
7	\$555	-\$2,248	\$314	-\$2,674
8	\$615	-\$1,633	\$321	-\$2,353
9	\$681	-\$952	\$328	-\$2,025
10	\$715	-\$237	\$317	-\$1,708
11	\$729	\$491	\$298	-\$1,409
12	\$743	\$1,235	\$280	-\$1,129
13	\$758	\$1,993	\$264	-\$865
14	\$773	\$2,766	\$248	-\$617
15	\$789	\$3,555	\$233	-\$384
16	\$805	\$4,360	\$219	-\$165
17	\$821	\$5,181	\$206	\$41

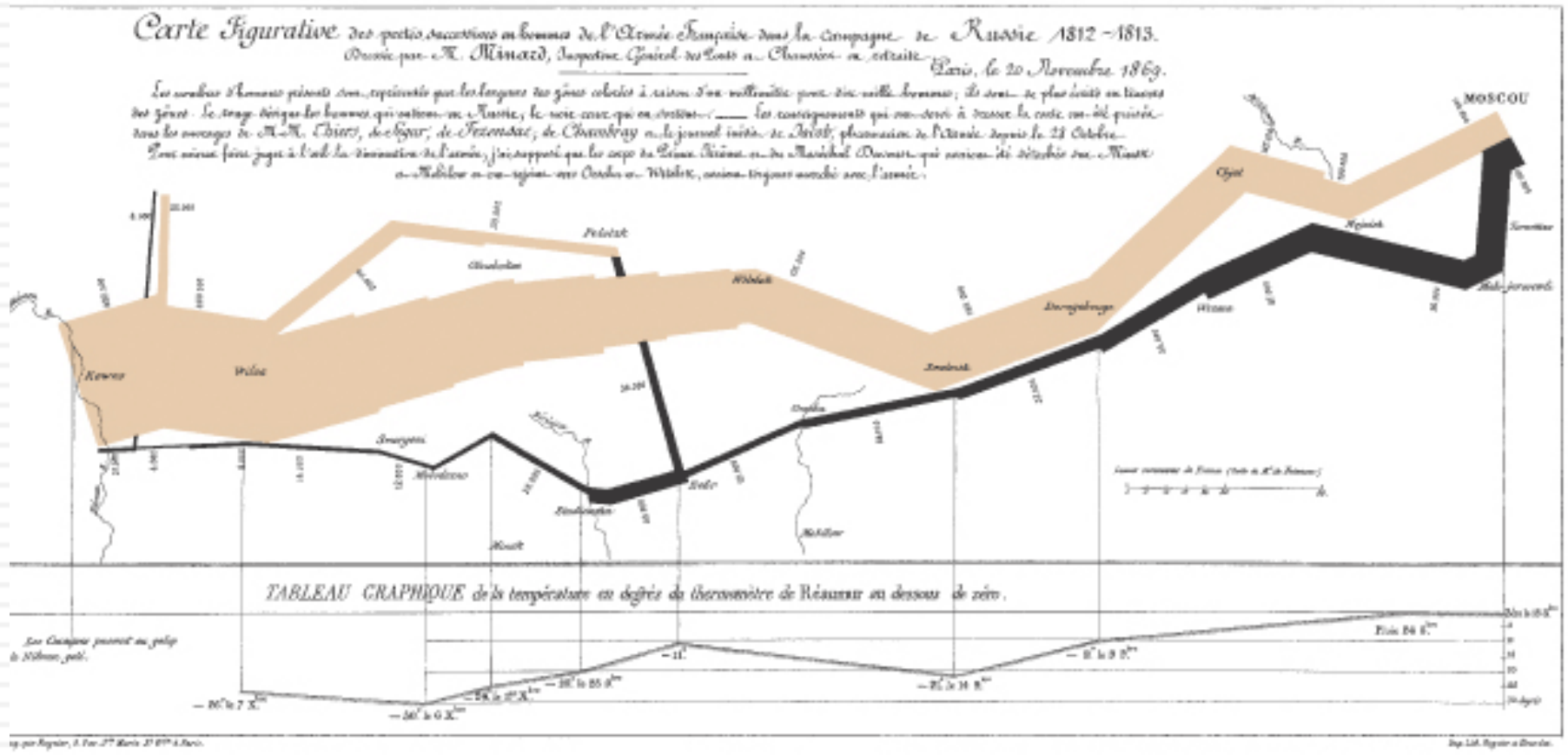
Payback = 10.3 years →

Discounted Payback  
= 16.8 years

# A slightly more sophisticated approach: Sensitivity Analysis & What-if Questions...

- The NPV, IRR and accounting returns for an investment will change as we change the values that we use for different variables.
- One way of analyzing uncertainty is to check to see how sensitive the decision measure (NPV, IRR..) is to changes in key assumptions. While this has become easier and easier to do over time, there are caveats that we would offer.
- Caveat 1: When analyzing the effects of changing a variable, we often hold all else constant. In the real world, variables move together.
- Caveat 2: The objective in sensitivity analysis is that we make better decisions, not churn out more tables and numbers.
  - Corollary 1: Less is more. Not everything is worth varying...
  - Corollary 2: A picture is worth a thousand numbers (and tables).

# And here is a really good picture...

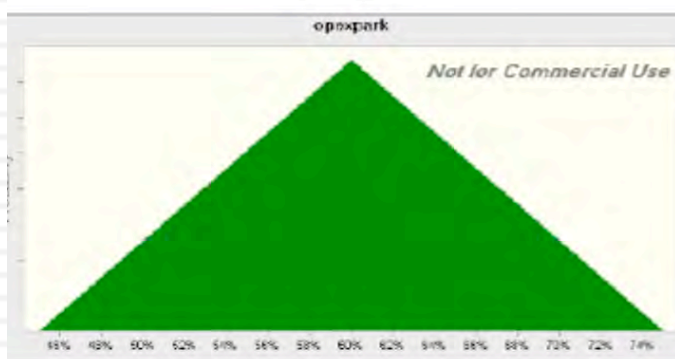


# The final step up: Incorporate probabilistic estimates.. Rather than expected values..

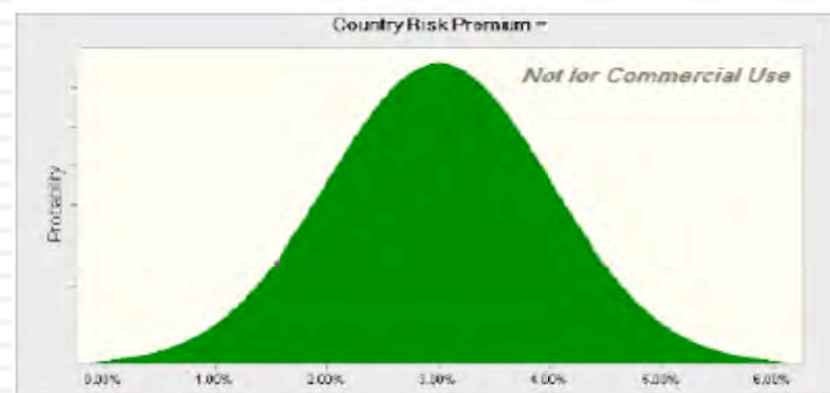
*Actual Revenues as % of Forecasted Revenues (Base case = 100%)*



*Operating Expenses at Parks as % of Revenues (Base Case = 60%)*

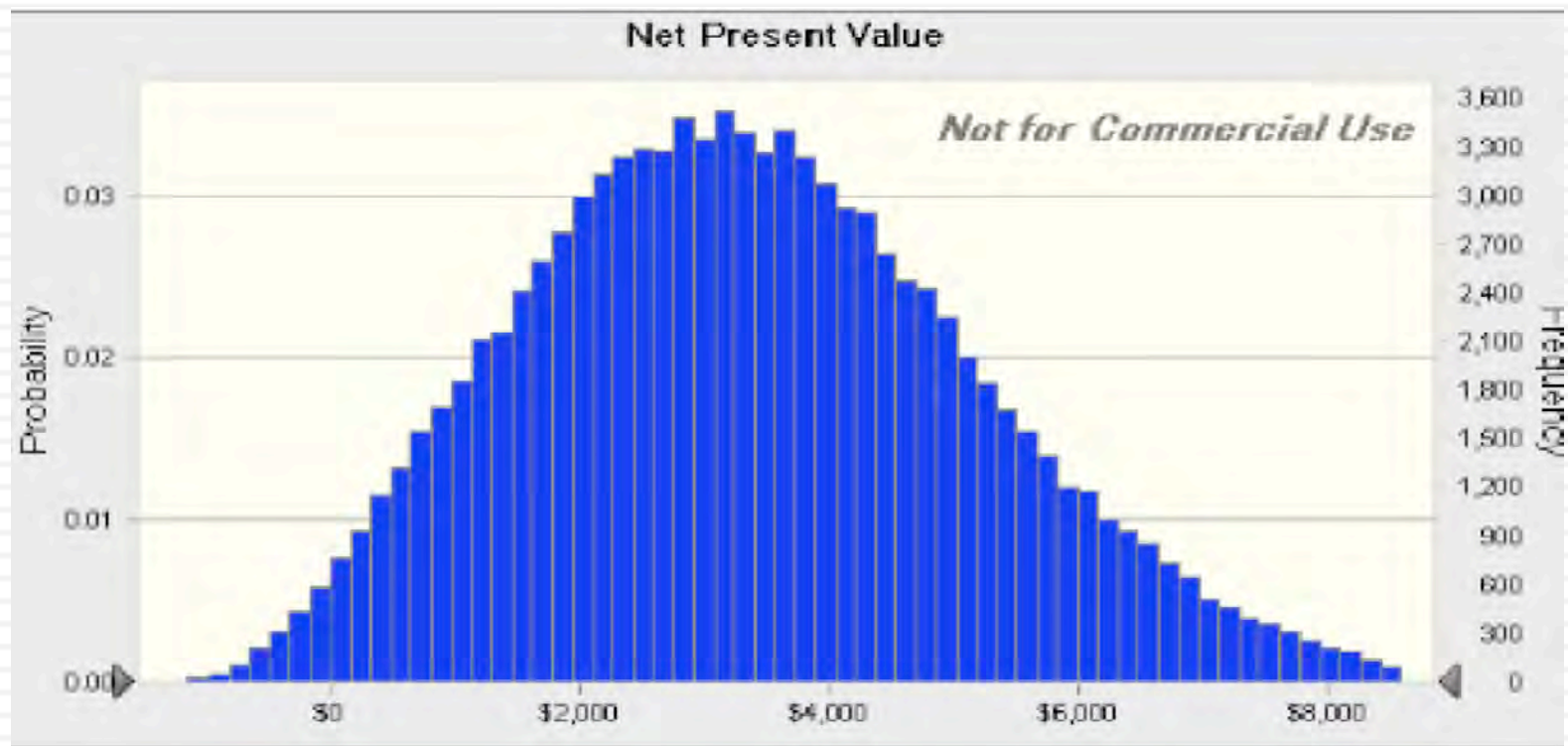


*Country Risk Premium (Base Case = 3% (Brazil))*



# The resulting simulation...

Average = \$3.40 billion  
Median = \$3.28 billion

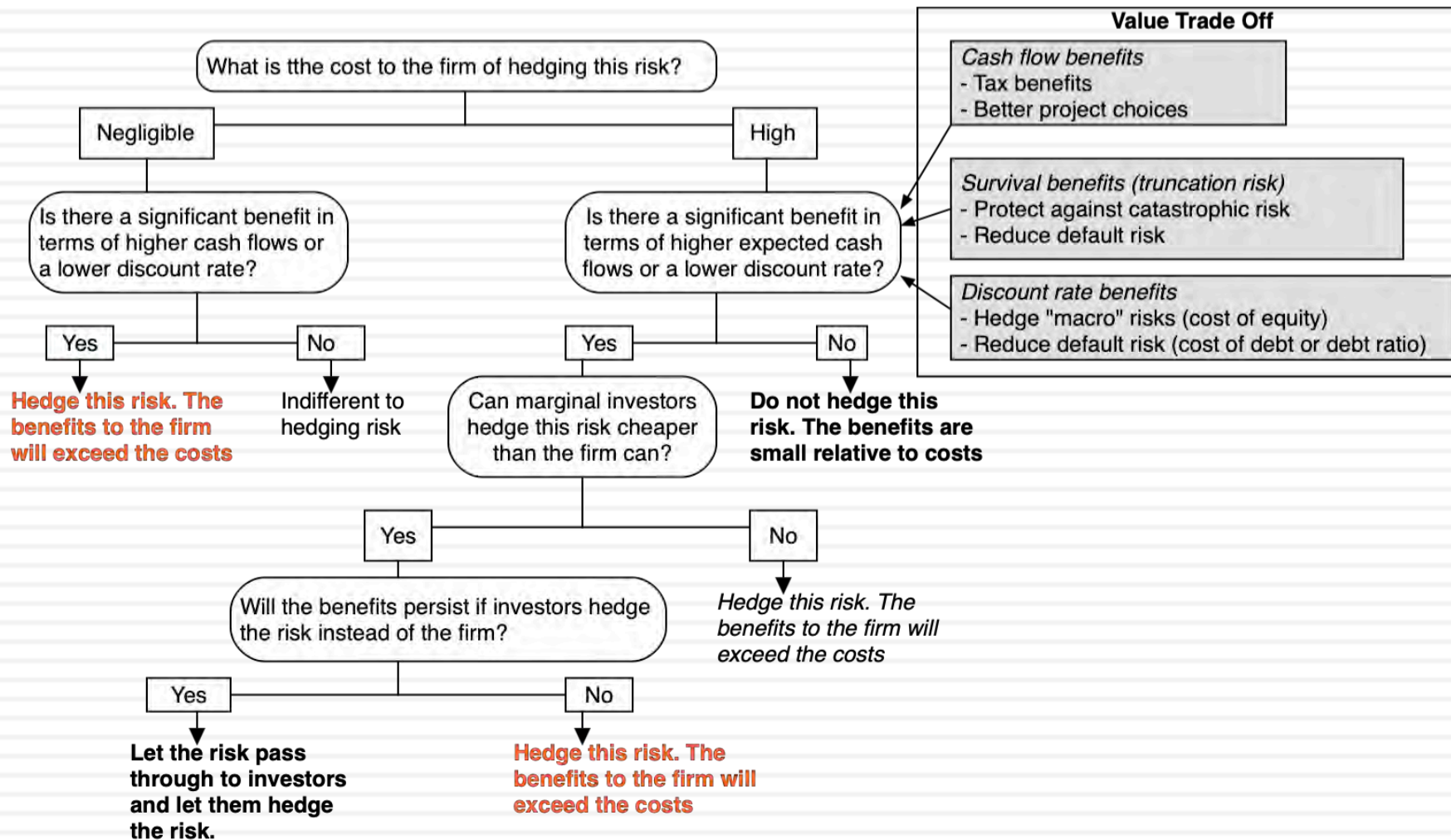


NPV ranges from -\$1 billion to +\$8.5 billion. NPV is negative 12% of the time.

# A side bar: Should you hedge risks?

- Disney can reduce the risk in this project by hedging against exchange rate risk. Should it?
  - a. Yes
  - b. No
  - c. Maybe

# To hedge or not to hedge..

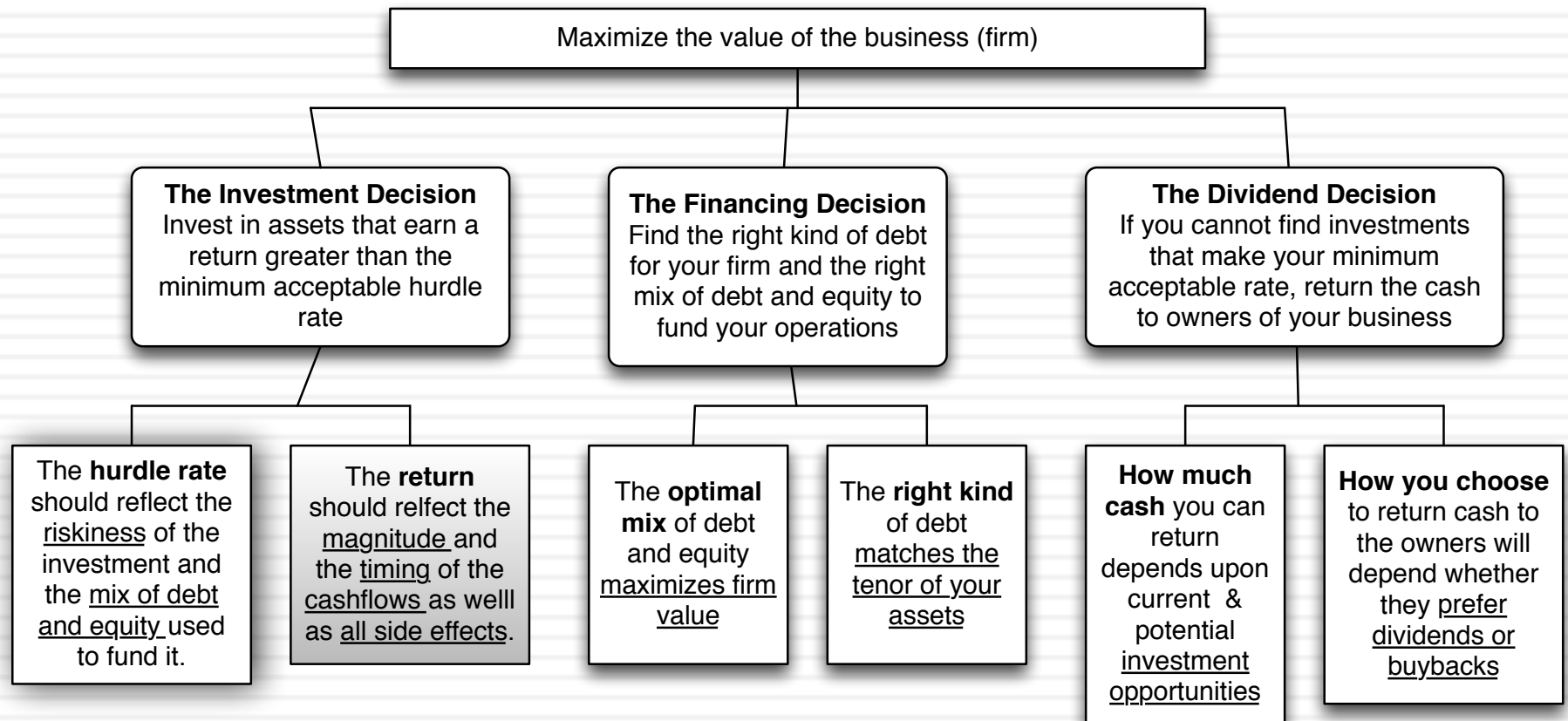


# A final thought: Side Costs and Benefits

- Most projects considered by any business create side costs and benefits for that business.
  - The side costs include the costs created by the use of resources that the business already owns (opportunity costs) and lost revenues for other projects that the firm may have.
  - The benefits that may not be captured in the traditional capital budgeting analysis include project synergies (where cash flow benefits may accrue to other projects) and options embedded in projects (including the options to delay, expand or abandon a project).
- The returns on a project should incorporate these costs and benefits.



# First Principles

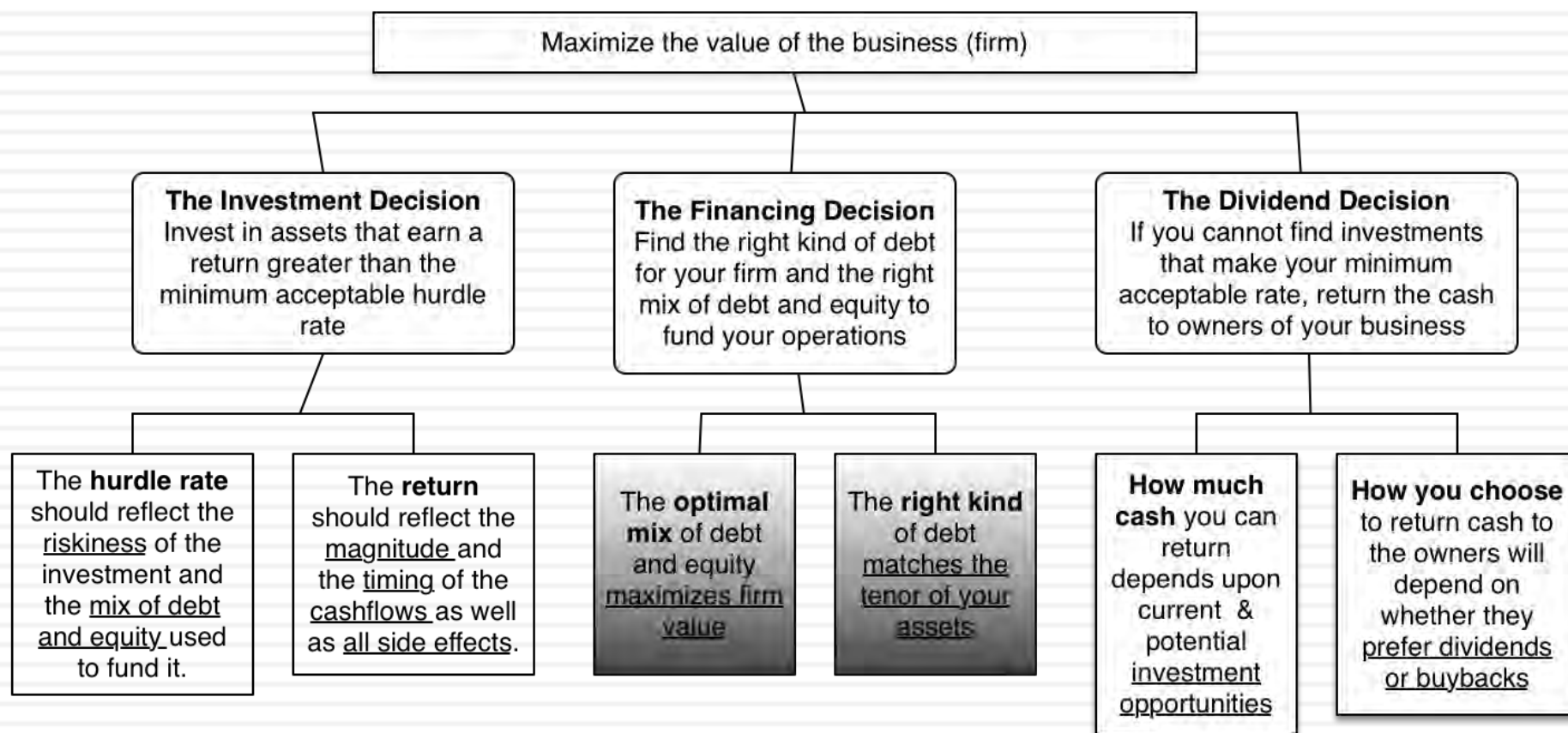




# CAPITAL STRUCTURE: THE CHOICES AND THE TRADE OFF

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

# First Principles



# Assessing the existing financing choices: Disney, Vale, Tata Motors & Baidu

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

# Debt: Summarizing the trade off

<i>Advantages of Debt</i>	<i>Disadvantages of debt</i>
<p><b>1. Tax Benefit:</b> Interest expenses on debt are tax deductible but cash flows to equity are generally not. <i>Implication: The higher the marginal tax rate, the greater the benefits of debt.</i></p>	<p><b>1. Expected Bankruptcy Cost:</b> 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. <i>Implication:</i>  <ol style="list-style-type: none"> <li><i>Firms with more stable earnings should borrow more, for any given level of earnings.</i></li> <li><i>Firms with lower bankruptcy costs should borrow more, for any given level of earnings.</i></li> </ol> </p>
<p><b>2. Added Discipline:</b> Borrowing money may force managers to think about the consequences of the investment decisions a little more carefully and reduce bad investments. <i>Implication: As the separation between managers and stockholders increases, the benefits to using debt will go up.</i></p>	<p><b>2. Agency Costs:</b> 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). <i>Implication: 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.</i></p>
	<p><b>3. Loss of flexibility:</b> 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. <i>Implication:</i>  <ol style="list-style-type: none"> <li><i>Firms that can forecast future funding needs better should be able to borrow more.</i></li> <li><i>Firms with better access to capital markets should be more willing to borrow more today.</i></li> </ol> </p>

# The Trade off for Disney, Vale, Tata Motors and Baidu

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<i>Debt trade off</i>	<i>Discussion of relative benefits/costs</i>
Tax benefits	Marginal tax rates of 40% in US (Disney & 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).
Added Discipline	The benefits should be highest at Disney, where there is a clear separation of ownership and management and smaller at the remaining firms.
Expected Bankruptcy Costs	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). 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.
Agency Costs	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.
Flexibility needs	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.

# Application Test: Would you expect your firm to gain or lose from using debt?

- Consider, 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

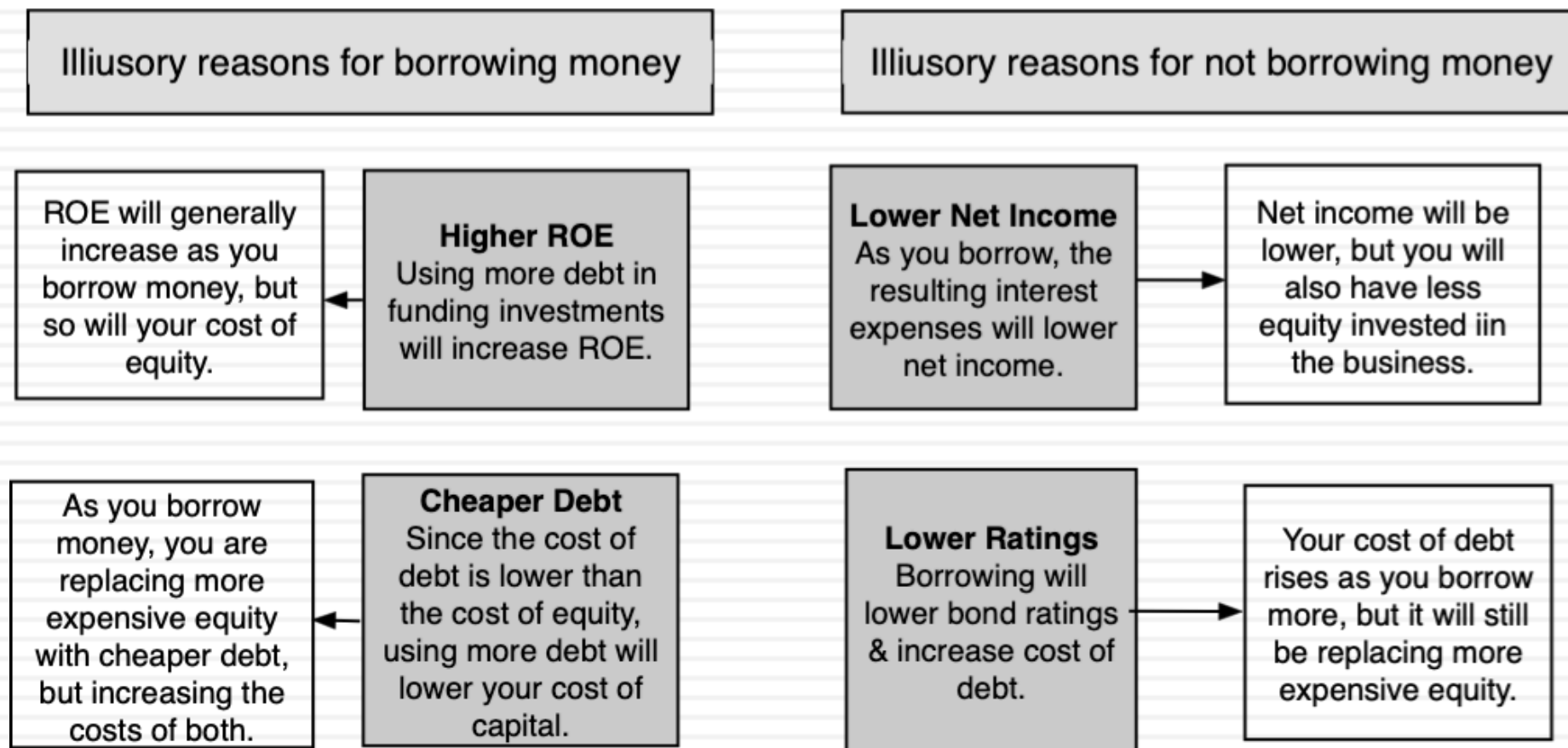
Benefits of debt	Costs of debt
Tax benefits	Expected Bankruptcy Cost
Added Discipline	Agency Costs
	Need for financial flexibility



# The Miller-Modigliani Theorem

- In an environment, where there are no taxes, default risk or agency costs, capital structure is irrelevant.
- In this world,
  - ▣ Leverage is irrelevant. A firm's value will be determined by its project cash flows.
  - ▣ 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

# Illusory Reasons for borrowing (or not) money



# Transient Reasons for borrowing or not borrowing money

- You may choose to borrow money, even though the fundamentals don't work for you, if you
  - Have subsidized debt: If your debt is subsidized either by an external entity (government or quasi government) or by over exuberant lenders, you will be borrowing money at rates below what you should be paying (given your default risk).
  - Value control: If you (as founders/managers) value control, you may decide not to raise fresh equity, even though it is the right type of financing for you, and borrow instead.
- You may choose not to borrow money, and issue equity, even though the fundamentals don't work for you, if you
  - Face inflexible lenders: Lenders and banks may be demanding too high a cost of debt, given your default risk.
  - Over priced equity: If you feel that your stock is over priced by the market.

# Pathways to the Optimal

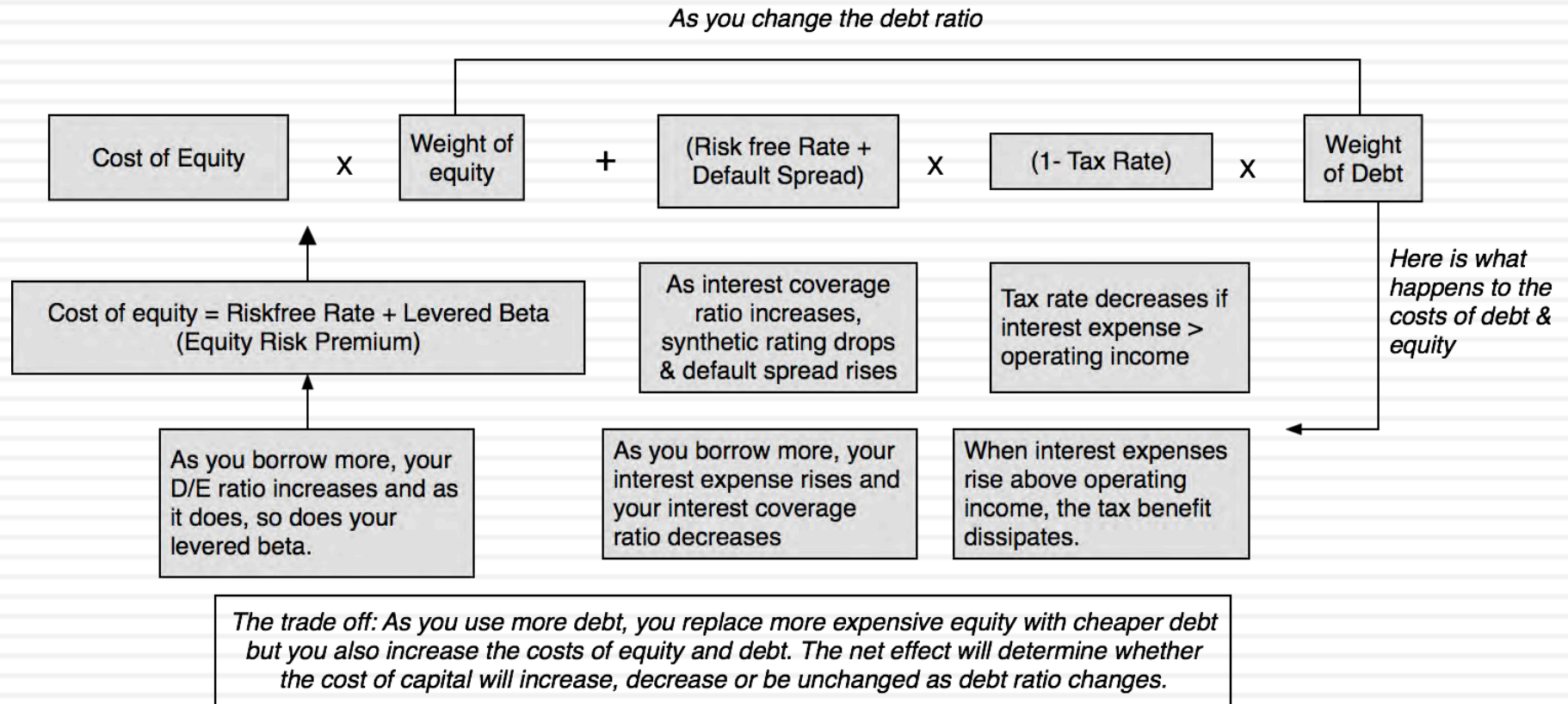
- The Cost of Capital Approach: The optimal debt ratio is the one that minimizes the cost of capital for a firm.
- The Sector Approach: The optimal debt ratio is the one that brings the firm close to its peer group in terms of financing mix.

# 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.

# The Debt Trade off on the Cost of Capital

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# 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):

$$\text{Cost of capital} = 8.52\% \frac{121,878}{(15,961+121,878)} + 2.40\% \frac{15,961}{(15,961+121,878)} = 7.81\%$$

# 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.



# I. Cost of Equity

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

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

$$\text{Cost of equity} = 2.75\% + \text{Levered beta} * 5.76\%$$

## II. Bond Ratings, Cost of Debt and Debt Ratios

Debt Ratio	\$ Debt	Interest Expense	Interest Coverage Ratio	Bond Rating	Pre-tax cost of debt	Tax rate	After-tax cost of debt
0%	\$0	\$0	$\infty$	Aaa/AAA	3.15%	36.10%	2.01%
10%	\$13,784	\$434	23.10	Aaa/AAA	3.15%	36.10%	2.01%
20%	\$27,568	\$868	11.55	Aaa/AAA	3.15%	36.10%	2.01%
30%	\$41,352	\$1,427	7.03	Aa2/AA	3.45%	36.10%	2.20%
40%	\$55,136	\$2,068	4.85	A2/A	3.75%	36.10%	2.40%
50%	\$68,919	\$6,892	1.46	B3/B-	10.00%	36.10%	6.39%
60%	\$82,703	\$9,511	1.05	Caa/CCC	11.50%	36.10%	7.35%
70%	\$96,487	\$11,096	0.90	Caa/CCC	11.50%	32.64%	7.75%
80%	\$110,271	\$13,508	0.74	Ca2/CC	12.25%	26.81%	8.97%
90%	\$124,055	\$16,437	0.61	C2/C	13.25%	22.03%	10.33%

# Disney's cost of capital schedule...

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

# 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?

# I. Why should we do this?

- 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

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

Enterprise value after recapitalization

= Existing enterprise value + PV of Savings = \$133,908 + \$19,623 = \$153,531 million

## 2. What if something goes wrong? The Downside Risk

- Doing What-if analysis on Operating Income
  - A. Statistical Approach
    - Standard Deviation In Past Operating Income
    - Reduce Base Case By One Standard Deviation (Or More)
  - B. “Economic Scenario” Approach
    - Look At What Happened To Operating Income During The Last Recession. (How Much Did It Drop In % Terms?)
    - Reduce Current Operating Income By Same Magnitude
- Constraint on Bond Ratings

# Disney's Operating Income: History

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

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%

# Disney: Safety Buffers?

EBIT drops by	EBIT	Optimal Debt ratio
0%	\$10,032	40%
10%	\$9,029	40%
20%	\$8,025	40%
30%	\$7,022	40%
40%	\$6,019	30%
50%	\$5,016	30%
60%	\$4,013	20%



# 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:

Cost of AA Rating Constraint = Value at 40% Debt – Value at 30% Debt = \$153,531 m – \$147,835 m = \$ 5,696 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:

Cost of AAA rating constraint = Value at 40% Debt – Value at 20% Debt = \$153,531 m – \$141,406 m = \$ 12,125 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.

# ⌚ Application Test: Your firm's optimal financing mix

- Using the optimal capital structure spreadsheet provided:
  - ▣ Estimate the optimal debt ratio for your firm
  - ▣ Estimate the new cost of capital at the optimal
  - ▣ Estimate the effect of the change in the cost of capital on firm value
  - ▣ Estimate the effect on the stock price
- In terms of the mechanics, what would you need to do to get to the optimal immediately?

Bloomberg FA page  
Capstru.xls

# Another Approach to the Optimal: 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)

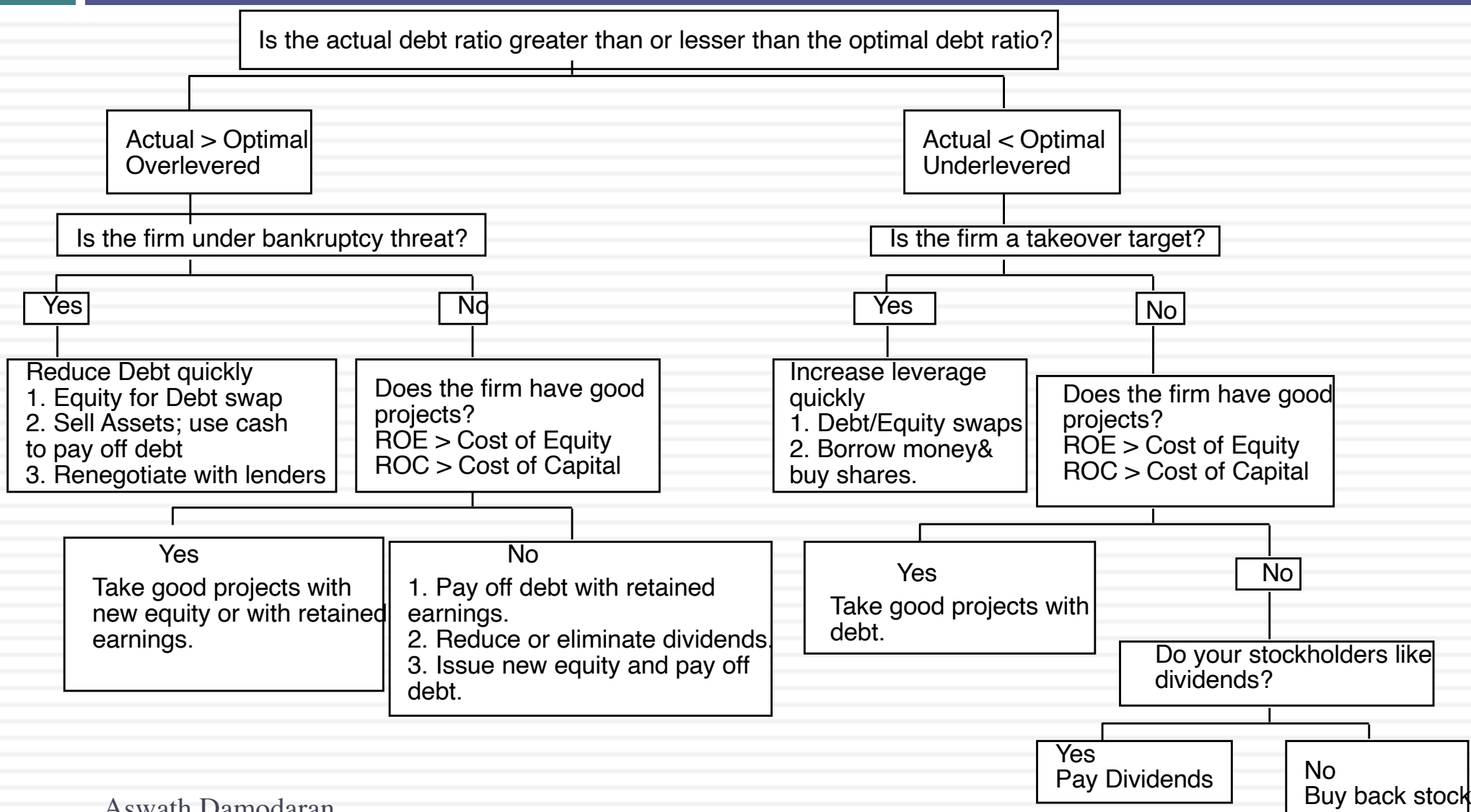
# Comparing to industry averages

<i>Company</i>	<i>Debt to Capital Ratio</i>		<i>Net Debt to Capital Ratio</i>		<i>Comparable group</i>	<i>Debt to Capital Ratio</i>		<i>Net Debt to Capital Ratio</i>	
	<i>Book value</i>	<i>Market value</i>	<i>Book value</i>	<i>Market value</i>		<i>Book value</i>	<i>Market value</i>	<i>Book value</i>	<i>Market value</i>
Disney	22.88%	11.58%	17.70%	8.98%	US Entertainment	39.03%	15.44%	24.92%	9.93%
Vale	39.02%	35.48%	34.90%	31.38%	Global Diversified Mining & Iron Ore (Market cap > \$1 b)	34.43%	26.03%	26.01%	17.90%
Tata Motors	58.51%	29.28%	22.44%	19.25%	Global Autos (Market Cap > \$1 b)	35.96%	18.72%	3.53%	0.17%
Baidu	32.93%	5.23%	20.12%	2.32%	Global Online Advertising	6.37%	1.83%	-27.13%	-2.76%

# Now that we have an optimal.. And an actual.. What next?

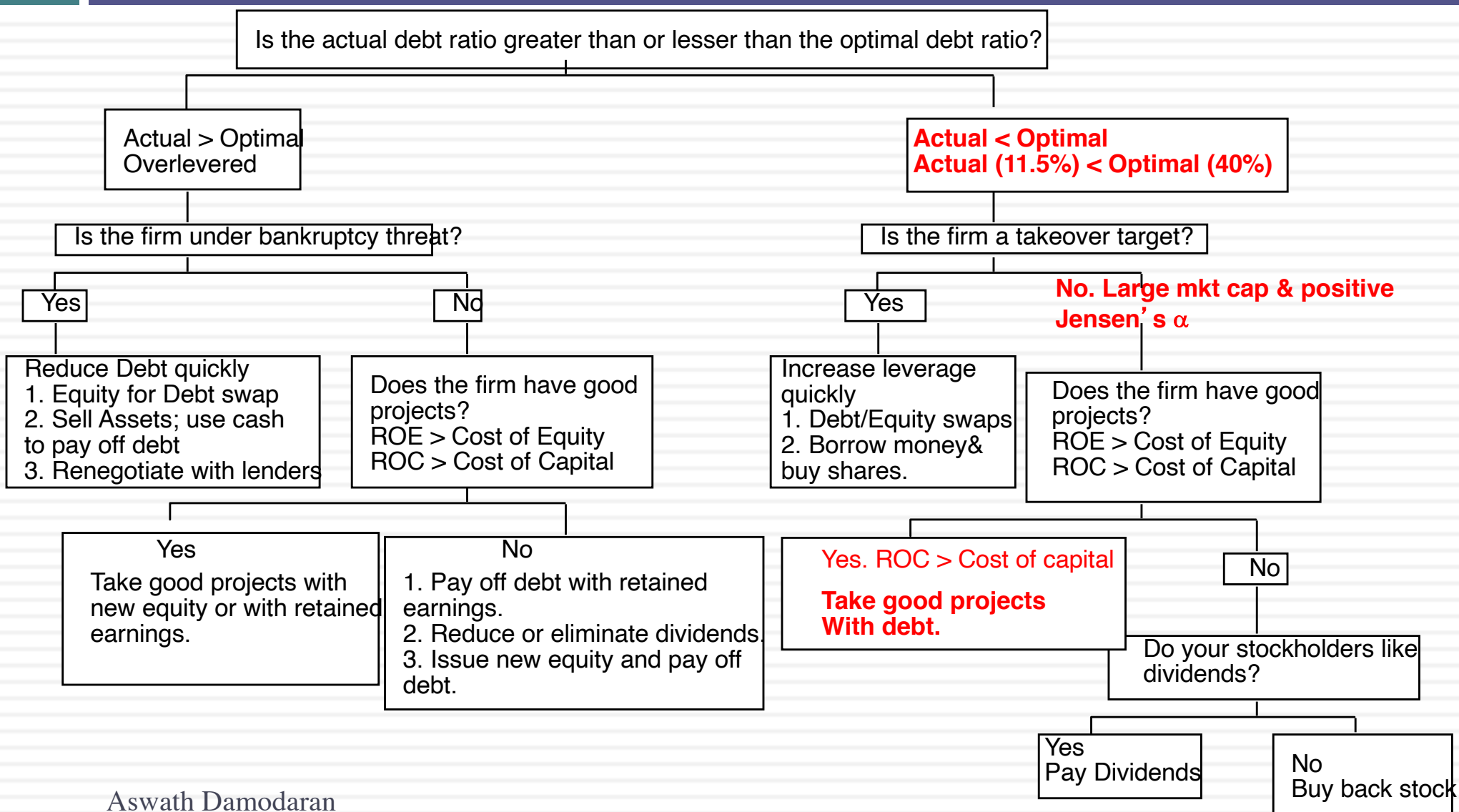
- At the end of the analysis of financing mix (using whatever tool or tools you choose to use), you can come to one of three conclusions:
  - ▣ The firm has the right financing mix
  - ▣ It has too little debt (it is under levered)
  - ▣ It has too much debt (it is over levered)
- The next step in the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





# Disney: Applying the Framework



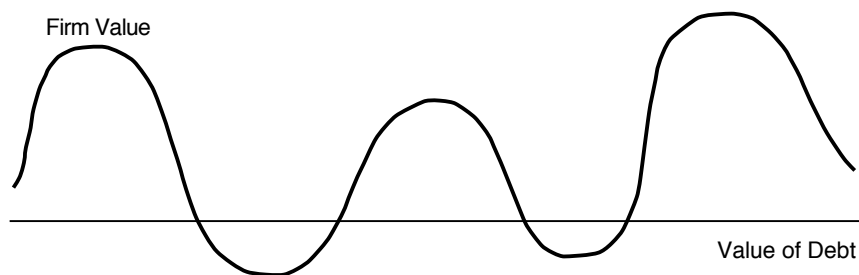
# Application Test: Getting to the Optimal

- 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

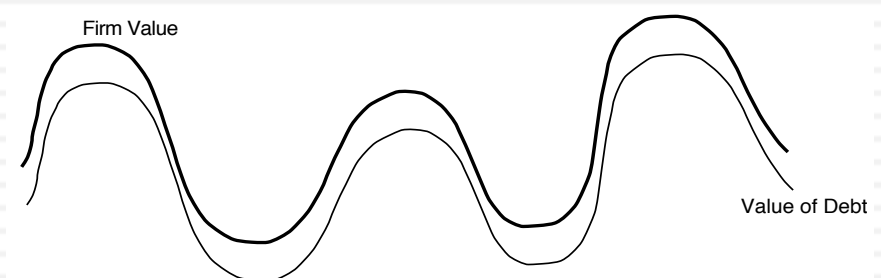
# Designing Debt: The Fundamental Principle

- 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.

Unmatched Debt

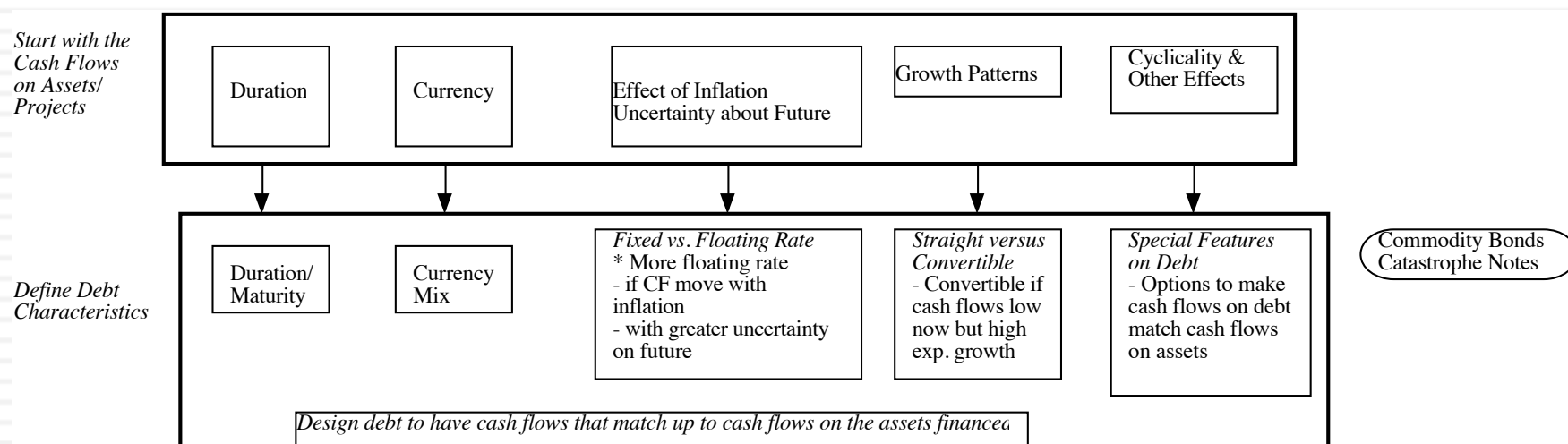


Matched Debt



# 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



# Allow for real world concerns, including...

- The tax code: Make sure that the financing you have designed to be debt meets the tax code definition of debt.
- Keeps competing interest groups happy: Find a way to keep lenders, equity investors and regulators happy (or at least not too unhappy).
- Sugar coat to make acceptable to bond holders: By adding protection features, especially if you are a firm with no or a bad history in bond markets.
- Don't lock in mistakes: Try not to lock in market mistakes that work against you.

# Designing Disney's Debt

<i>Business</i>	<i>Project Cash Flow Characteristics</i>	<i>Type of Financing</i>
Studio entertainment	<p>Movie projects are likely to</p> <ul style="list-style-type: none"> <li>• Be short-term</li> <li>• 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)</li> <li>• Have net cash flows that are heavily driven by whether the movie is a hit, which is often difficult to predict</li> </ul>	<p>Debt should be</p> <ol style="list-style-type: none"> <li>1. Short-term</li> <li>2. Primarily dollar debt. Mixed currency debt, reflecting audience make-up.</li> <li>3. If possible, tied to the success of movies.</li> </ol>
Media networks	<p>Projects are likely to be</p> <ol style="list-style-type: none"> <li>1. Short-term</li> <li>2. Primarily in dollars, though foreign component is growing, especially for ESPN.</li> <li>3. Driven by advertising revenues and show success (Nielsen ratings)</li> </ol>	<p>Debt should be</p> <ol style="list-style-type: none"> <li>1. Short-term</li> <li>2. Primarily dollar debt</li> <li>3. If possible, linked to network ratings</li> </ol>
Park resorts	<p>Projects are likely to be</p> <ol style="list-style-type: none"> <li>1. Very long-term</li> <li>2. Currency will be a function of the region (rather than country) where park is located.</li> <li>3. Affected by success of studio entertainment and media networks divisions</li> </ol>	<p>Debt should be</p> <ol style="list-style-type: none"> <li>1. Long-term</li> <li>2. Mix of currencies, based on tourist makeup at the park.</li> </ol>
Consumer products	<p>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</p>	<p>Debt should be</p> <ol style="list-style-type: none"> <li>1. Medium-term</li> <li>2. Dollar debt</li> </ol>
Interactive	<p>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.</p>	<p>Debt should be short-term, convertible US dollar debt.</p>

# Recommendations for Disney

- 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 foreign currency debt. As its broadcasting businesses expand into Latin America, it may want to consider using either Mexican Peso or Brazilian Real debt as well.

# 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

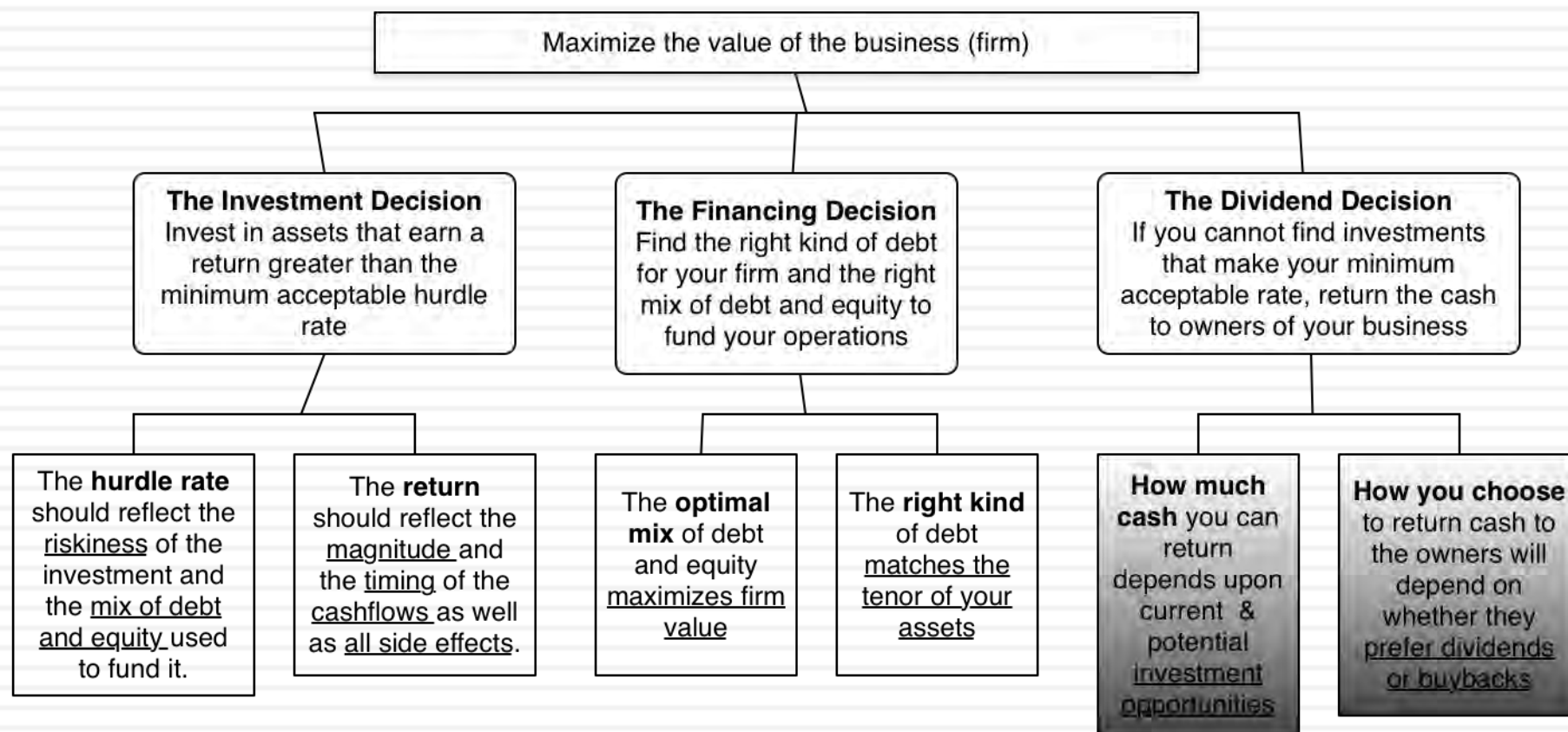
- It can swap some of its existing fixed rate, dollar debt for floating rate, foreign currency debt. Given Disney's standing in financial markets and its large market capitalization, this should not be difficult to do.
- If Disney is planning new debt issues, either to get to a higher debt ratio or to 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.



# RETURNING CASH TO THE OWNERS: DIVIDEND POLICY

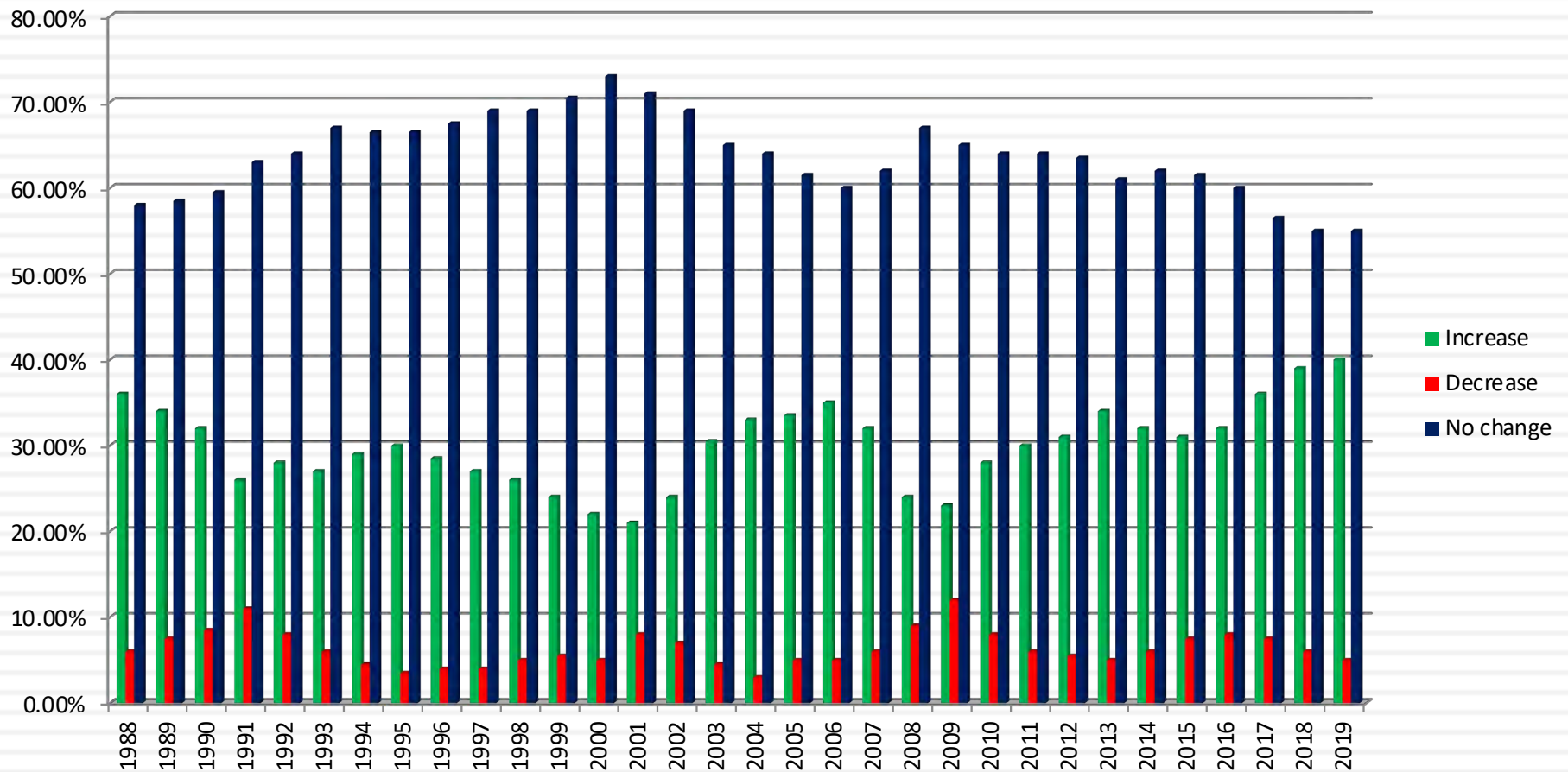
“Companies don’t have cash. They hold cash for their stockholders.”

# First Principles

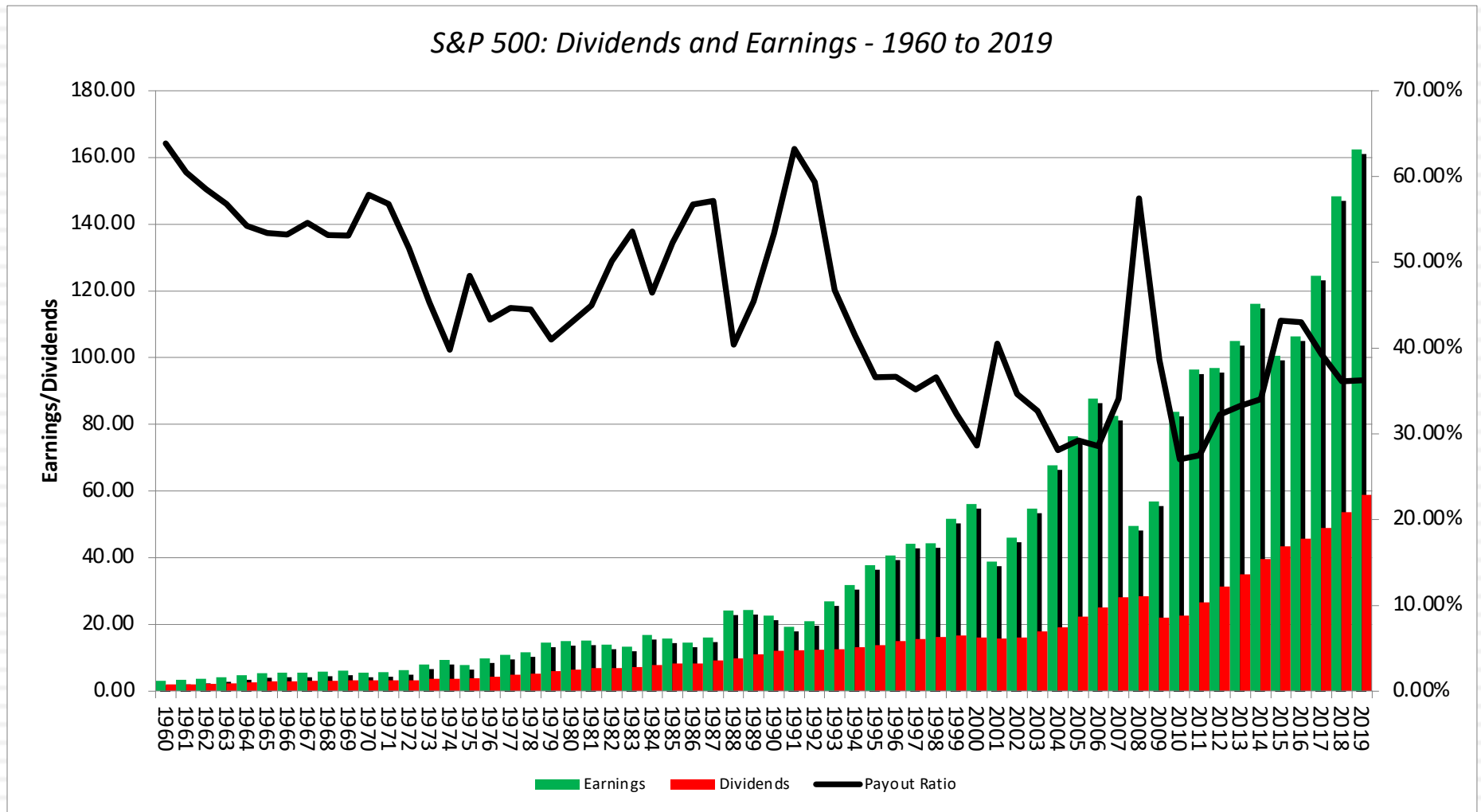


# I. Dividends are sticky

Figure 10.6: Dividend Changes at US companies

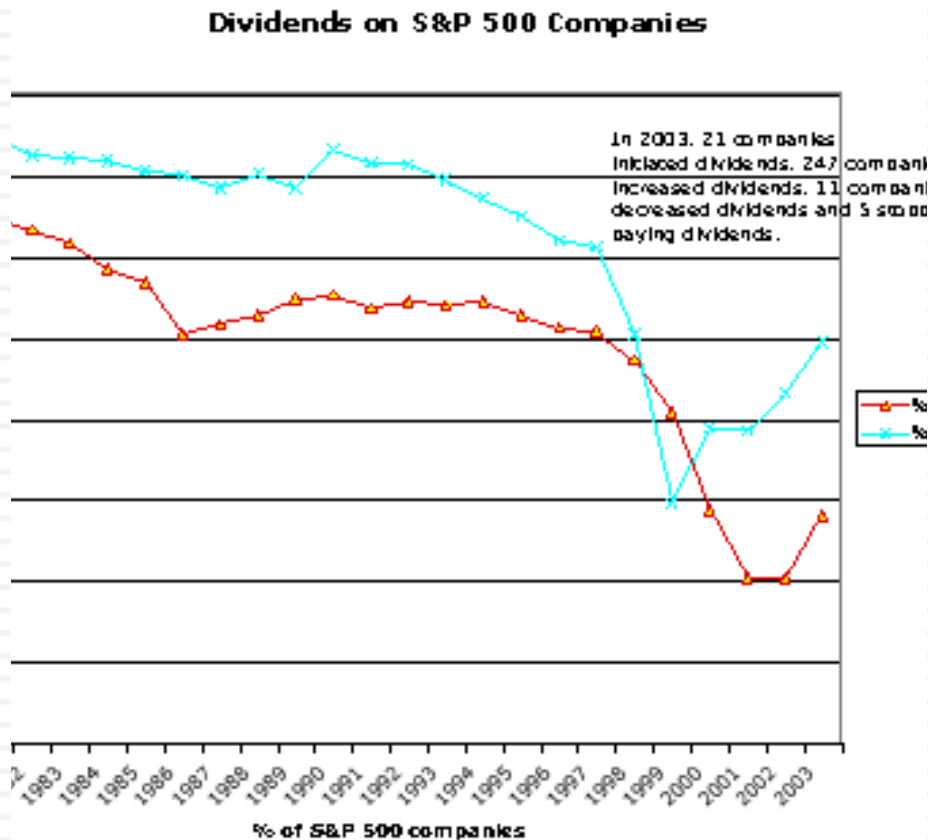


# II. Dividends tend to follow earnings



## II. Are affected by tax laws...

**In 2003**

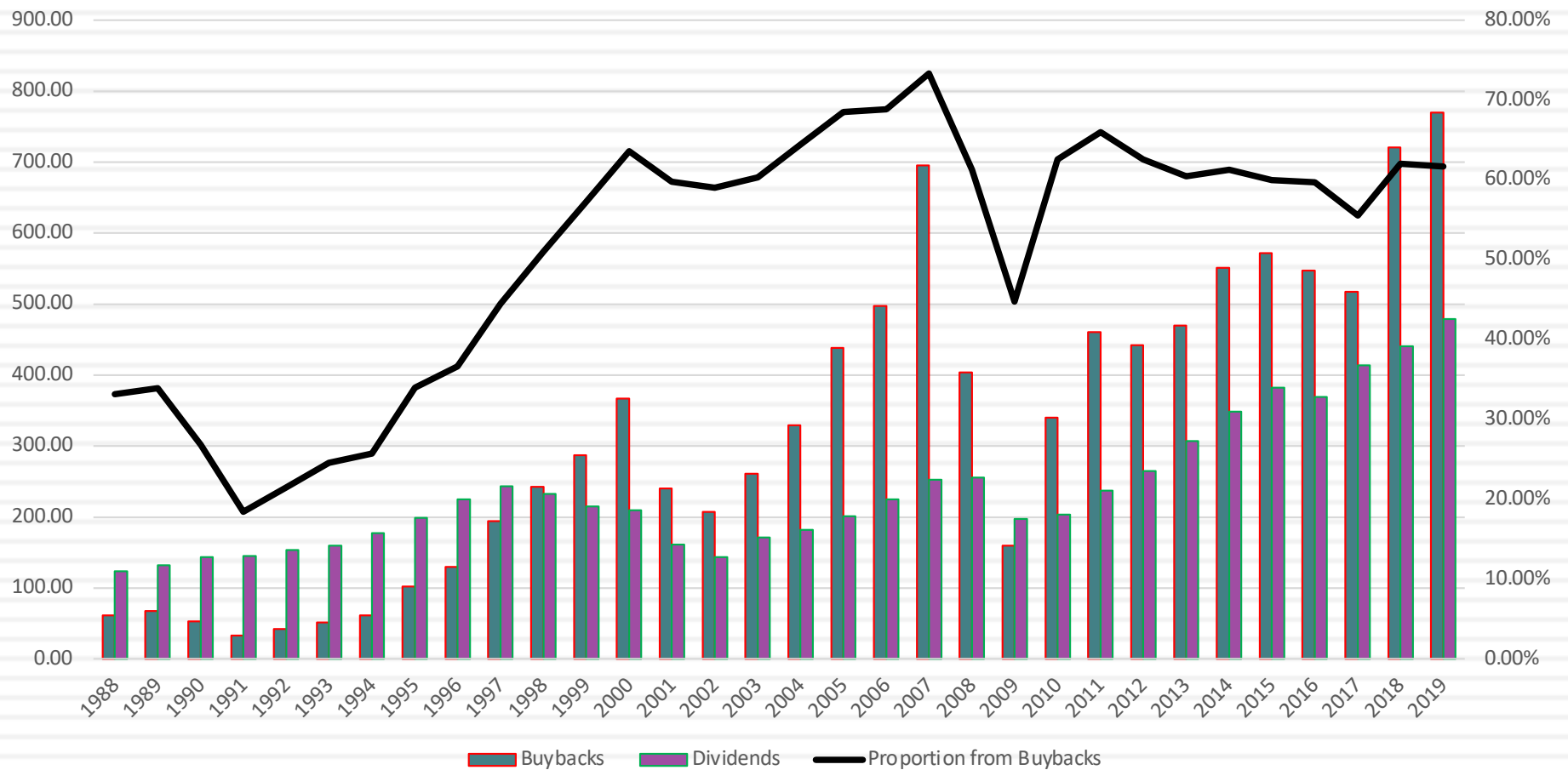


**In the last quarter of 2012**

- 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...

*Dividends and Buybacks on S&P 500: 1988- 2019*



# 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.

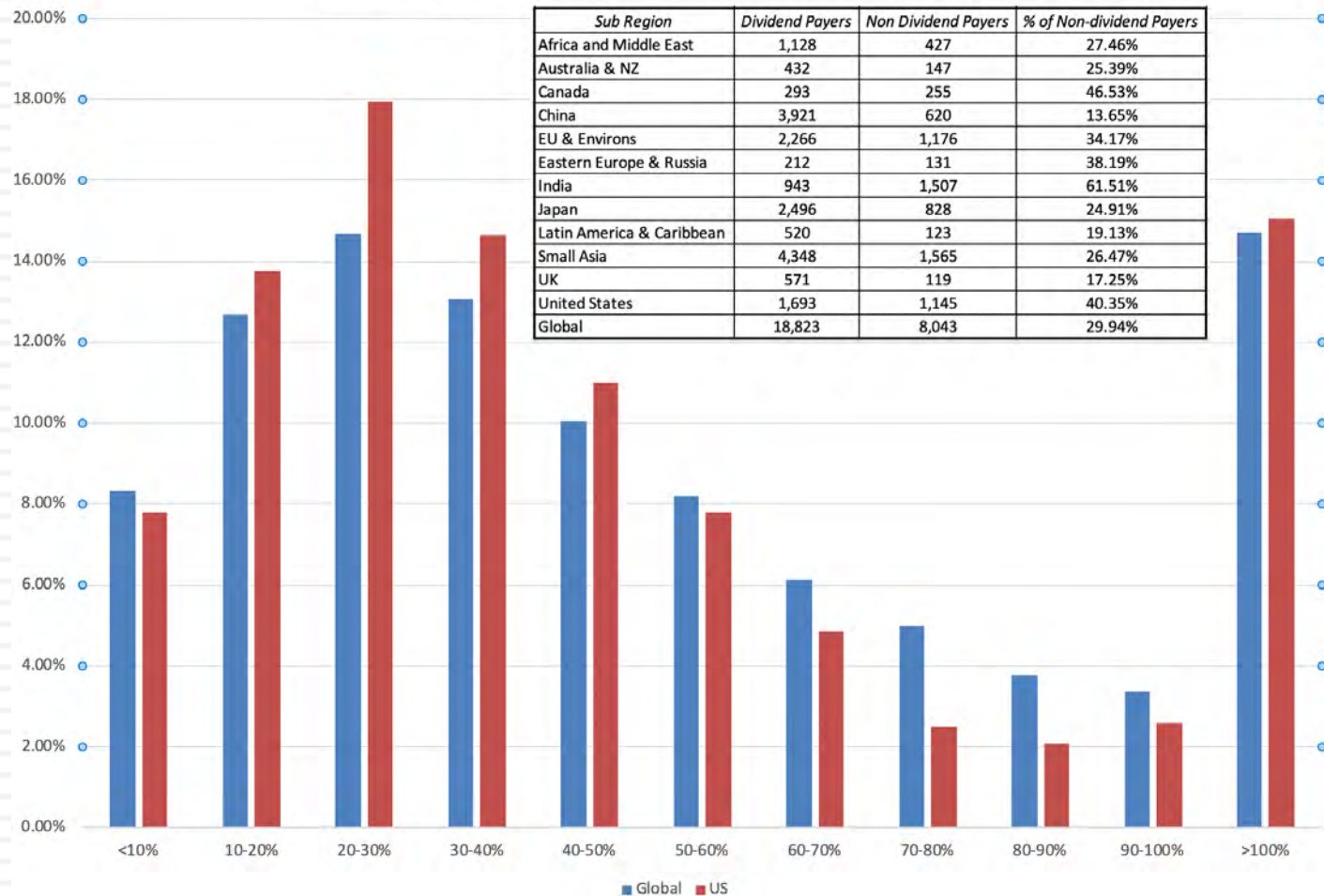
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# Dividend Payout Ratio: January 2020

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Dividend Payout Ratios - Just Dividend Paying firms: US and Global



# Dividend Yields: January 2020

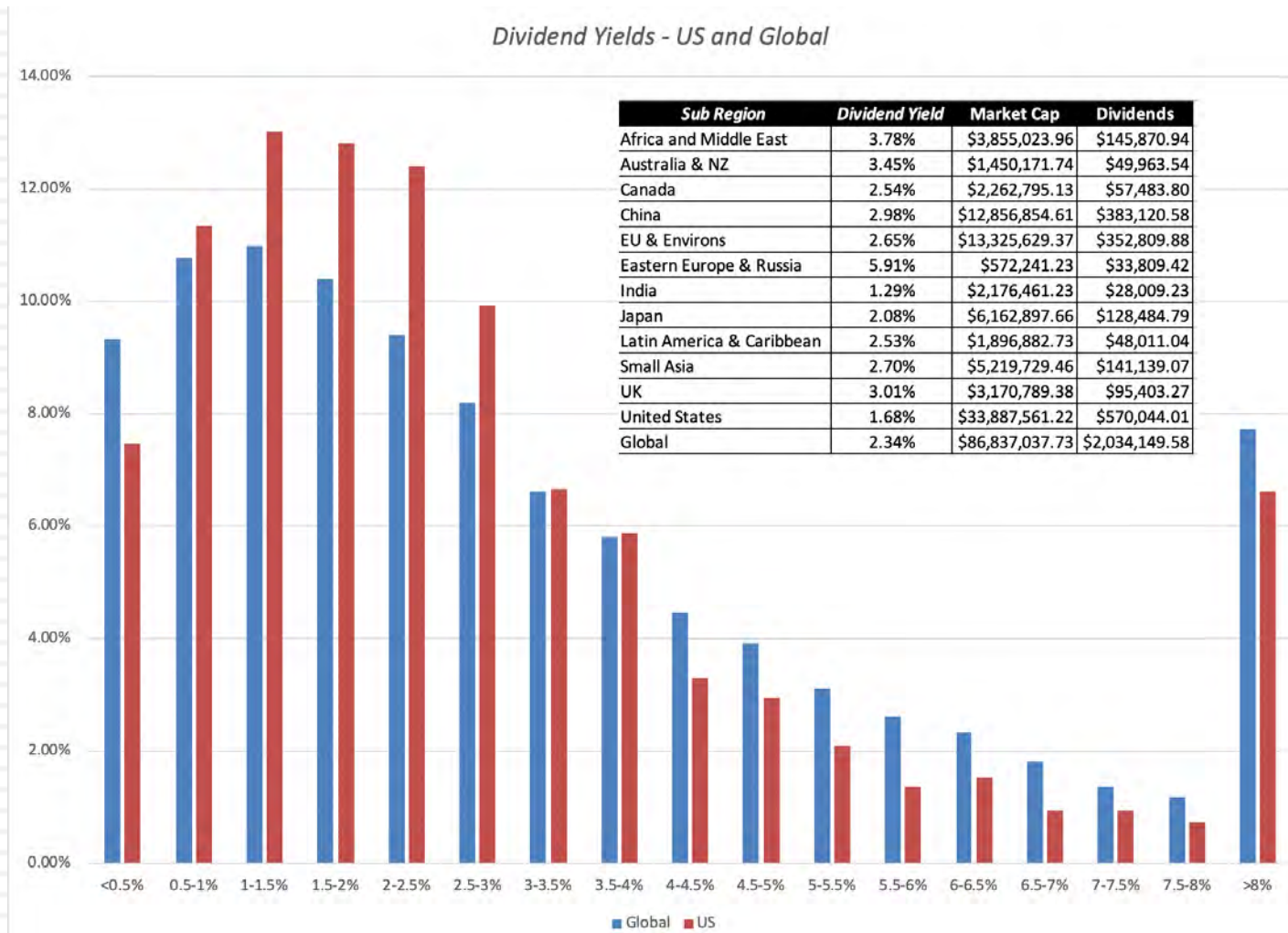
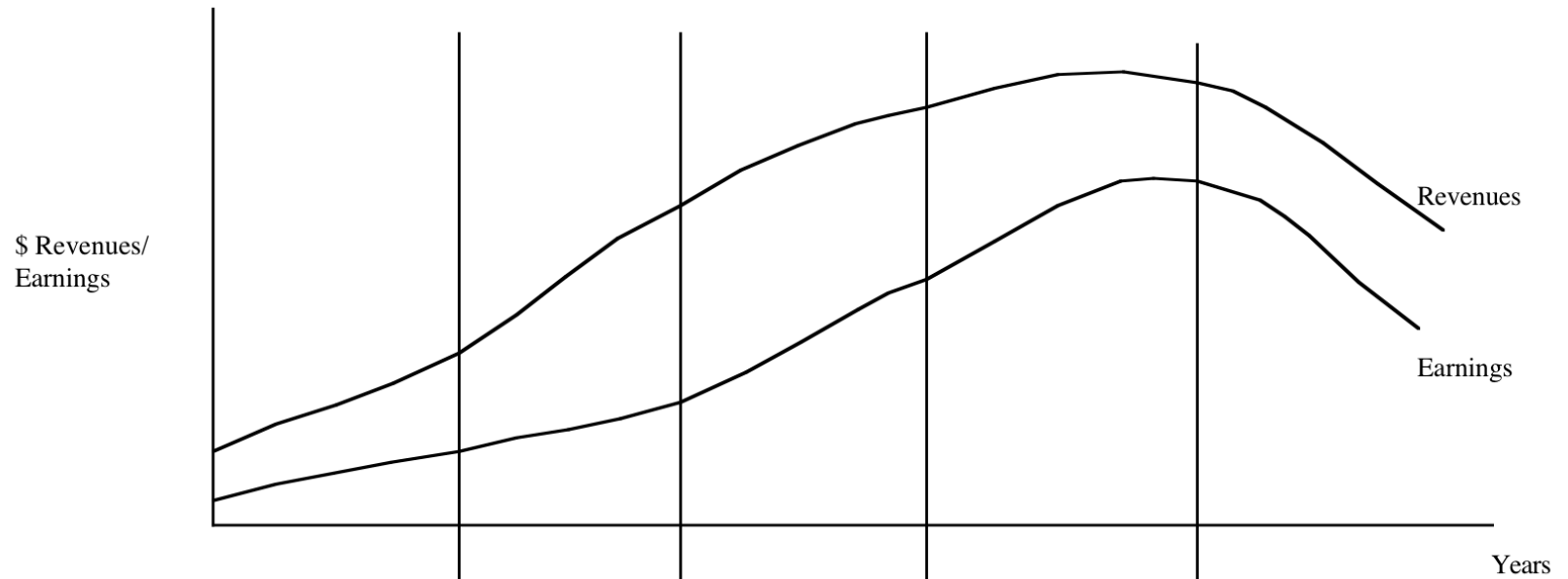


Figure 10.7: Life Cycle Analysis of Dividend Policy



<i>External funding needs</i>	High, but constrained by infrastructure	High, relative to firm value.	Moderates, relative to firm value.	Low, as projects dry up.	Low, as projects dry up.
<i>Internal financing</i>	Negative or low	Negative or low	Low, relative to funding needs	High, relative to funding needs	More than funding needs
<i>Capacity to pay dividends</i>	None	None	Very low	Increasing	High
Growth stage	Stage 1 Start-up	Stage 2 Rapid Expansion	Stage 3 High Growth	Stage 4 Mature Growth	Stage 5 Decline

# Dividend Policy: Disney et al.

	Disney	Vale	Tata Motors	Baidu	Deutsche Bank
Dividend Yield - Last 12 months	1.09%	6.56%	1.31%	0.00%	1.96%
Dividend Payout ratio - Last 12 months	21.58%	113.45%	16.09%	0.00%	362.63%
Dividend Yield - 2008-2012	1.17%	4.01%	1.82%	0.00%	3.14%
Dividend Payout - 2008-2012	17.11%	37.69%	15.53%	0.00%	37.39%

# 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**

# 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.

# 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 could the company have paid out during the period under question?
- Step 2: How much did the the company actually pay out during the period in 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 companies we are analyzing the cash returned looked as follows.

	<i>Disney</i>		<i>Vale</i>		<i>Tata Motors</i>		<i>Baidu</i>		<i>Deutsche Bank</i>	
Year	Dividends	Buybacks	Dividends	Buybacks	Dividends	Buybacks	Dividends	Buybacks	Dividends	Buybacks
2008	\$648	\$648	\$2,993	\$741	7,595₹	0₹	¥0	¥0	2,274 €	0 €
2009	\$653	\$2,669	\$2,771	\$9	3,496₹	0₹	¥0	¥0	309 €	0 €
2010	\$756	\$4,993	\$3,037	\$1,930	10,195₹	0₹	¥0	¥0	465 €	0 €
2011	\$1,076	\$3,015	\$9,062	\$3,051	15,031₹	0₹	¥0	¥0	691 €	0 €
2012	\$1,324	\$4,087	\$6,006	\$0	15,088₹	970₹	¥0	¥0	689 €	0 €
<b>2008-12</b>	<b>\$4,457</b>	<b>\$15,412</b>	<b>\$23,869</b>	<b>\$5,731</b>	<b>51,405₹</b>	<b>970₹</b>	<b>¥0</b>	<b>¥0</b>	<b>¥4,428</b>	<b>¥0</b>

# 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

- Principal Repayments

+ Proceeds from New Debt Issues

= Free Cash flow to Equity

# Disney's FCFE: 2008 – 2012

	2012	2011	2010	2009	2008	Aggregate
Net Income	\$6,136	\$5,682	\$4,807	\$3,963	\$3,307	\$23,895
- (Cap. Exp - Depr)	\$604	\$1,797	\$1,718	\$397	\$122	\$4,638
- $\Delta$ Working Capital	(\$133)	\$940	\$950	\$308	(\$109)	\$1,956
Free CF to Equity (pre-debt)	\$5,665	\$2,945	\$2,139	\$3,258	\$3,294	\$17,301
+ Net Debt Issued	\$1,881	\$4,246	\$2,743	\$1,190	(\$235)	\$9,825
= Free CF to Equity (actual debt)	\$7,546	\$7,191	\$4,882	\$4,448	\$3,059	\$27,126
Free CF to Equity (target debt ratio)	\$5,720	\$3,262	\$2,448	\$3,340	\$3,296	\$18,065
Dividends	\$1,324	\$1,076	\$756	\$653	\$648	\$4,457
Dividends + Buybacks	\$5,411	\$4,091	\$5,749	\$3,322	\$1,296	\$19,869

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).

# FCFE for a Bank?

- We redefine reinvestment as investment in regulatory capital.

$$FCFE_{\text{Bank}} = \text{Net Income} - \text{Increase in Regulatory Capital (Book Equity)}$$

- 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 and expects to generate \$ 150 million in net income:

$$FCFE = \$150 \text{ million} - (11,000 - 10,000) * (.075) = \$75 \text{ million}$$

*Deutsche Bank: FCFE estimates (November 2013)*

	Current	1	2	3	4	5
Asset Base	439,851 €	453,047 €	466,638 €	480,637 €	495,056 €	509,908 €
Capital ratio	16.00%	16.00%	16.00%	16.00%	16.00%	16.00%
Tier 1 Capital	70,376 €	72,487 €	74,662 €	76,902 €	79,209 €	81,585 €
Change in regulatory capital		2,111 €	2,175 €	2,240 €	2,307 €	2,376 €
Book Equity	76,829 €	78,940 €	81,115 €	83,355 €	85,662 €	88,038 €
ROE	-1.08%	0.74%	2.55%	4.37%	6.18%	8.00%
Net Income	-757 €	584 €	2,072 €	3,642 €	5,298 €	7,043 €
- Investment in Regulatory Capital		2,111 €	2,175 €	2,240 €	2,307 €	2,376 €
FCFE		-1,528 €	-102 €	1,403 €	2,991 €	4,667 €

# Dividends versus FCFE: Across the globe

<i>Dividend/FCFE Category</i>	<i>Australia, NZ and Canada</i>	<i>Developed Europe</i>	<i>Emerging Markets</i>	<i>Japan</i>	<i>United States</i>	<i>Global</i>
FCFE>0, Dividends+Buybacks=0	34.68%	15.35%	9.33%	4.55%	16.08%	14.53%
FCFE>0, FCFE>Dividends+Buybacks	12.40%	18.38%	21.29%	13.26%	31.93%	21.01%
Cash Accumulators	47.08%	33.73%	30.62%	17.81%	48.01%	35.54%
FCFE<0, Dividends+Buybacks=0	28.19%	13.53%	11.75%	6.07%	8.64%	11.60%
FCFE>0, Dividends+Buybacks>FCFE	14.16%	33.23%	30.39%	44.18%	22.96%	29.16%
FCFE<0, Dividends+Buybacks>0	10.57%	19.51%	27.24%	31.94%	20.39%	23.70%
Cash Overpayers	24.73%	52.74%	57.63%	76.12%	43.35%	52.86%

# Application Test: Estimating your firm's FCFE

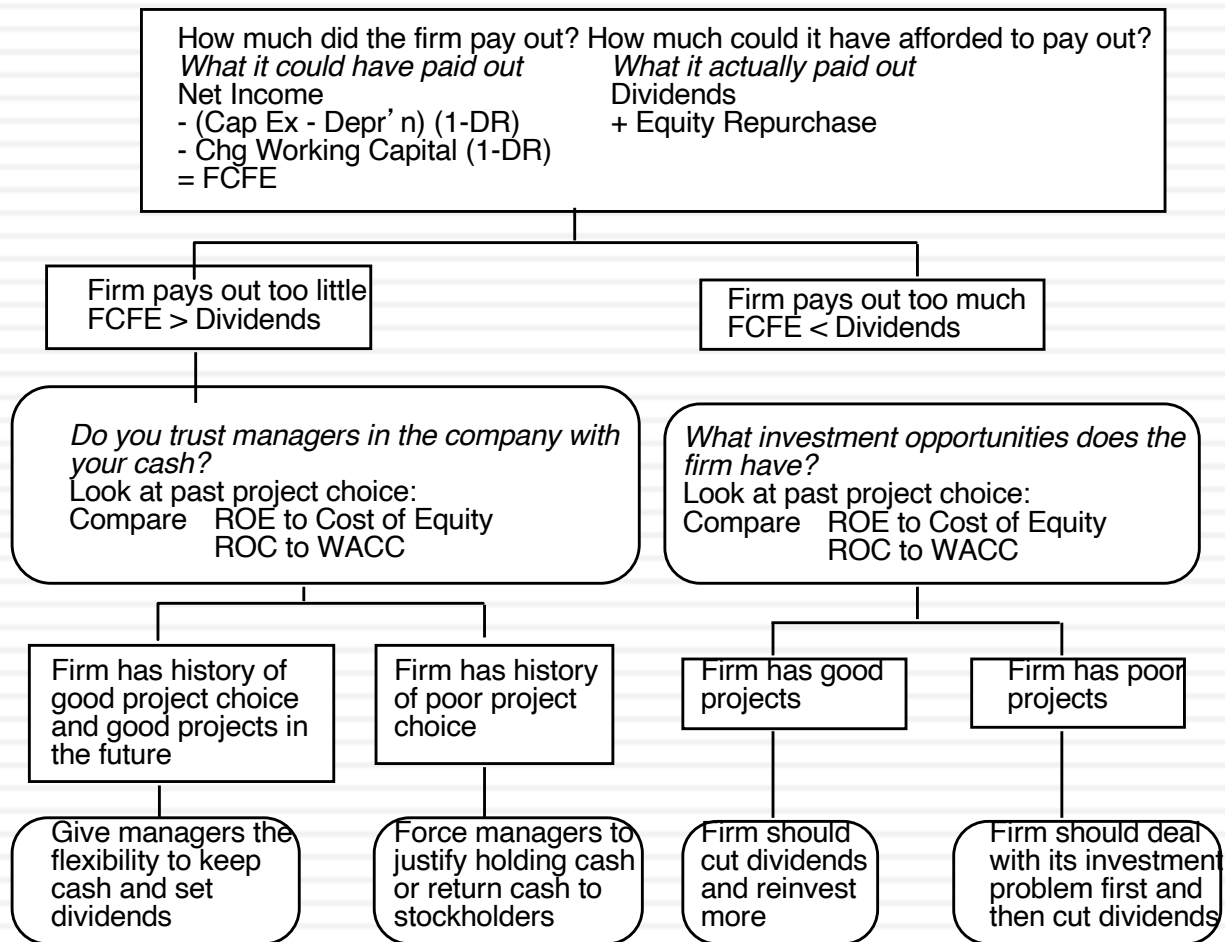
- In General,  
Net Income  
+ Depreciation & Amortization  
- Capital Expenditures  
- Change in Non-Cash Working Capital  
- Preferred Dividend  
- Principal Repaid  
+ New Debt Issued  
  
= FCFE

- 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

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# A Practical Framework for Analyzing Dividend Policy



# A Dividend Matrix

Quality of projects taken: ROE versus Cost of Equity

Poor projects

Good projects

Dividends paid out relative to FCFE Cash Surplus  Cash Deficit	Cash Surplus + Poor Projects Significant pressure to pay out more to stockholders as dividends or stock buybacks	Cash Surplus + Good Projects Maximum flexibility in setting dividend policy
	Cash Deficit + Poor Projects Cut out dividends but real problem is in investment policy.	Cash Deficit + Good Projects Reduce cash payout, if any, to stockholders



# 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 it's 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

# 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

# A twist: Disney in 2013

- Disney did return to holding cash between 2008 and 2013, with dividends and buybacks amounting to \$7 billion less than the FCFE (with actual debt used) 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

# Fast Forward: Disney in 2019

- Bob Iger is still CEO, but without a clear successor in place. Disney's stock has lagged the market, but it has made or is planning to make big (and expensive) moves.
  - Having acquired Fox for more than \$70 billion, Disney is looking at bringing the two companies together, shedding parts where there is overlap and building on synergies.
  - It is also thinking about spending billions to create a streaming channel for Disney content, partly in response to the growth of Netflix and partly to capture changes in the entertainment business.
- As an investor, would you push for more or less cash to be returned by the company?
  - a. More cash returned
  - b. Less cash returned

Why?

## Case 2: Vale – Dividends versus FCFE

	Aggregate	Average
Net Income	\$42,948.00	\$8,589.60
Dividends	\$23,869.00	\$4,773.80
Dividend Payout Ratio	55.58%	87.76%
Stock Buybacks	\$5,731.00	\$1,146.20
Dividends + Buybacks	\$29,600.00	\$5,920.00
Cash Payout Ratio	68.92%	
Free CF to Equity (pre-debt)	(\$3,076.00)	(\$615.20)
Free CF to Equity (actual debt)	(\$1,266.00)	(\$253.20)
Free CF to Equity (target debt ratio)	\$13,252.43	\$2,650.49
Cash payout as % of pre-debt FCFE	FCFE negative	
Cash payout as % of actual FCFE	FCFE negative	
Cash payout as % of target FCFE	223.36%	

# 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

# Case 3: BP: Summary of Dividend Policy: 1982-1991

<i>Summary of calculations</i>				
	<i>Average</i>	<i>Standard Deviation</i>	<i>Maximum</i>	<i>Minimum</i>
<i>Free CF to Equity</i>	\$571.10	\$1,382.29	\$3,764.00	(\$612.50)
<i>Dividends</i>	\$1,496.30	\$448.77	\$2,112.00	\$831.00
<i>Dividends+Repurchases</i>	\$1,496.30	\$448.77	\$2,112.00	\$831.00
<i>Dividend Payout Ratio</i>	84.77%			
<i>Cash Paid as % of FCFE</i>	262.00%			
<i>ROE - Required return</i>	-1.67%	11.49%	20.90%	-21.59%



# BP: Just Desserts!

British Petroleum said yesterday that it would cut its dividend by 55 percent, take a pretax restructuring charge of \$1.82 billion for the second quarter and lay off 11,500 employees, or 10 percent of its worldwide work force. 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 depository rights, each of which represents 12 shares of the London-based company, dropped \$3.625, or 7.36 percent, to \$45.375. It was the most active issue on the New York Stock Exchange, with 5.89 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 \$868 million, down 22 percent.

## Quick: Recovery Seems Unlikely

Adding to the gloom at B.P., the new chief executive, David A. G. Simon, 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

Europe, recovery will depend upon seasonal heating oil demand," Mr. Simon 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

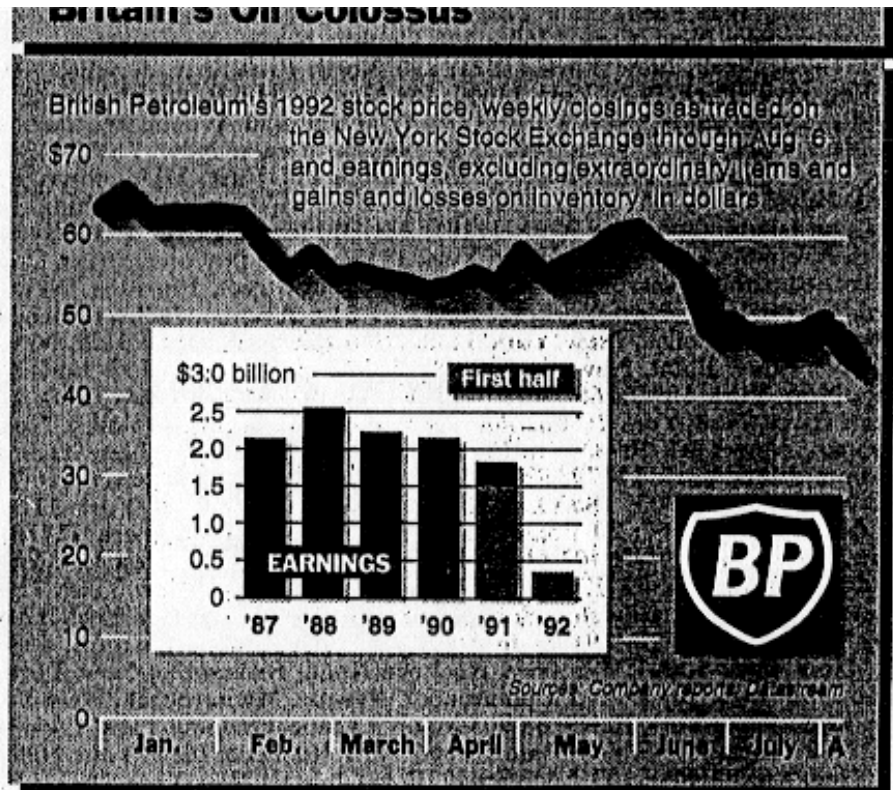
## The giant British oil company bet on rising oil prices.

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, declined to \$193 million from \$515 million, valuing inventories on a replacement-cost basis. James J. Murchie, an analyst at Stanford C. Bernstein, estimated that after exceptional items, earnings per share fell to 30 cents in the second quarter, compared with 62 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.



after B.P. acquired Sohio, said, "What you've got is a company that thought oil prices were going to go to \$25 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 maintain its

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

## 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.

Company	Dividend Yield		Dividend Payout		Comparable Group	Dividend Yield	Dividend Payout
	2013	Average 2008-12	2013	Average 2008-12			
Disney	1.09%	1.17%	21.58%	17.11%	US Entertainment	0.96%	22.51%
Vale	6.56%	4.01%	113.45%	37.69%	Global Diversified Mining & Iron Ore (Market cap > \$1 b)	3.07%	316.32%
Tata Motors	1.31%	1.82%	16.09%	15.53%	Global Autos (Market Cap > \$1 b)	2.13%	27.00%
Baidu	0.00%	0.00%	0.00%	0.00%	Global Online Advertising	0.09%	8.66%
Deutsche Bank	1.96%	3.14%	362.63%	37.39%	European Banks	1.96%	79.32%

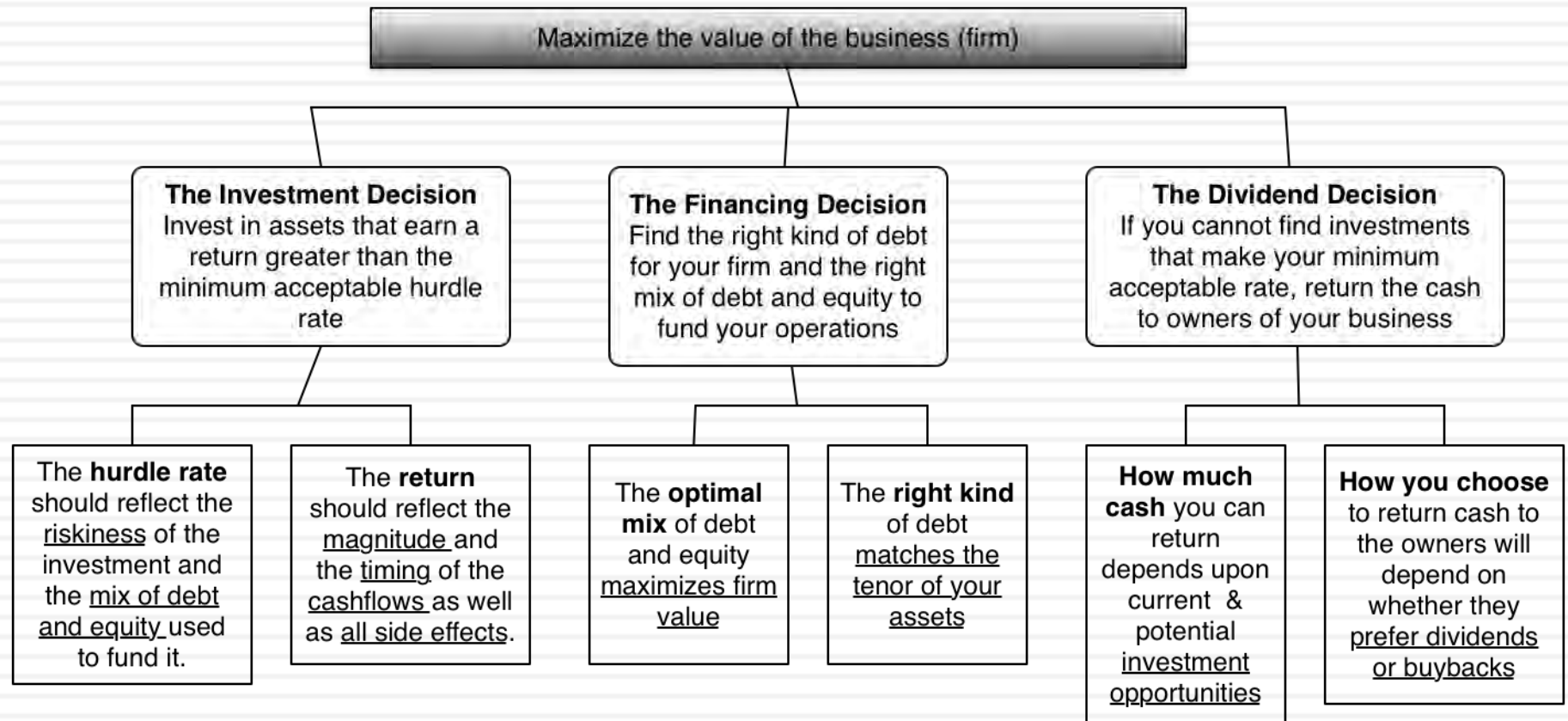


# VALUATION

Cynic: A person who knows the price of everything but the value of nothing..  
Oscar Wilde



# First Principles



# Three approaches to valuation

1. 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.
2. 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.
3. 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.

# Intrinsic Value: Four Basic Propositions

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The value of an asset is the present value of the expected cash flows on that asset, over its expected life:

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

- 1. The IT Proposition:* If “it” does not affect the cash flows or alter risk (thus changing discount rates), “it” cannot affect value.
- 2. The DUH Proposition:* For an asset to have value, the expected cash flows have to be positive some time over the life of the asset.
- 3. The DON'T FREAK OUT Proposition:* Assets that generate cash flows early in their life will be worth more than assets that generate cash flows later; the latter may however have greater growth and higher cash flows to compensate.
- 4. The VALUE IS NOT PRICE Proposition:* The value of an asset may be very different from its price.

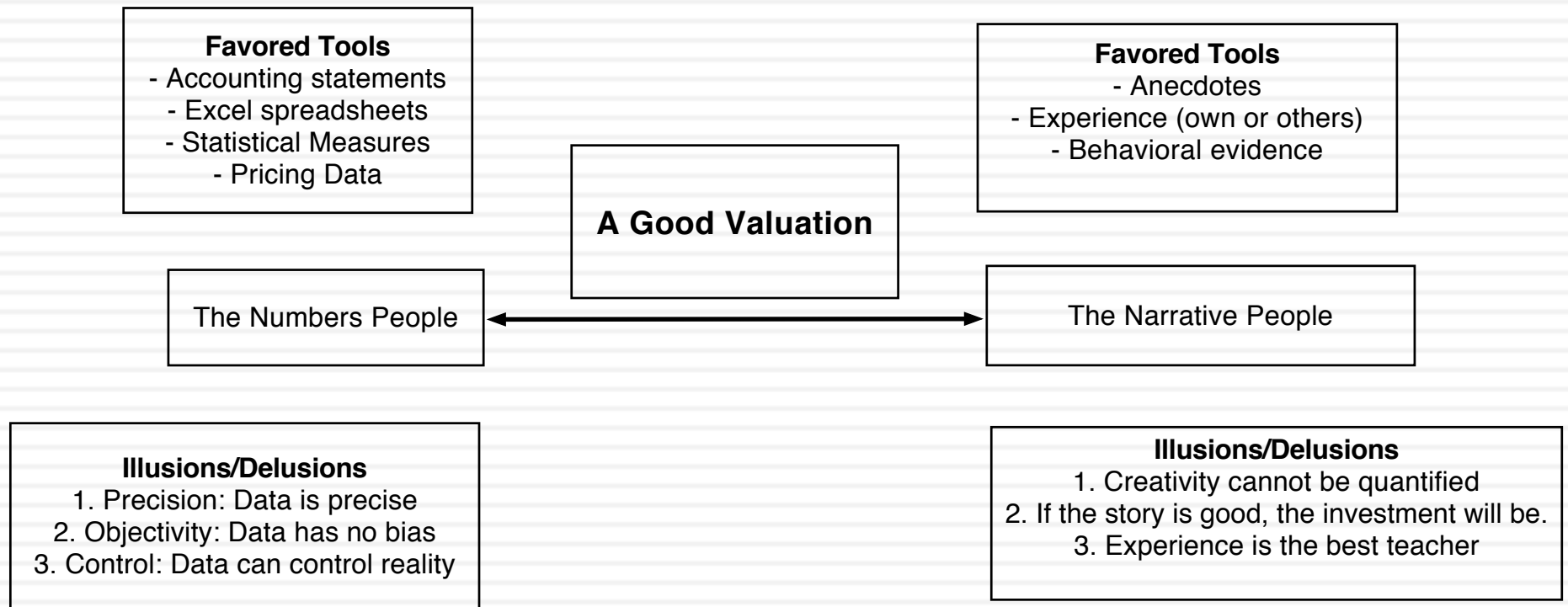
# DCF Choices: Equity Valuation versus Firm Valuation

**Firm Valuation:** Value the entire business

Assets		Liabilities	
Existing Investments Generate cashflows today Includes long lived (fixed) and short-lived (working capital) assets	Assets in Place	Debt	Fixed Claim on cash flows Little or No role in management <i>Fixed Maturity</i> <i>Tax Deductible</i>
Expected Value that will be created by future investments	Growth Assets	Equity	Residual Claim on cash flows Significant Role in management <i>Perpetual Lives</i>

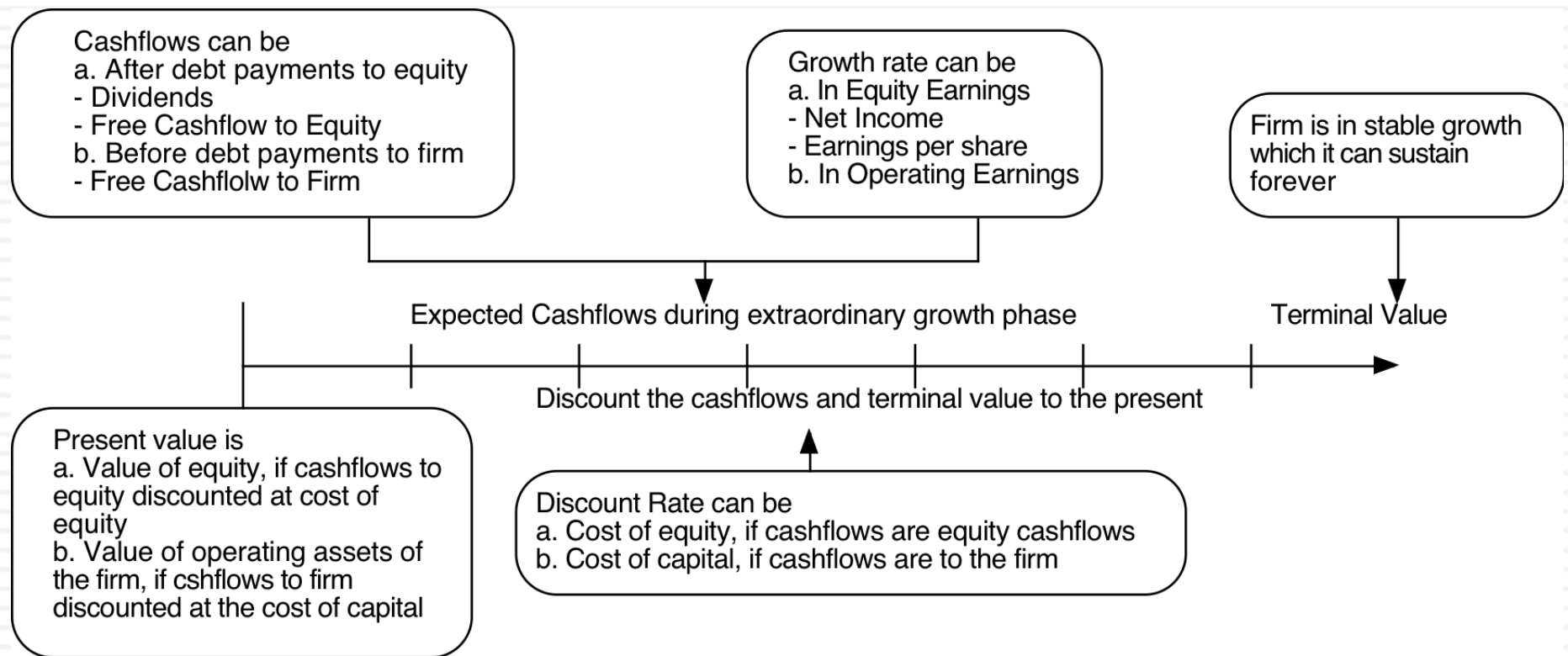
**Equity valuation:** Value just the equity claim in the business

# Stories + Numbers = Value

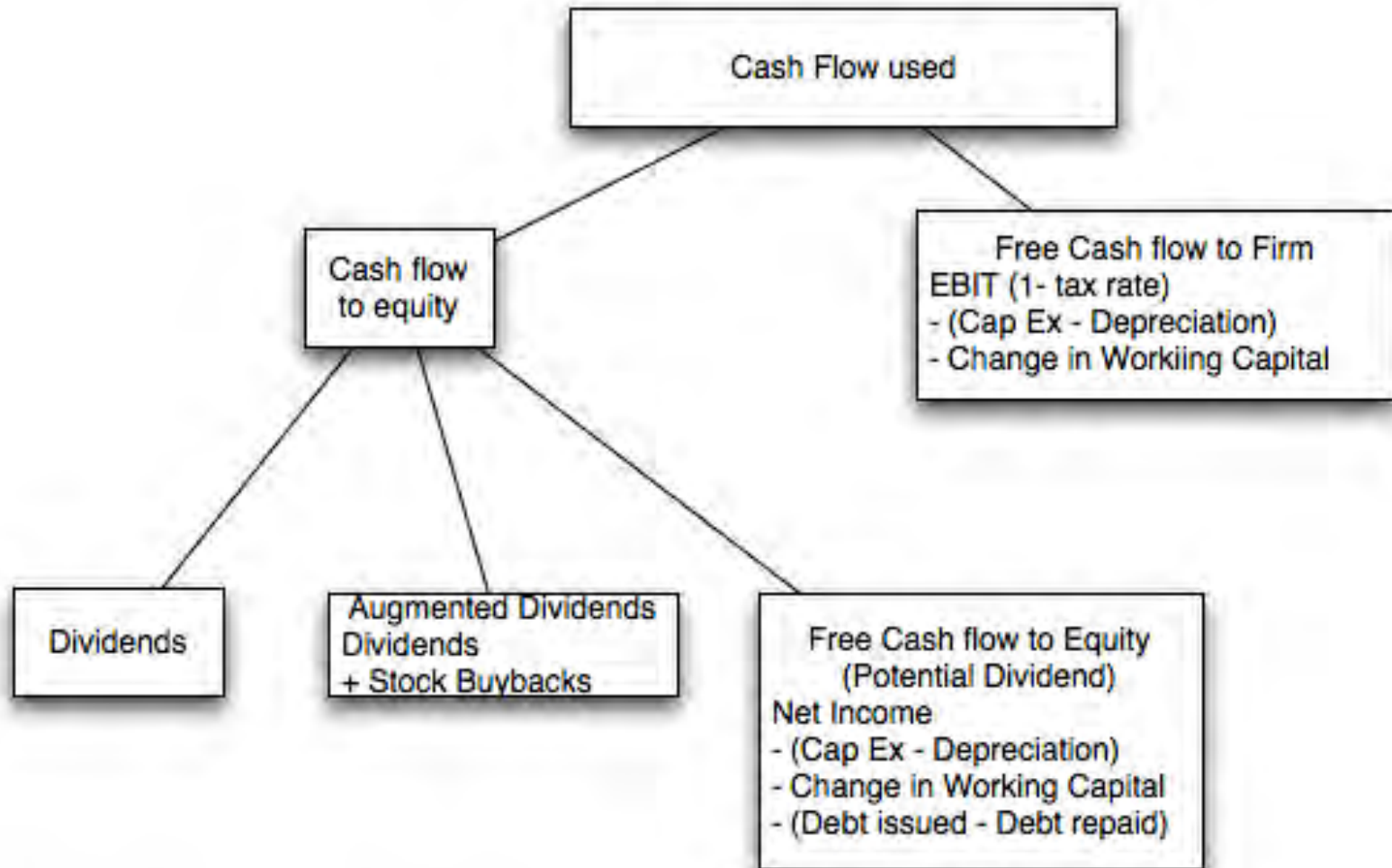




# The Ingredients that determine value.



# I. Estimating Cash Flows



# 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

- Keep it current: When doing a valuation, you need a discount rate that reflects today's conditions. Not only does this require you to update the base risk free rate, but also your risk premiums (equity risk premium and default spread) and perhaps even your measures of risk (betas, default risk measures)
- Keep it consistent: At an intuitive level, the discount rate used should be consistent with both the riskiness and the type of cash flow 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.
- Keep it in perspective: The discount rate obviously matters in a discounted cash flow valuation, but not as much as your other inputs. In fact, as uncertainty about the future increases, the more you should focus on estimating cash flows and the less you should focus on discount rates.

# 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%.

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

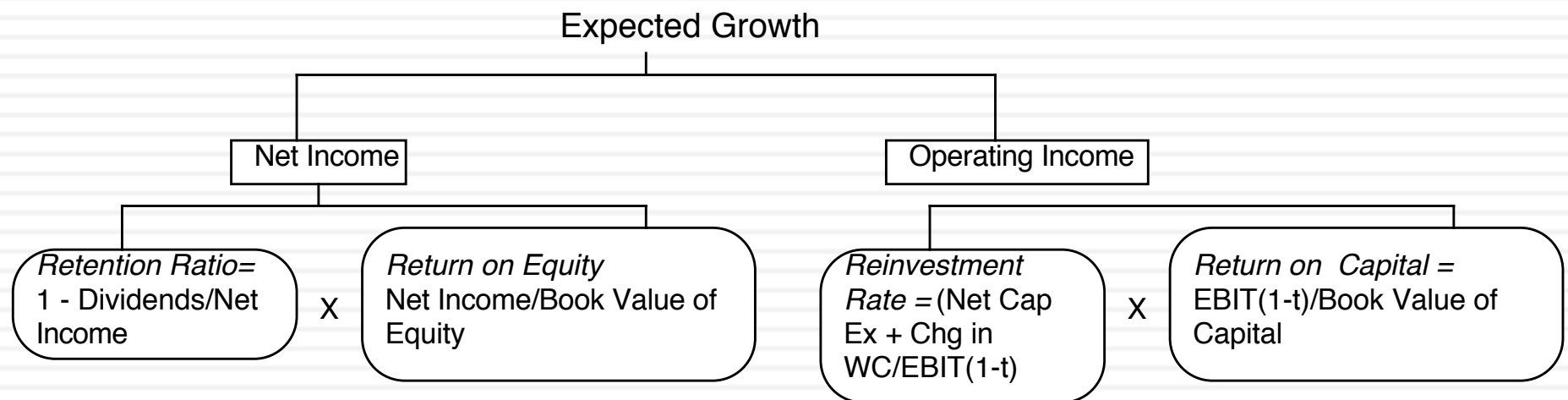
- The cost of capital was calculated using these costs and the weights based on market values of equity (121,878) and debt (15,961):

$$\text{Cost of capital} = 8.52\% \frac{121,878}{(15,961+121,878)} + 2.40\% \frac{15,961}{(15,961+121,878)} = 7.81\%$$

# But costs of equity and capital can and should change over time...

Year	Beta	Cost of Equity	After-tax Cost of Debt	Debt Ratio	Cost of capital
1	1.0013	8.52%	2.40%	11.50%	7.81%
2	1.0013	8.52%	2.40%	11.50%	7.81%
3	1.0013	8.52%	2.40%	11.50%	7.81%
4	1.0013	8.52%	2.40%	11.50%	7.81%
5	1.0013	8.52%	2.40%	11.50%	7.81%
6	1.0010	8.52%	2.40%	13.20%	7.71%
7	1.0008	8.51%	2.40%	14.90%	7.60%
8	1.0005	8.51%	2.40%	16.60%	7.50%
9	1.0003	8.51%	2.40%	18.30%	7.39%
10	1.0000	8.51%	2.40%	20.00%	7.29%

# III. Expected Growth



# 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:

$$\text{Return on Capital}_{2013} = \frac{\text{EBIT} (1-t)}{(\text{BV of Equity} + \text{BV of Debt} - \text{Cash})} = \frac{10,032 (1-.361)}{(41,958 + 16,328 - 3,387)} = 12.61\%$$

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.

$$\text{Expected Growth Rate from Existing Fundamentals} = 53.93\% * 12.61\% = 6.8\%$$



## 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:

$$\text{Value} = \sum_{t=1}^{t=N} \frac{CF_t}{(1+r)^t} + \frac{\text{Terminal Value}}{(1+r)^N}$$

- 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)

# Estimating Stable Period Inputs: 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 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%

# V. From firm value to equity value per share

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

# Disney: Inputs to Valuation

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

# Disney - November 2013

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

Reinvestment Rate  
53.93%

Return on Capital  
12.61%

**Expected Growth**  
 $.5393 \times .1261 = .068$  or 6.8%

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

Terminal Value<sub>10</sub> = 9,086 / (.0729 - .025) = 189,738

First 5 years

Growth declines gradually to 2.75%

Op. Assets 125,484  
 + Cash: 3,931  
 + Non op inv 2,849  
 - Debt 15,961  
 - Minority Int 2,721  
 = Equity 113,582  
 - Options 869  
**Value/Share \$ 62.26**

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

**Term Yr**  
 12,114  
 3,029  
 9,086

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

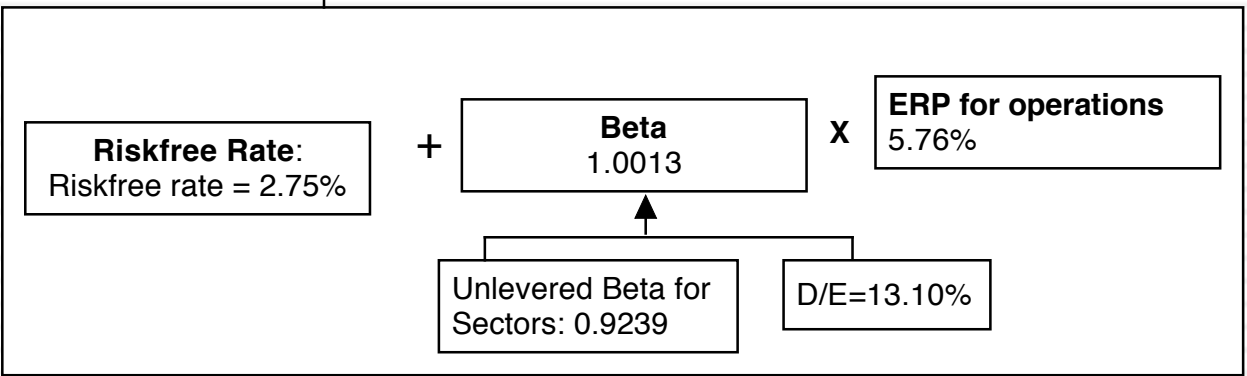
Cost of capital declines gradually to 7.29%

**Cost of Equity**  
8.52%

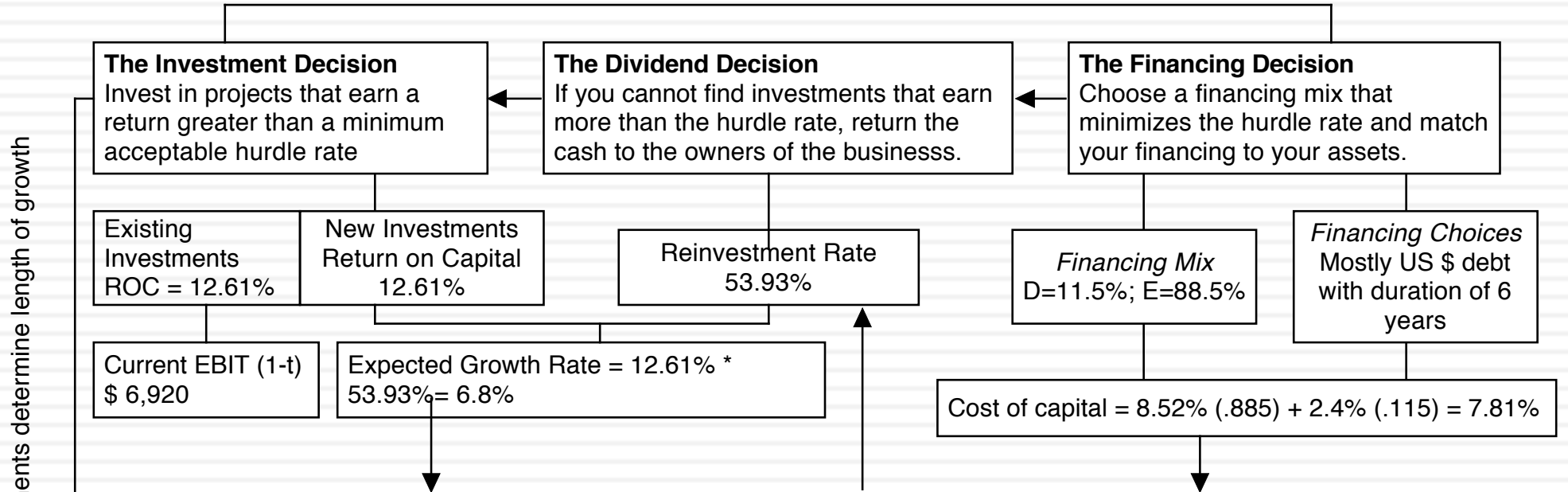
**Cost of Debt**  
 $(2.75\% + 1.00\%)(1 - .361)$   
 = 2.40%  
 Based on actual A rating

**Weights**  
 E = 88.5% D = 11.5%

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



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



Strategic investments determine length of growth period

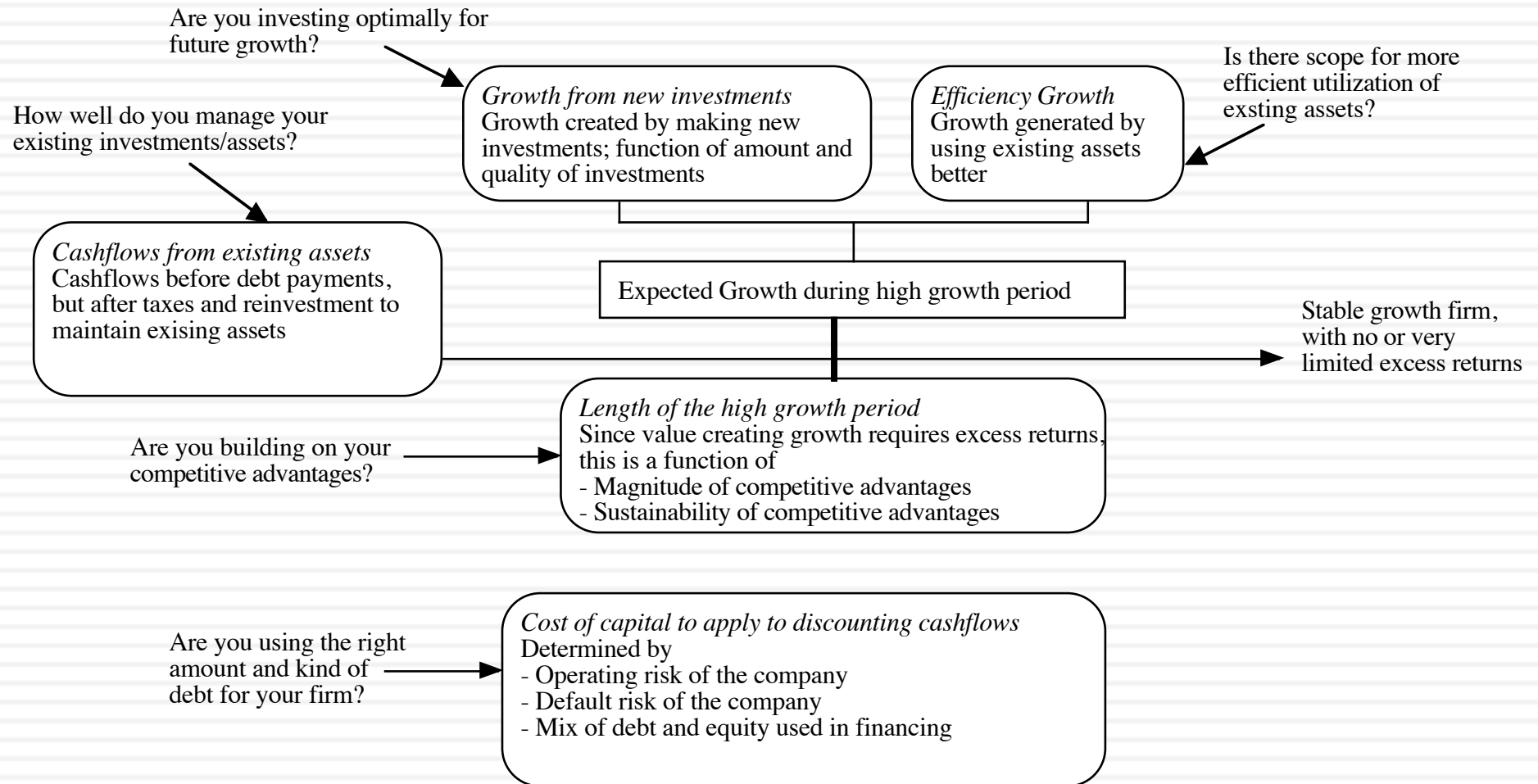
Year	Expected Growth	EBIT (1-t)	Reinvestment	FCFF	Terminal Value	Cost of capital	PV
1	6.80%	\$7,391	\$3,985	\$3,405		7.81%	\$3,158
2	6.80%	\$7,893	\$4,256	\$3,637		7.81%	\$3,129
3	6.80%	\$8,430	\$4,546	\$3,884		7.81%	\$3,099
4	6.80%	\$9,003	\$4,855	\$4,148		7.81%	\$3,070
5	6.80%	\$9,615	\$5,185	\$4,430		7.81%	\$3,041
6	5.94%	\$10,187	\$4,904	\$5,283		7.71%	\$3,367
7	5.08%	\$10,704	\$4,534	\$6,170		7.60%	\$3,654
8	4.22%	\$11,156	\$4,080	\$7,076		7.50%	\$3,899
9	3.36%	\$11,531	\$3,550	\$7,981		7.39%	\$4,094
10	2.50%	\$11,819	\$2,955	\$8,864	\$189,738	7.29%	\$94,966

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

Disney: Corporate Financing Decisions and Firm Value

# Ways of changing value...





# Disney (Restructured)- November 2013

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

Reinvestment Rate  
50.00%

*More selective acquisitions & payoff from gaming*

Return on Capital  
14.00%

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

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

First 5 years

Growth declines gradually to 2.75%

Terminal Value<sub>10</sub> = 9,206 / (.0676 - .025) = 216,262

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

**Term Yr**  
 12,275  
 3,069  
 9,206

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

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

Cost of capital declines gradually to 6.76%

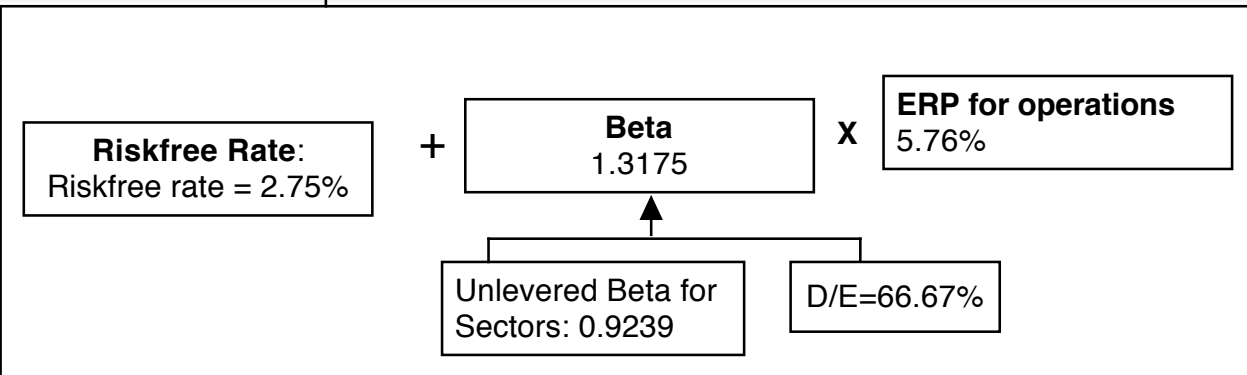
**Cost of Equity**  
10.34%

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

**Weights**  
 E = 60% D = 40%

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

*Move to optimal debt ratio, with higher beta.*



# First Principles

