VALUATION: ART, SCIENCE OR MAGIC?

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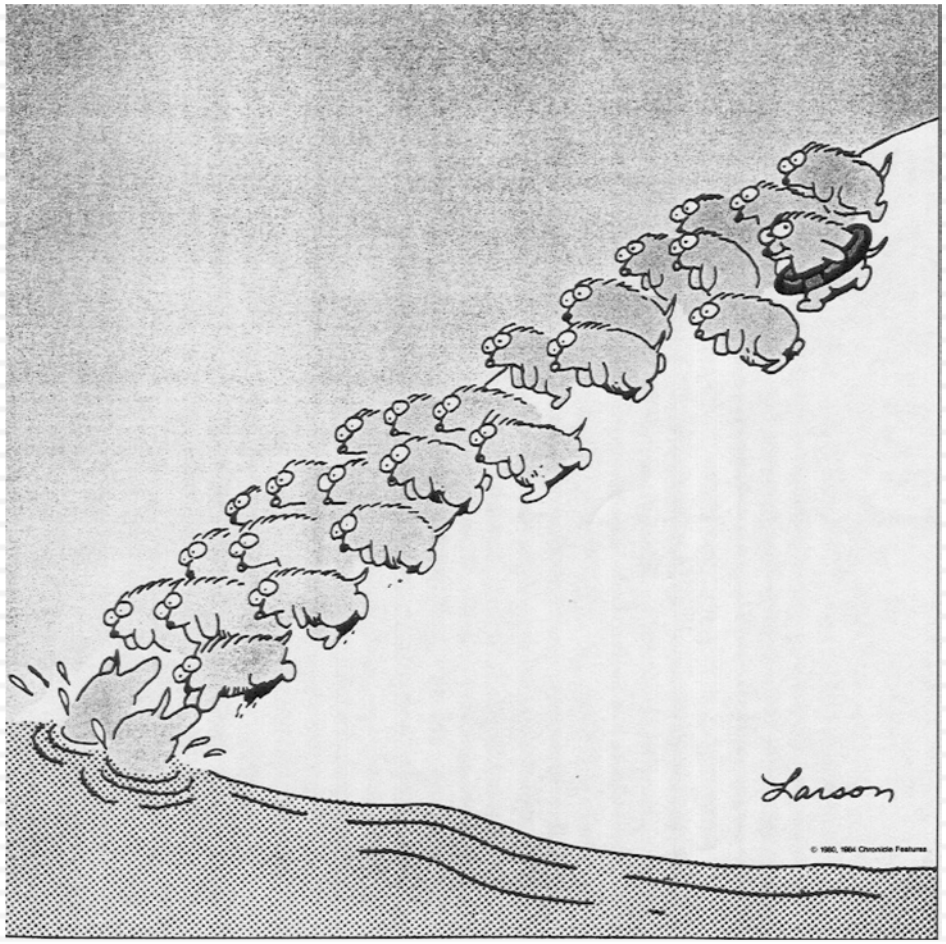
Some Initial Thoughts

" One hundred thousand lemmings cannot be wrong"

Graffiti



Theme 1: Characterizing Valuation as a discipline

- In a science, if you get the inputs right, you should get the output right. The laws of physics and mathematics are universal and there are no exceptions. **Valuation is not a science**.
- In an art, there are elements that can be taught but there is also a magic that you either have or you do not. The essence of an art is that you are either a great artist or you are not. **Valuation is not an art.**
- A craft is a skill that you learn by doing. The more you do it, the better you get at it. **Valuation is a craft.**

Theme 2: Valuing an asset is not the same as pricing that asset

Drivers of intrinsic value
- Cashflows from existing assets
- Growth in cash flows
- Quality of Growth

Drivers of price
- Market moods & momentum
- Surface stories about fundamentals

Accounting Estimates

Valuation Estimates

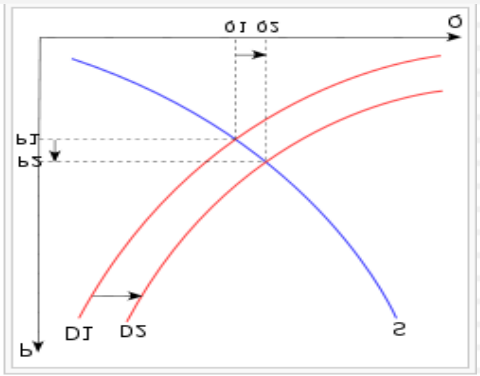
INTRINSIC VALUE

Value

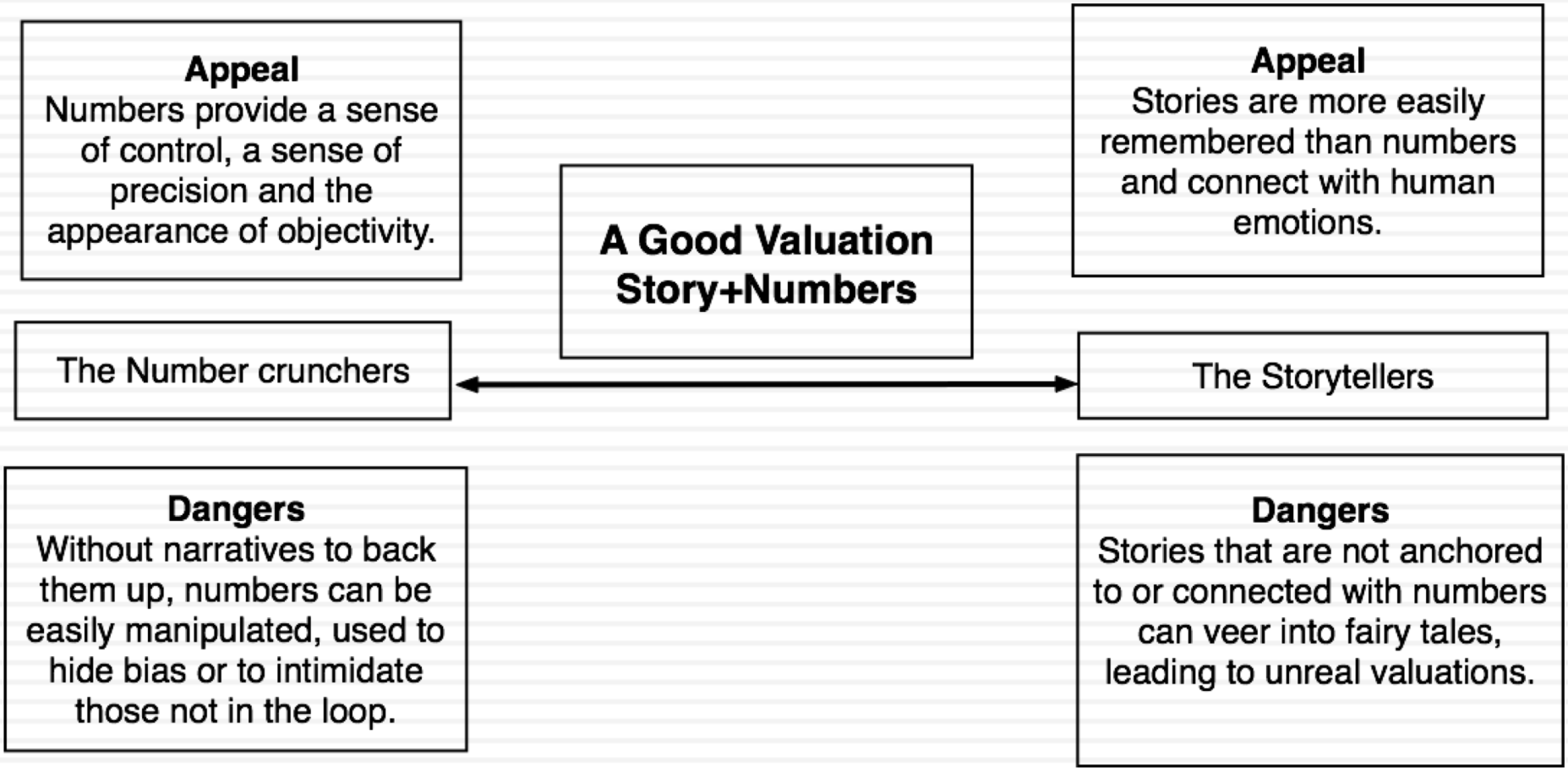
THE GAP
Is there one?
If so, will it close?
If it will close, what will cause it to close?

Price

PRICE



Theme 3: Good valuation = Story + Numbers



Theme 4: If you value something, you should be willing to act on it..

- What theory? There is very little theory in valuation and I am not sure what an academic valuation would like like and am not sure that I want to find out.
- Pragmatism, not purity: The end game is to estimate a value for an asset. I plan to get there, even if it means taking short cuts and making assumptions that would make purists blanch.
- Faith: To act on your valuations, you have to have faith in
  - In your own valuation judgments.
  - In markets: that prices will move towards your value estimates.

  That faith will have to be earned and will be tested.

Misconceptions about Valuation

- Myth 1: A valuation is an objective search for "true" value
  - Truth 1.1: All valuations are biased. The only questions are how much and in which direction.
  - Truth 1.2: The direction and magnitude of the bias in your valuation is directly proportional to who pays you and how much you are paid.
- Myth 2.: A good valuation provides a precise estimate of value
  - Truth 2.1: There are no precise valuations.
  - Truth 2.2: The payoff to valuation is greatest when valuation is least precise.
- Myth 3: . The more quantitative a model, the better the valuation
  - Truth 3.1: One's understanding of a valuation model is inversely proportional to the number of inputs required for the model.
  - Truth 3.2: Simpler valuation models do much better than complex ones.

Approaches to Valuation

- **Intrinsic valuation**, relates the value of an asset to the present value of expected future cashflows on that asset. In its most common form, this takes the form of a discounted cash flow valuation.
- **Relative valuation**, estimates the value of an asset by looking at the pricing of 'comparable' assets relative to a common variable like earnings, cash flows, book value or sales.
- **Contingent claim valuation**, uses option pricing models to measure the value of assets that share option characteristics.

Discounted Cash Flow Valuation

- *What is it*: In discounted cash flow valuation, the value of an asset is the present value of the expected cash flows on the asset.
- *Philosophical Basis*: Every asset has an intrinsic value that can be estimated, based upon its characteristics in terms of cash flows, growth and risk.
- *Information Needed*: To use discounted cash flow valuation, you need
  - to estimate the life of the asset
  - to estimate the cash flows during the life of the asset
  - to estimate the discount rate to apply to these cash flows to get present value
- *Market Inefficiency*: Markets are assumed to make mistakes in pricing assets across time, and are assumed to correct themselves over time, as new information comes out about assets.

Risk Adjusted Value: Three Basic Propositions

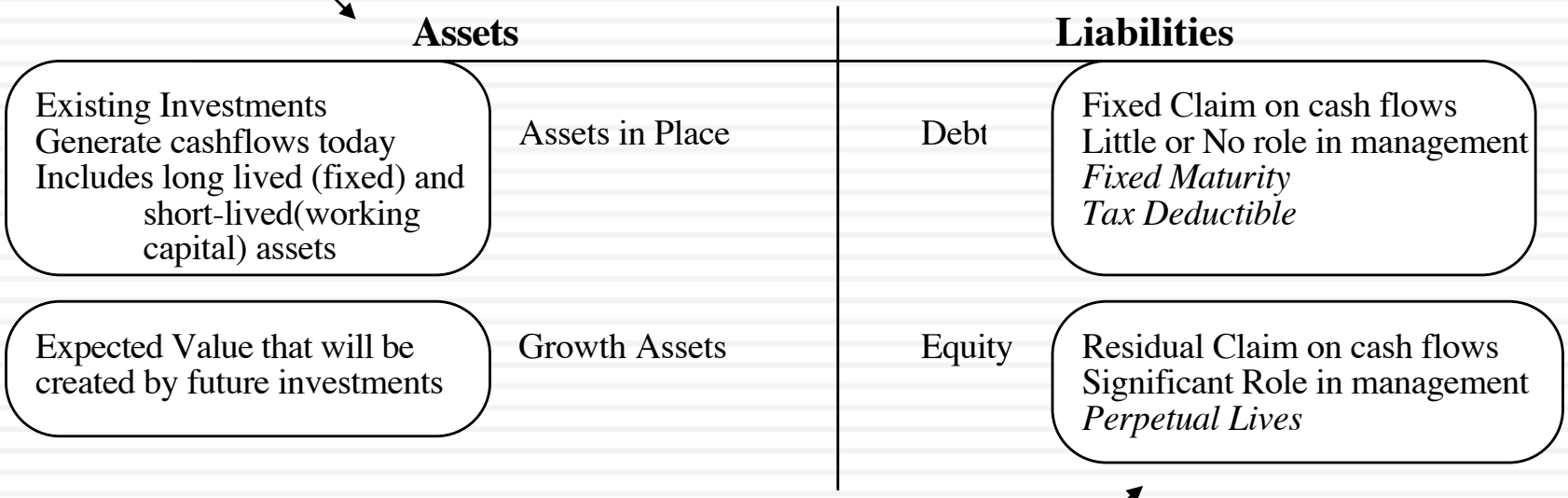
- The value of a risky asset can be estimated by discounting the expected cash flows on the asset over its life at a risk-adjusted discount rate:

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

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.

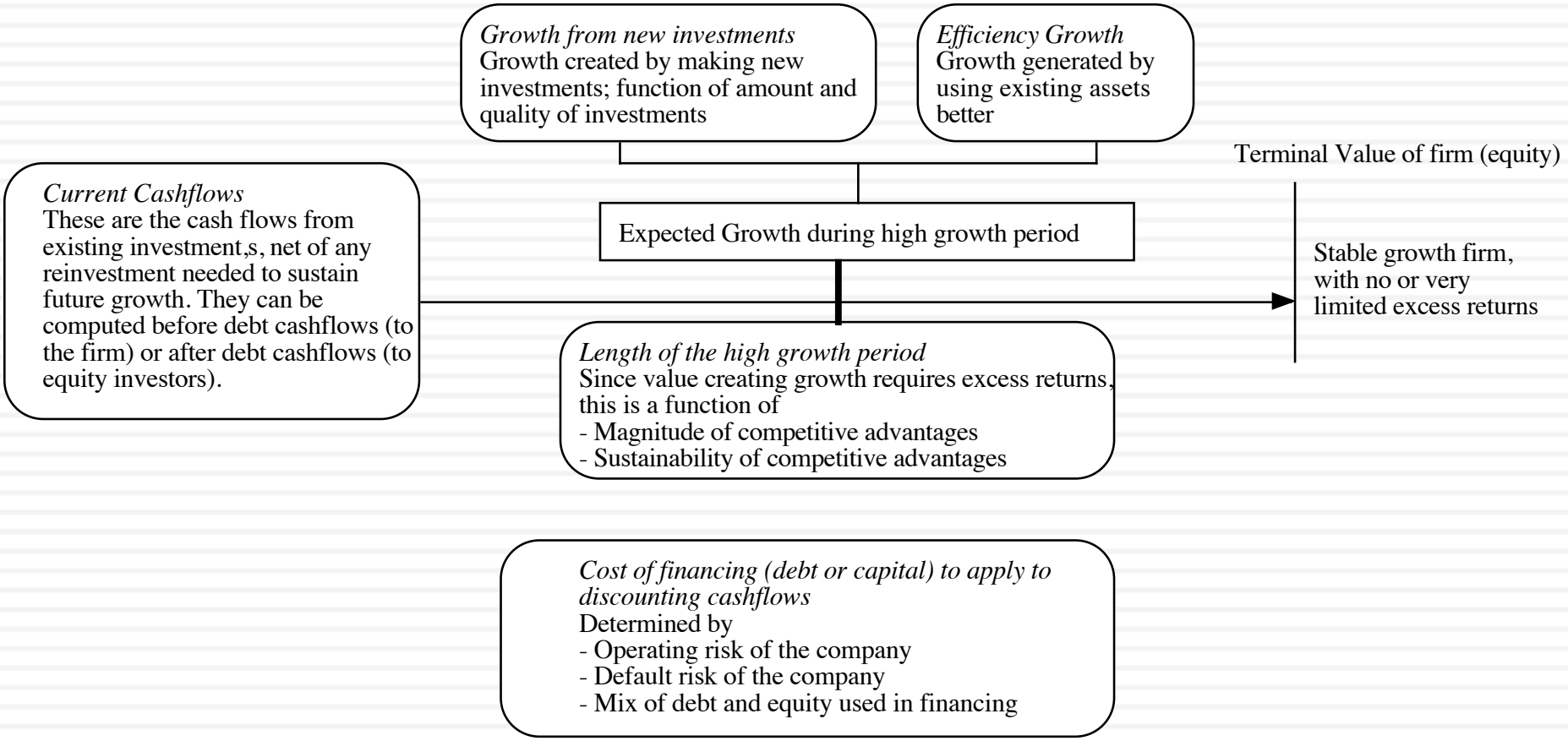
DCF Choices: Equity Valuation versus Firm Valuation

Firm Valuation: Value the entire business

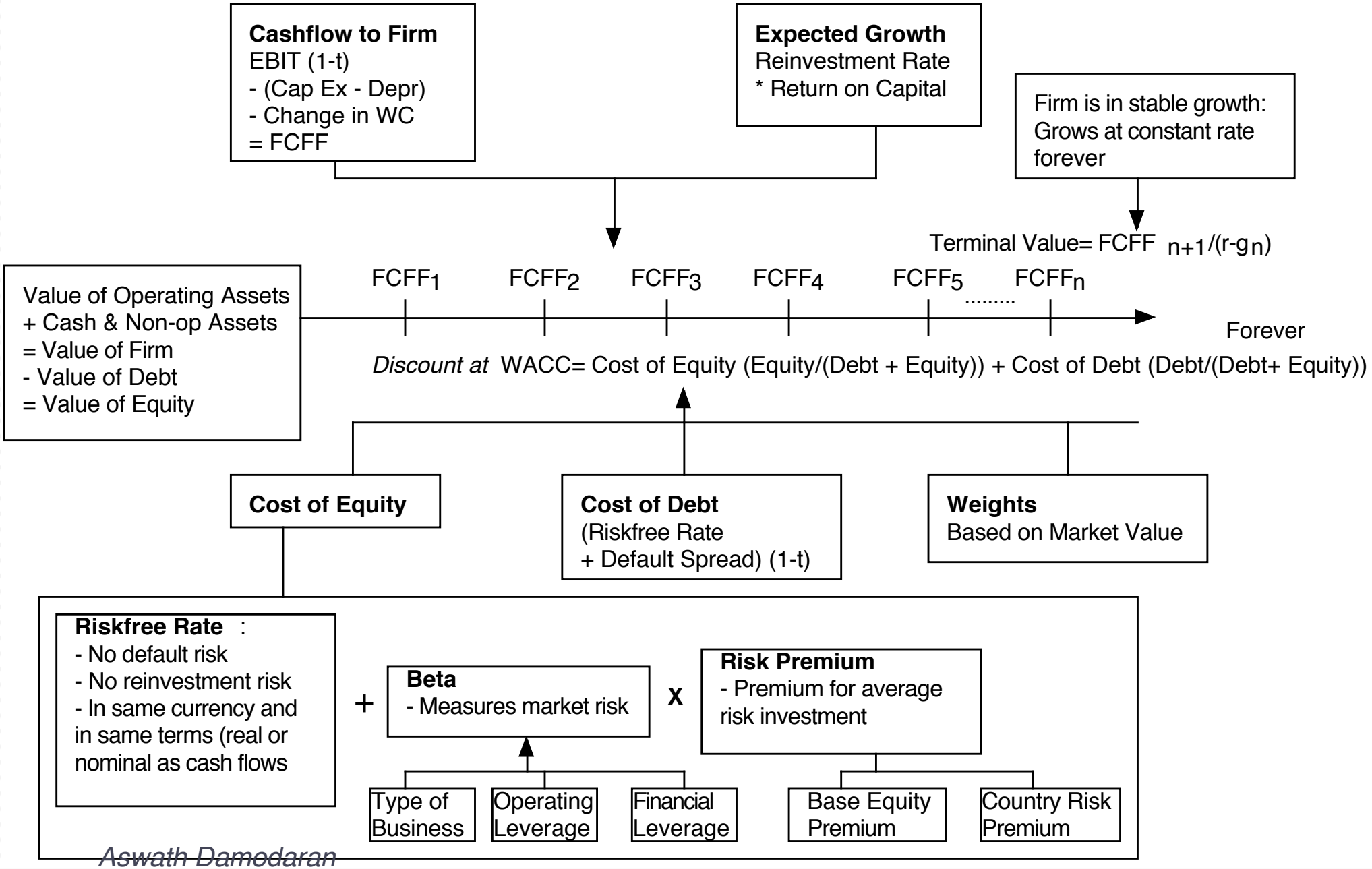


Equity valuation: Value just the equity claim in the business

The Drivers of Value…



DISCOUNTED CASHFLOW VALUATION



Amgen: Status Quo

Cap Ex = Acc net Cap Ex(255) + Acquisitions (3975) + R&D (2216)

Current Cashflow to Firm
EBIT(1-t)= :7336(1-**.28**)= 6058
- Nt CpX= 6443
- Chg WC 37
= FCFF - 423
Reinvestment Rate = 6480/6058 =106.98%
Return on capital = 16.71%

Reinvestment Rate 60%

Return on Capital 16%

Expected Growth in EBIT (1-t)
.60*.16=.096
9.6%

Stable Growth
g = 4%; Beta = 1.10;
Debt Ratio= 20%; Tax rate=35%
Cost of capital = 8.08%
ROC= 10.00%;
Reinvestment Rate=4/10=40%

Terminal Value$_{10}$= 7300/(.0808-.04) = 179,099

First 5 years

Growth decreases gradually to 4%

Year	1	2	3	4	5	6	7	8	9	10	Term Yr
EBIT	$9,221	$10,106	$11,076	$12,140	$13,305	$14,433	$15,496	$16,463	$17,306	$17,998	18718
EBIT (1-t)	$6,639	$7,276	$7,975	$8,741	$9,580	$10,392	$11,157	$11,853	$12,460	$12,958	12167
- Reinvestment	$3,983	$4,366	$4,785	$5,244	$5,748	$5,820	$5,802	$5,690	$5,482	$5,183	4867
= FCFF	$2,656	$2,911	$3,190	$3,496	$3,832	$4,573	$5,355	$6,164	$6,978	$7,775	7300

Op. Assets 94214
+ Cash: 1283
- Debt 8272
=Equity 87226
-Options 479
Value/Share $ 74.33

Cost of Capital (WACC) = 11.7% (0.90) + 3.66% (0.10) = 10.90%

Debt ratio increases to 20%
Beta decreases to 1.10

On May 1,2007, Amgen was trading at $ 55/share

Cost of Equity
11.70%

Cost of Debt
(4.78%+..85%)(1-.35)
= 3.66%

Weights
E = 90% D = 10%

Riskfree Rate:
Riskfree rate = 4.78%

+

Beta
1.73

Unlevered Beta for Sectors: 1.59

D/E=11.06%

x

Risk Premium
4%

Tata Motors: April 2010

Average reinvestment rate from 2005-09: 179.59%; without acquisitions: 70%

Current Cashflow to Firm
EBIT(1-t) : Rs 20,116
- Nt CpX Rs 31,590
- Chg WC Rs 2,732
= FCFF - Rs 14,205
Reinv Rate = (31590+2732)/20116 = 170.61%; Tax rate = 21.00%
Return on capital = 17.16%

Reinvestment Rate 70%

Return on Capital 17.16%

Expected Growth = .70*.1716=0.1201

Stable Growth
g = 5%; Beta = 1.00
Country Premium= 3%
Cost of capital = 10.39%
Tax rate = 33.99%
ROC= 10.39%;
Reinvestment Rate=g/ROC =5%/ 10.39%= 48.11%

Terminal Value= 23493/(.1039-.05) = Rs 435,686

Rs Cashflows

Year	1	2	3	4	5	6	7	8	9	10
EBIT (1-t)	₹ 22,533	₹ 25,240	₹ 28,272	₹ 31,668	₹ 35,472	₹ 39,236	₹ 42,848	₹ 46,192	₹ 49,150	₹ 51,607
- Reinvestment	₹ 15,773	₹ 17,668	₹ 19,790	₹ 22,168	₹ 24,830	₹ 25,242	₹ 25,138	₹ 24,482	₹ 23,264	₹ 21,503
FCFF	₹ 6,760	₹ 7,572	₹ 8,482	₹ 9,500	₹ 10,642	₹ 13,994	₹ 17,711	₹ 21,710	₹ 25,886	₹ 30,104

45278
21785
23493

Op. Assets	210,813
+ Cash:	11418
+ Crosshold	140576
- Debt	109198
=Equity	253,628

Value/Share Rs 614

Discount at Cost of Capital (WACC) = 14.00% (.747) + 8.09% (0.253) = 12.50%

Growth declines to 5% and cost of capital moves to stable period level.

Cost of Equity
14.00%

Cost of Debt
(5%+ 4.25%+3%)(1-.3399)
= 8.09%

Weights
E = 74.7% D = 25.3%

On April 1, 2010
Tata Motors price = Rs 781

Riskfree Rate:
Rs Riskfree Rate= 5%

\+ **Beta** 1.20 X **Mature market premium** 4.5% + **Lambda** 0.80 X Country Equity Risk Premium 4.50%

Unlevered Beta for Sectors: 0.98

Firm's D/E Ratio: 34%

Country Default Spread 3% X Rel Equity Mkt Vol 1.50

Ergis: May 2018 (in Polish Zloty)

Cash flows from existing assets

	Industry (Global data)	Ergis: 2017	Ergis: 2013-2017
Revenue growth =	5.76%	7.76%	3.48%
Pre-tax operating margin =	9.05%	4.47%	4.54%
Sales to capital ratio =	1.64	2.02	2.06
Return on invested capital =	12.04%	6.31%	7.59%

The Payoff from growth

Revenues will grow 3.48% a year for next 5 years, tapering down to 2.39% growth in year 10

Operatng margin (pre-tax) will increase slightly to 4.54%, average from 2013-17.

Sales/Invested Capital will remain at 2.06 (average from 2013-17)

Maturty and Closure

Stable Growth
g = 2.39%;
Cost of capital = 6.89%
ROC= 6.89%;
Reinvestment Rate=g/ROC
= 2.39%/6.89% = 34.69%

Terminal Value = 23.28/(.0689-..0239) = 517.34

Cashflows

	Base year	1	2	3	4	5	6	7	8	9	10	Terminal year
Revenue growth rate		3.48%	3.48%	3.48%	3.48%	3.48%	3.26%	3.04%	2.83%	2.61%	2.39%	2.39%
Revenues	749.60 zł	775.69 zł	802.68 zł	830.61 zł	859.52 zł	889.43 zł	918.44 zł	946.40 zł	973.15 zł	998.53 zł	1,022.39 zł	1,046.83 zł
EBIT (Operating) margin	4.47%	4.48%	4.49%	4.49%	4.50%	4.51%	4.51%	4.52%	4.53%	4.53%	4.54%	4.54%
EBIT (Operating income)	33.54 zł	34.76 zł	36.02 zł	37.33 zł	38.68 zł	40.09 zł	41.46 zł	42.78 zł	44.05 zł	45.27 zł	46.42 zł	47.53 zł
Tax rate	30.26%	30.26%	30.26%	30.26%	30.26%	30.26%	29.21%	28.16%	27.10%	26.05%	25.00%	25.00%
EBIT(1-t)	23.39 zł	24.24 zł	25.12 zł	26.03 zł	26.98 zł	27.96 zł	29.35 zł	30.73 zł	32.11 zł	33.47 zł	34.81 zł	35.64 zł
- Reinvestment		12.66 zł	13.10 zł	13.56 zł	14.03 zł	14.52 zł	14.08 zł	13.57 zł	12.98 zł	12.32 zł	11.58 zł	12.36 zł
FCFF		11.58 zł	12.02 zł	12.47 zł	12.95 zł	13.44 zł	15.26 zł	17.16 zł	19.13 zł	21.15 zł	23.23 zł	23.28 zł
Cost of capital		6.19%	6.19%	6.19%	6.19%	6.19%	6.33%	6.47%	6.61%	6.75%	6.89%	6.89%
Cumulated discount factor		0.9417	0.8869	0.8352	0.7865	0.7407	0.6966	0.6543	0.6137	0.5749	0.5379	
PV(FCFF)		10.90 zł	10.66 zł	10.42 zł	10.18 zł	9.95 zł	10.63 zł	11.23 zł	11.74 zł	12.16 zł	12.49 zł	

PV(Terminal value)	278.25 zł
PV (CF over next 10 years)	110.37 zł
Value of operating assets =	388.62 zł
- Debt	182.90 zł
- Minority interests	0.49 zł
+ Cash	21.50 zł
+ Non-operating assets	0.89 zł
Value of equity	227.62 zł
Number of shares	38.40
Estimated value /share	5.93 zł

Discount at Cost of Capital (WACC) = 9.92% (.462) + 3.98% (1-.20) (.538) = 6.19%

The Risk in the Cash flows

On May 1, 2018, Ergis was trading at 3.95 zloty per share.

Cost of Equity
9.92%

Cost of Debt
2.39%+ 0.87% + 0.72% = 3.98%

Weights
E = 46.2% D = 53.8%

Riskfree Rate:
Zloty Risk free Rate =
3.26% - 0.87% = 2.39%

\+

Beta = 1.30

X

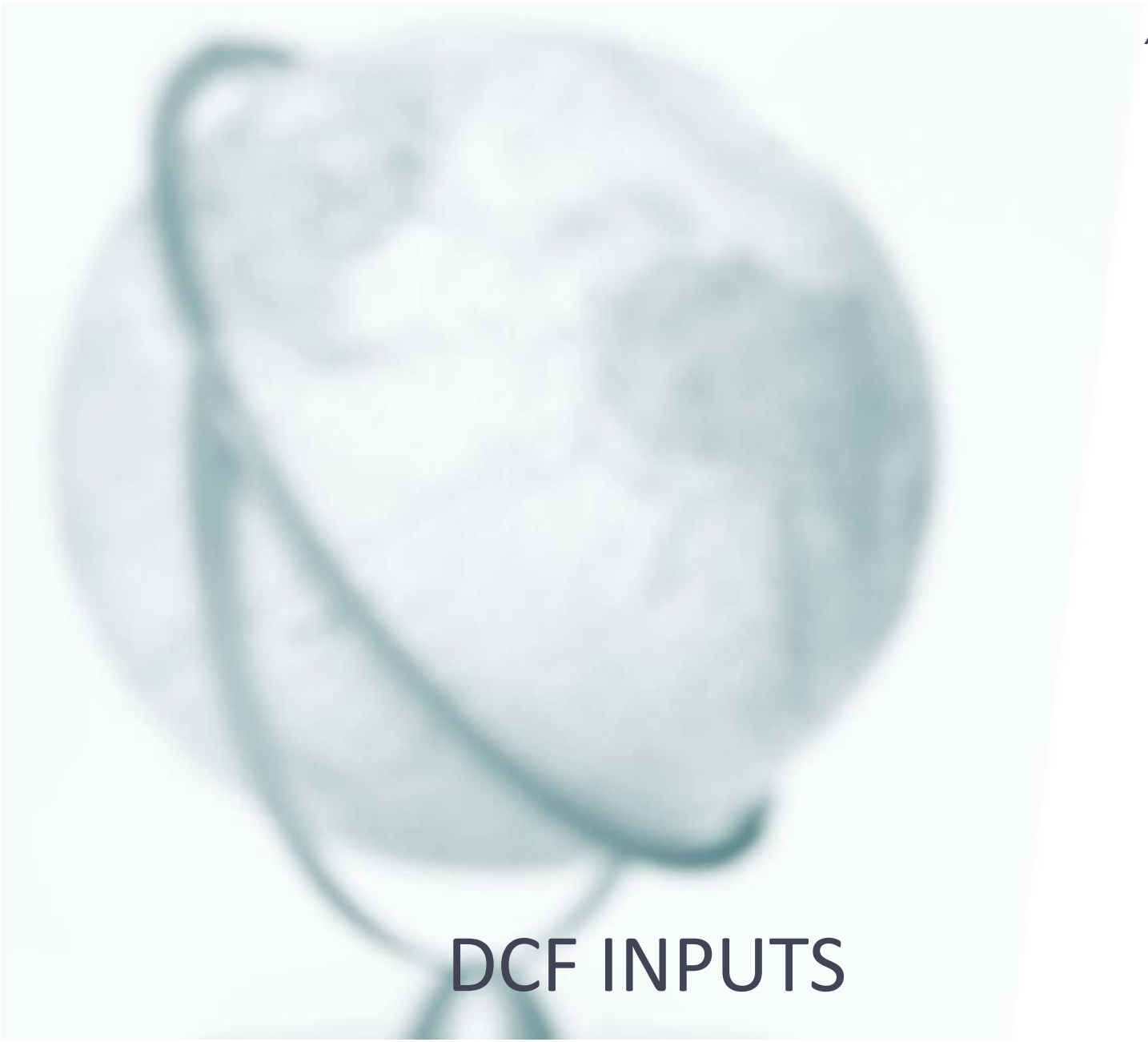
D/E Ratio: 116.41%

Business	Revenues	EV/Sales	Estimated Value	% of Value	Unlevered Beta
Packaging & Container	$ 614.00	1.5255	$ 936.67	81.82%	0.6198
Chemical (Basic)	$ 135.00	1.5419	$ 208.16	18.18%	1.0369
Company	$ 749.00		$ 1,144.83	100.00%	0.6957

ERP = 5.78%

Country	Revenues	ERP	Weight	Weighted ERP
Poland	345.08 zł	6.06%	46.04%	2.79%
Germany	134.74 zł	5.08%	17.98%	0.91%
France	76.12 zł	5.65%	10.15%	0.57%
Netherlands	30.34 zł	5.08%	4.05%	0.21%
United Kingdom	31.31 zł	5.65%	4.18%	0.24%
Rest of Europe	132.00 zł	6.01%	17.61%	1.06%
Company	**749.58 zł**		**100.00%**	**5.78%**

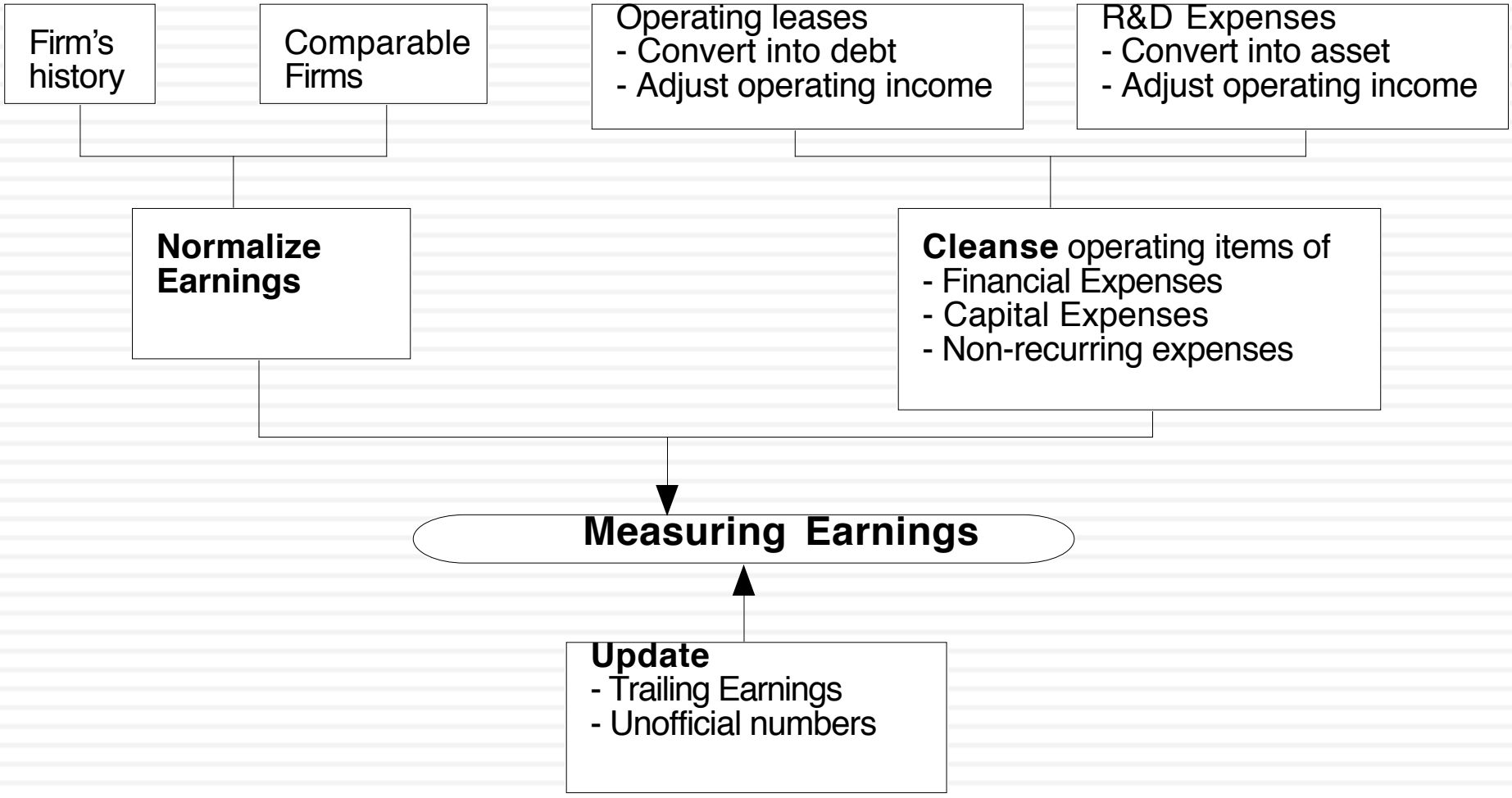
Aswath Damodaran



DCF INPUTS

"Garbage in, garbage out"

I. Measure earnings right..



Operating Leases at Amgen in 2007

- Amgen has lease commitments and its cost of debt (based on it's A rating) is 5.63%.

Year	Commitment	Present Value
1	$96.00	$90.88
2	$95.00	$85.14
3	$102.00	$86.54
4	$98.00	$78.72
5	$87.00	$66.16
6-12	$107.43	$462.10 ($752 million prorated)

- Debt Value of leases = $869.55
- Debt outstanding at Amgen = $7,402 + $ 870 = $8,272 million
- Adjusted Operating Income = Stated OI + Lease expense this year – Depreciation
  = 5,071 m + 69 m - 870/12 = $5,068 million (12 year life for assets)
- Approximate Operating income= stated OI + PV of Lease commitment * Pre-tax cost of debt
  = $5,071 m + 870 m (.0563) = $ 5,120 million

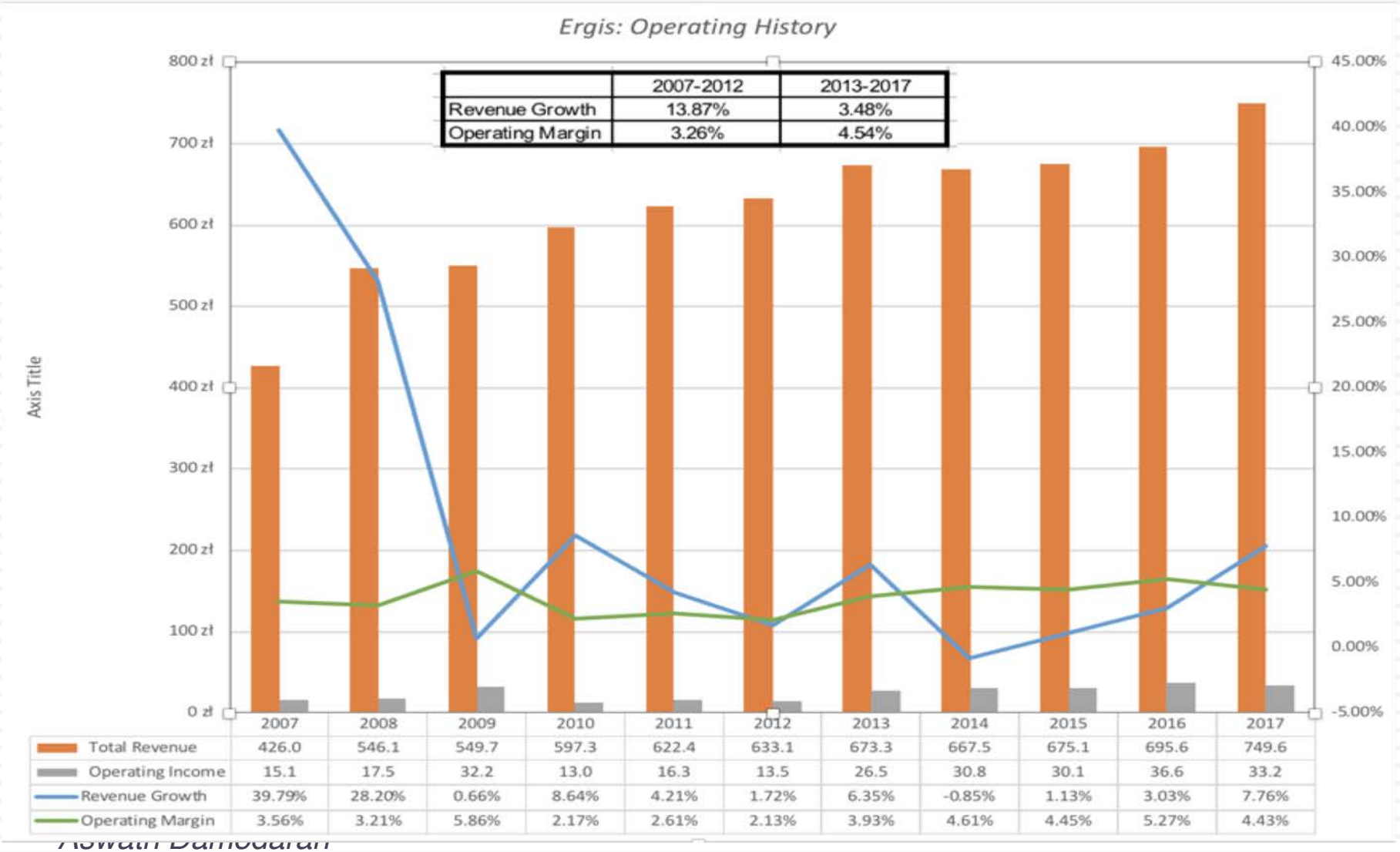
Capitalizing R&D Expenses: Amgen

- R & D was assumed to have a 10-year life.

Year	R&D Expense	Unamortized portion		Amortization this year
Current	3366.00	1.00	3366.00	
-1	2314.00	0.90	2082.60	$231.40
-2	2028.00	0.80	1622.40	$202.80
-3	1655.00	0.70	1158.50	$165.50
-4	1117.00	0.60	670.20	$111.70
-5	865.00	0.50	432.50	$86.50
-6	845.00	0.40	338.00	$84.50
-7	823.00	0.30	246.90	$82.30
-8	663.00	0.20	132.60	$66.30
-9	631.00	0.10	63.10	$63.10
-10	558.00		0.00	$55.80
Value of Research Asset =			$10,112.80	$1,149.90

- Adjusted Operating Income = $5,120 + 3,366 - 1,150 = $7,336 million

Ergis: A Bad Business?



	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Revenue	426.0	546.1	549.7	597.3	622.4	633.1	673.3	667.5	675.1	695.6	749.6
Operating Income	15.1	17.5	32.2	13.0	16.3	13.5	26.5	30.8	30.1	36.6	33.2
Revenue Growth	39.79%	28.20%	0.66%	8.64%	4.21%	1.72%	6.35%	-0.85%	1.13%	3.03%	7.76%
Operating Margin	3.56%	3.21%	5.86%	2.17%	2.61%	2.13%	3.93%	4.61%	4.45%	5.27%	4.43%

II. Get the big picture (not the accounting one) when it comes to cap ex and working capital

- Capital expenditures should include
  - Research and development expenses, once they have been re-categorized as capital expenses.
  - Acquisitions of other firms, whether paid for with cash or stock.
- Working capital should be defined not as the difference between current assets and current liabilities but as the difference between non-cash current assets and non-debt current liabilities.
- On both items, start with what the company did in the most recent year but do look at the company's history and at industry averages.

Amgen's Net Capital Expenditures

- The accounting net cap ex at Amgen is small:
  - Accounting Capital Expenditures = $1,218 million
  - - Accounting Depreciation = $ 963 million
  - Accounting Net Cap Ex = $ 255 million
- We define capital expenditures broadly to include R&D and acquisitions:
  - Accounting Net Cap Ex = $ 255 million
  - Net R&D Cap Ex = (3366-1150) = $2,216 million
  - Acquisitions in 2006 = $3,975 million
  - Total Net Capital Expenditures = $ 6,443 million
- Acquisitions have been a volatile item. Amgen was quiet on the acquisition front in 2004 and 2005 and had a significant acquisition in 2003.

III. The government bond rate is not always the risk free rate

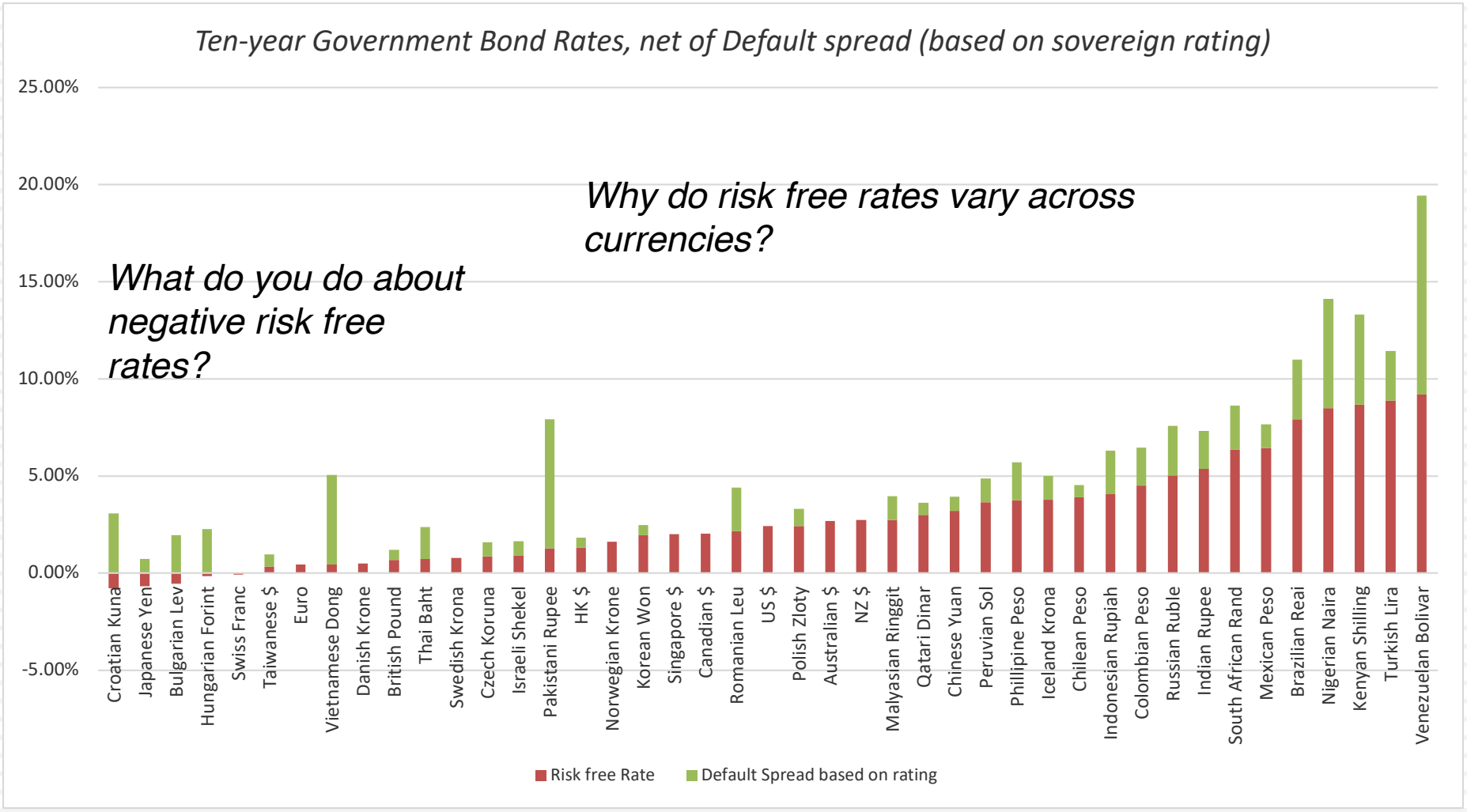
- When valuing Amgen in US dollars, the US$ ten-year bond rate of 4.78% was used as the risk free rate. We assumed that the US treasury was default free.
- When valuing Tata Motors in Indian rupees in 2010, the Indian government bond rate of 8% was not default free. Using the Indian government's local currency rating of Ba2 yielded a default spread of 3% for India and a riskfree rate of 5% in Indian rupees.

  Risk free rate in Indian Rupees = 8% - 3% = 5%

- To value Ergis in Polish Zloty, you need a risk free rate in Zloty. The Polish government bond was yielding 3.26% on May 1, 2018. The default spread for Poland, given its local currency sovereign rating of A2, was 0.87% on May 1, 2018, yielding a riskfree rate of 2.39%.

  Riskfree rate in Zloty = 3.26% - 0.87% = 2.39%

Risk free rates will vary across currencies!



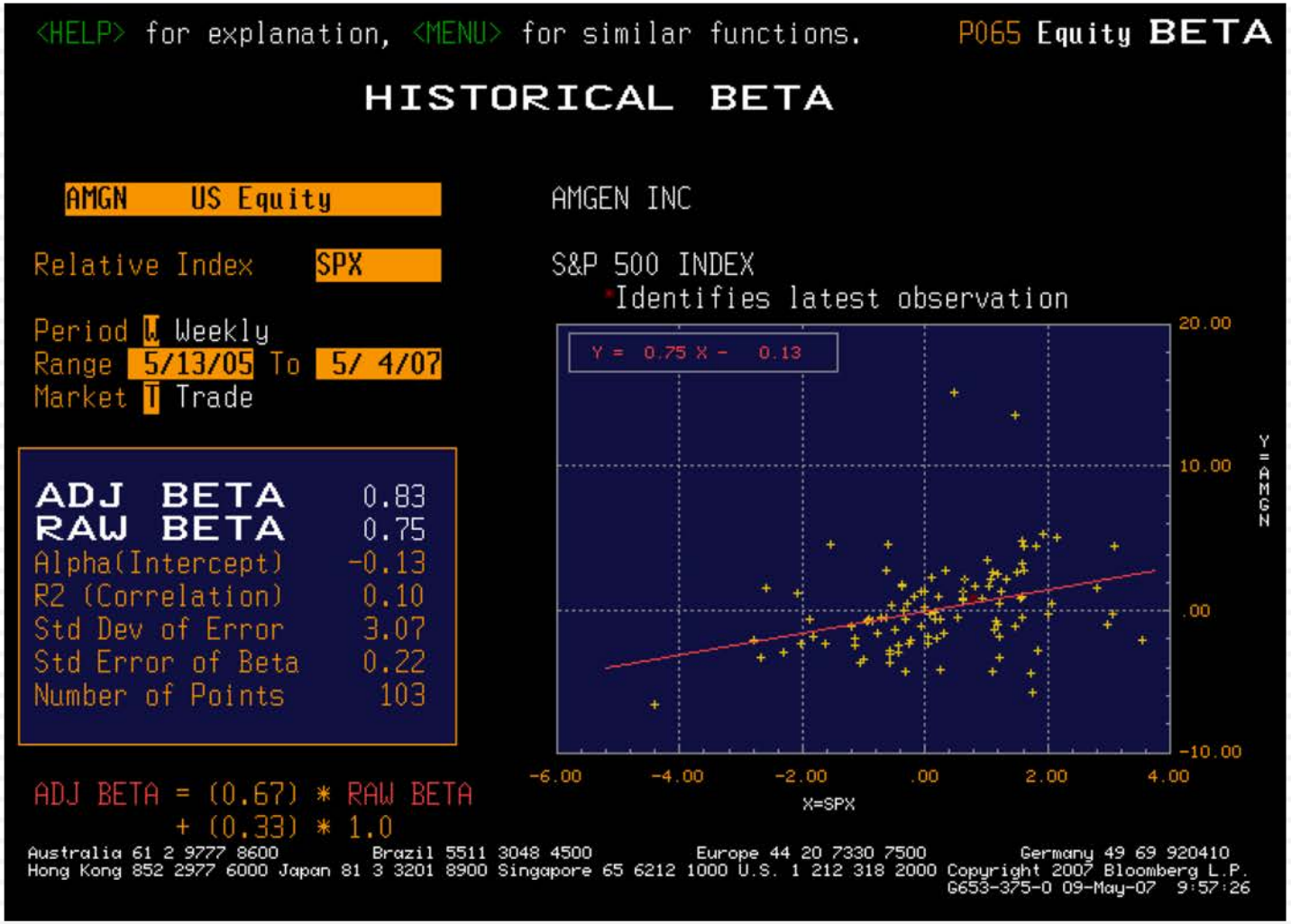
Risk free Rate: A Sanity Check

- The risk free rate in a currency is a sum of the expected inflation in the currency and a real interest rate. If you assume that the global real interest rate is a constant, the only differential between risk free rates should be the inflation differential.
- If you have the US treasury bond rate (or a German Euro bond rate), you can add the differential inflation rate between the currency and the US dollar (or Euro) to the US T.Bond rate (or Euro risk free rate) to get to a currency risk free rate.
  - LC Risk free rate = Risk free rate in $ + (Inflation rate in LC – Inflation rate in US $)
- The expected inflation rate in the US dollar is about 2%. What is the expected inflation rate in Poland?

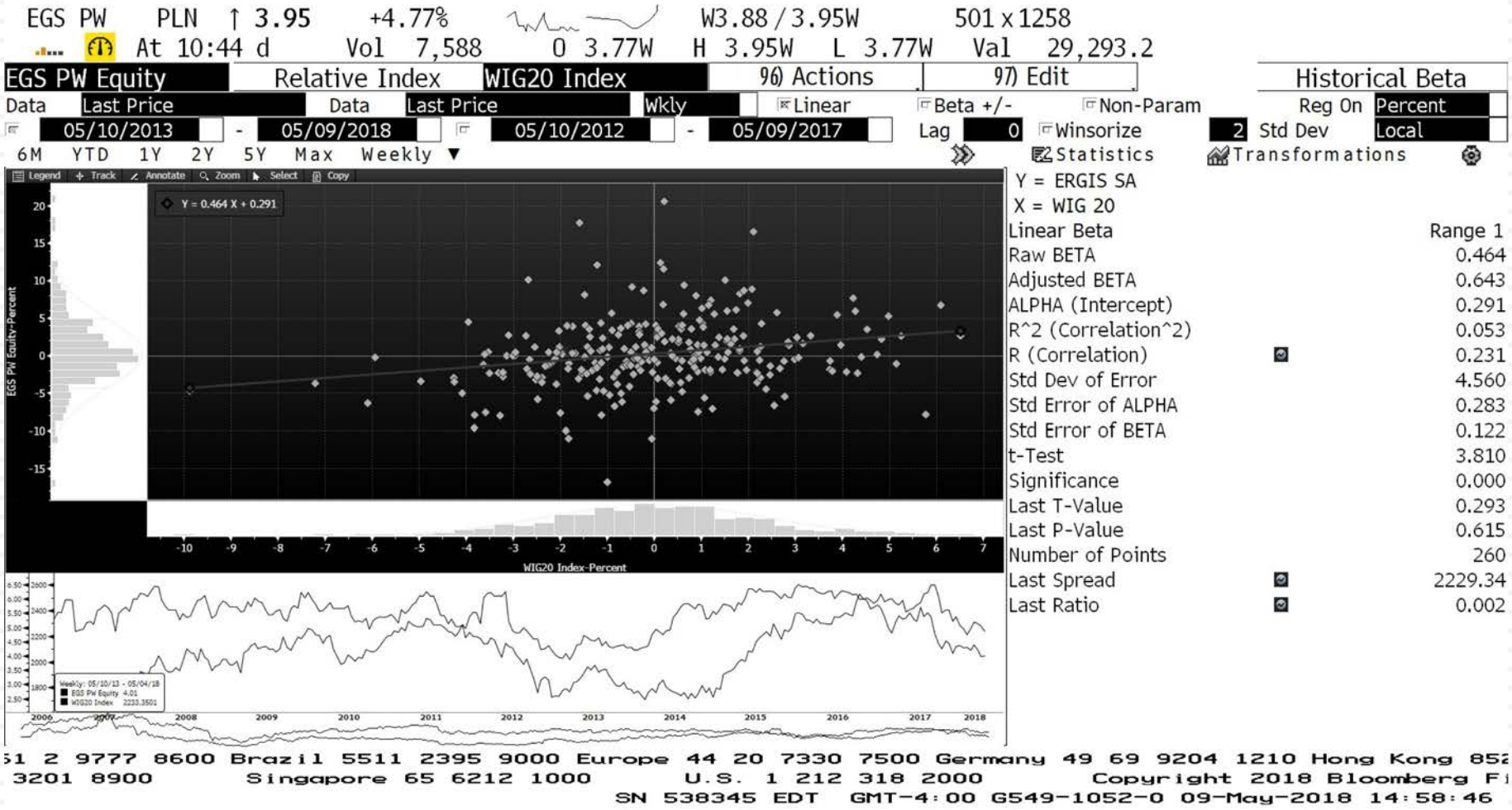
But valuations should not! Valuing Tata Motors

	In Indian Rupees	In US $
Risk free Rate	5.00%	2.00%
Expected inflation rate	4.00%	1.00%
Cost of capital - High Growth - Stable Growth	 12.50% 10.39%	 9.25% 7.21%
Expected growth rate - High Growth - Stable Growth	 12.01% 5.00%	 8.78% 2.00%
Return on Capital - High Growth - Stable Growth	 17.16% 10.39%	 13.78% 7.21%
Value per share	Rs 614	$12.79/share (roughly Rs 614 at current exchange rate)

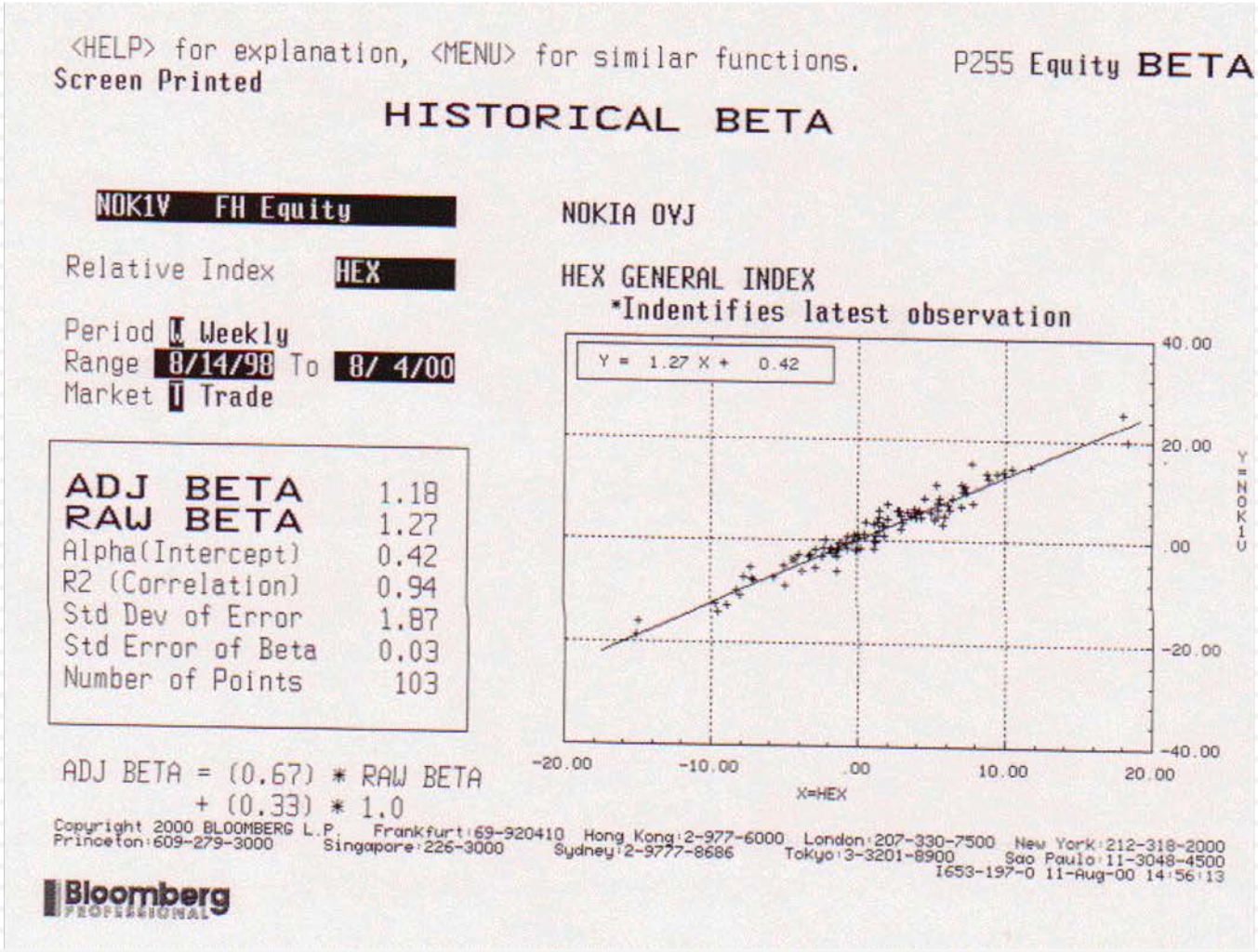
IV. Betas do not come from regressions… and are noisy…



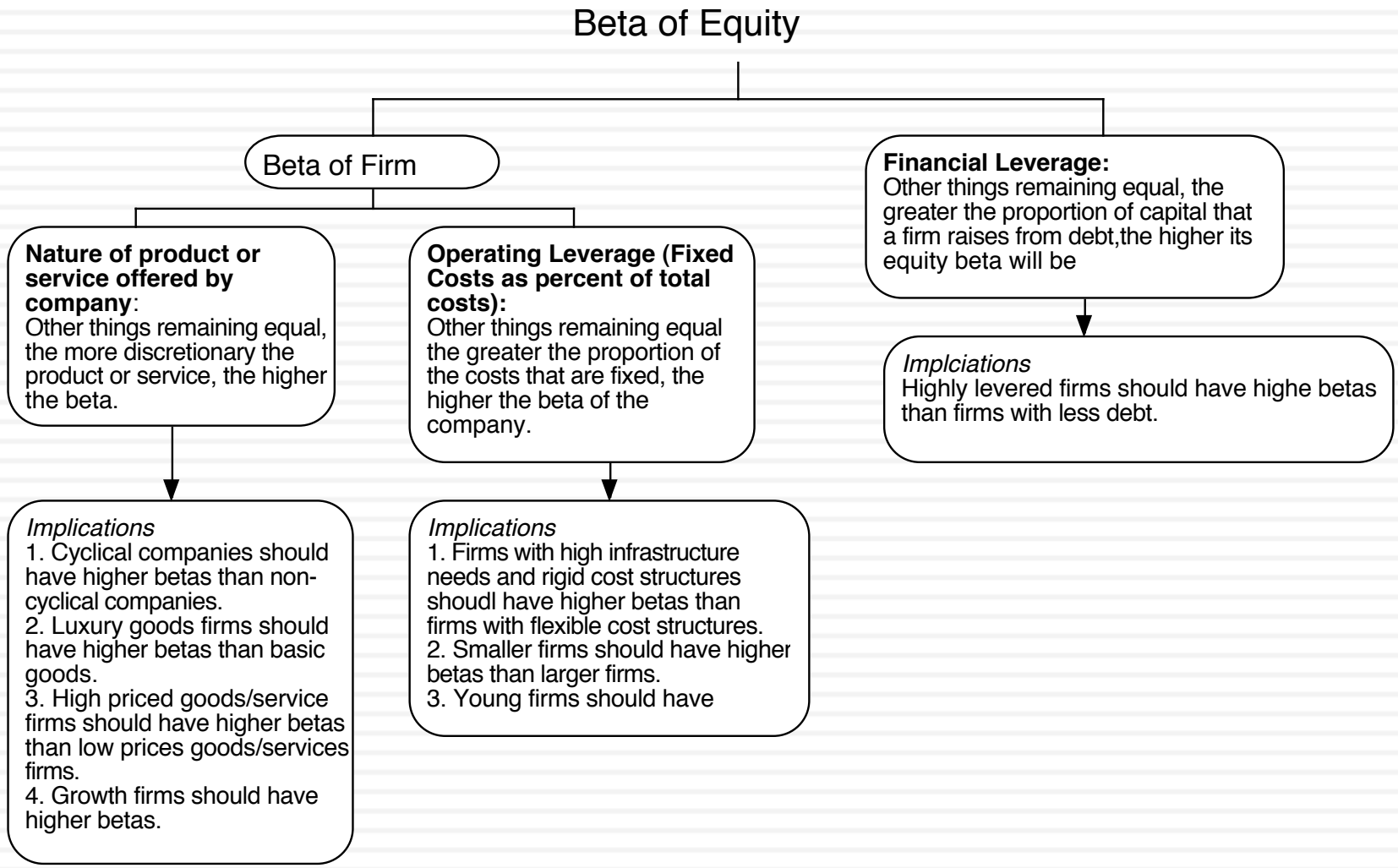
And are meaningless when run against narrow indices..



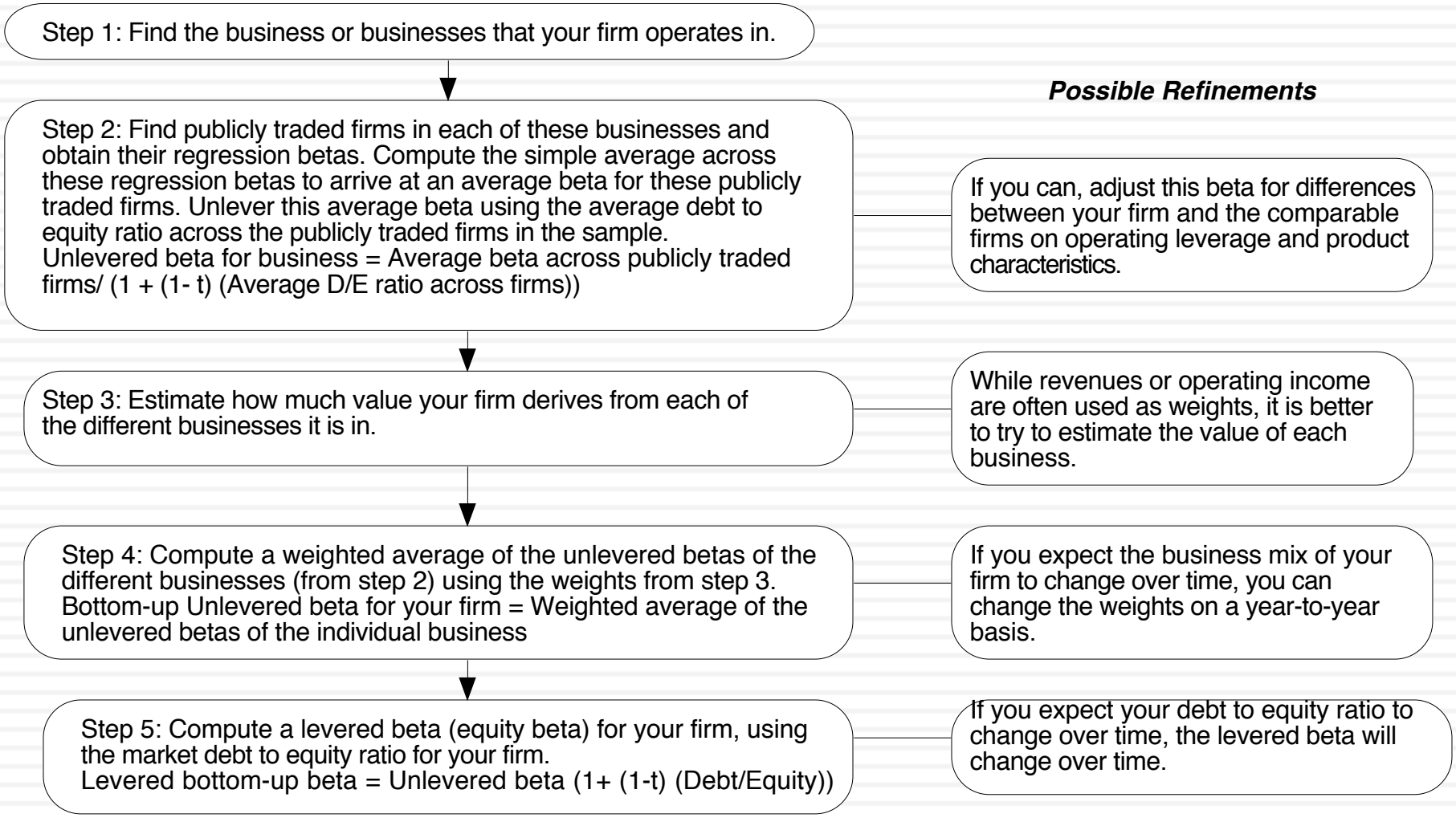
Even if they look really good…



Determinants of Betas



Bottom-up Betas



Three examples…

- Amgen
  - The unlevered beta for pharmaceutical firms is 1.59. Using Amgen's debt to equity ratio of 11%, the bottom up beta for Amgen is
    - Bottom-up Beta = 1.59 (1+ (1-.35)(.11)) = 1.73
- Tata Motors
  - The unlevered beta for automobile firms is 0.98. Using Tata Motor's debt to equity ratio of 33.87%, the bottom up beta for Tata Motors is
    - Bottom-up Beta = 0.98 (1+ (1-.3399)(.3387)) = 1.20
- Ergis

Business	Revenues	EV/Sales	Estimated Value	% of Value	Unlevered Beta
Packaging & Container	$ 614.00	1.5255	$ 936.67	81.82%	0.6198
Chemical (Basic)	$ 135.00	1.5419	$ 208.16	18.18%	1.0369
Company	$ 749.00		$ 1,144.83	100.00%	0.6957

Levered Beta = 0.70 (1+ (1-.20)(749/268,491)) = 1.30

V. And the past is not always a good indicator of the future.

	Arithmetic Average		Geometric Average	
	Stocks - T. Bills	Stocks - T. Bonds	Stocks - T. Bills	Stocks - T. Bonds
1928-2017	8.09%	6.38%	6.26%	4.77%
Std Error	2.10%	2.24%		
1968-2017	6.58%	4.24%	5.28%	3.29%
Std Error	2.39%	2.70%		
2008-2017	9.85%	5.98%	8.01%	4.56%
Std Error	6.12%	8.70%		

- 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.

But in the future..

Base year cash flow (last 12 mths)
Dividends (TTM): 48.12
+ Buybacks (TTM): 60.16
= Cash to investors (TTM): **108.28**

Expected cashflow growth in next 5 years
Cash flow growth = Top down analyst estimate of earnings growth for S&P 500 = 7.05%

	Last 12 months	1	2	3	4	5	*Terminal Year*
Expected Earnings	124.94	133.75	143.18	153.27	164.08	175.64	179.88
Expected Dividends + Buybacks =	108.28	$ 115.91	$ 124.08	$ 132.83	$ 142.19	$ 152.22	155.88

Earnings and Cash flows grow @2.41% (set equal to risk free rate) a year forever.

S&P 500 on 1/1/18= **2673.61**

$$2673.61 = \frac{115.91}{(1+r)} + \frac{124.08}{(1+r)^2} + \frac{132.82}{(1+r)^3} + \frac{142.19}{(1+r)^4} + \frac{152.22}{(1+r)^5} + \frac{152.22\ (1.0241)}{(r-0.0241)(1+r)^5}$$

The last term in this equation is the expected index level at the end of year 5 (capturing price appreciaiton)

Solve for r

r = Implied Expected Return on Stocks = 7.49%

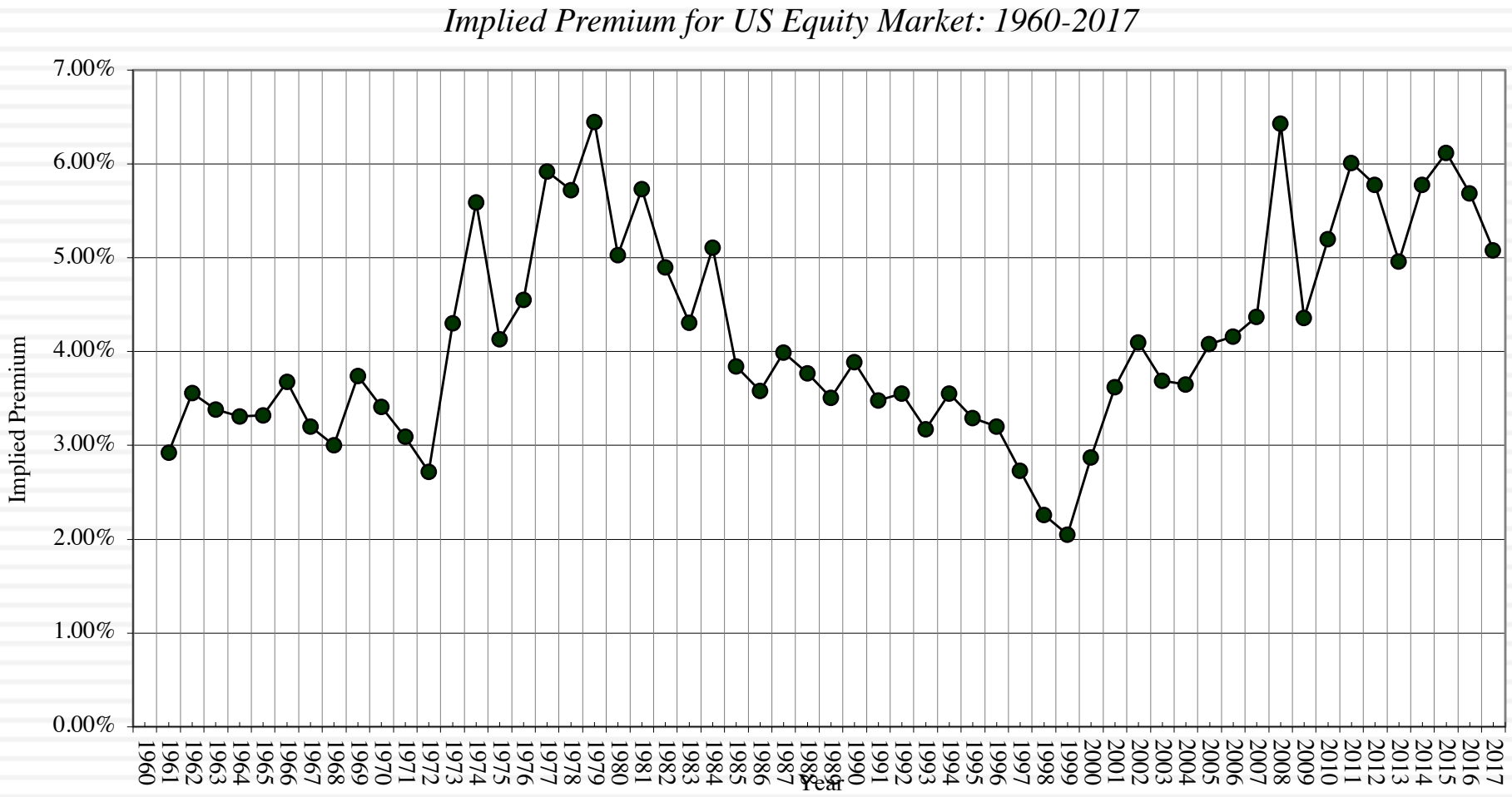
Minus

Risk free rate = T.Bond rate on 1/1/18= 2.41%

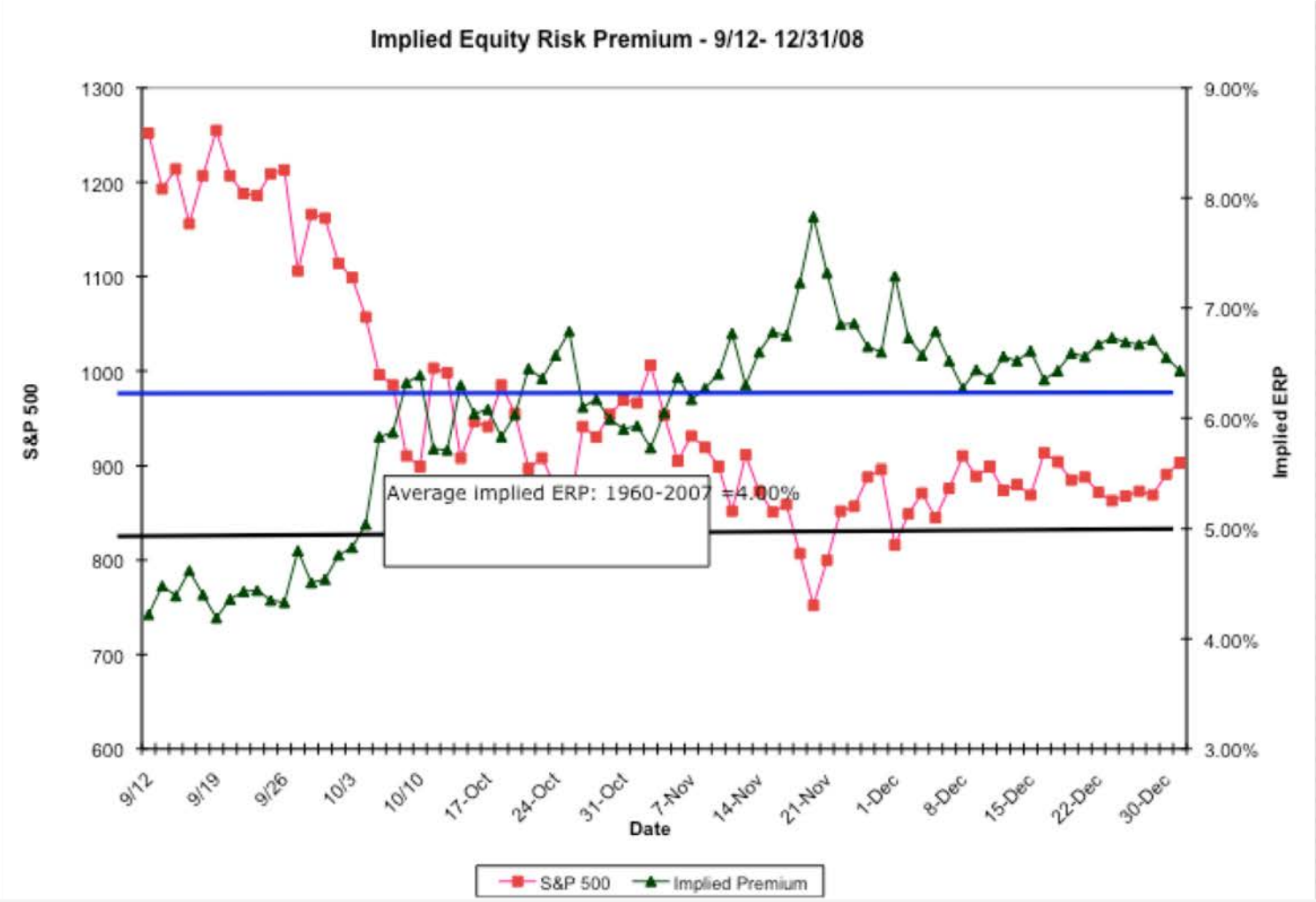
Equals

Implied Equity Risk Premium (1/1/18) = 7.49% - 2.41% = **5.08%**

Implied Premiums in the US: 1960-2017



The Anatomy of a Crisis: Implied ERP from September 12, 2008 to January 1, 2009



Implied Premium for India using the Sensex: April 2010

- Level of the Index = 17559
- FCFE on the Index = 3.5% (Estimated FCFE for companies in index as % of market value of equity)
- Other parameters
  - Riskfree Rate = 5% (Rupee)
  - Expected Growth (in Rupee)
    - Next 5 years = 20% (Used expected growth rate in Earnings)
    - After year 5 = 5%
- Solving for the expected return:
  - Expected return on Equity = 11.72%
  - Implied Equity premium for India =11.72% - 5% = 6.72%

Emerging versus Developed Markets: Implied Equity Risk Premiums

$$PBV = \frac{(Return\ on\ equity - Expected\ growth\ rate)}{(Cost\ of\ equity - Expected\ growth\ rate)}$$

$$Cost\ of\ Equity = \frac{(ROE - Expected\ growth\ rate)}{PBV} + Expected\ growth\ rate$$

Start of year	PBV Developed	PBV Emerging	ROE Developed	ROE Emerging	US T.Bond rate	Growth Rate Developed	Growth Rate Emerging	Cost of Equity (Developed)	Cost of Equity (Emerging)	**Differential ERP**
2004	2.00	1.19	10.81%	11.65%	4.25%	3.75%	5.25%	7.28%	10.63%	**3.35%**
2005	2.09	1.27	11.12%	11.93%	4.22%	3.72%	5.22%	7.26%	10.50%	**3.24%**
2006	2.03	1.44	11.32%	12.18%	4.39%	3.89%	5.39%	7.55%	10.11%	**2.56%**
2007	1.67	1.67	10.87%	12.88%	4.70%	4.20%	5.70%	8.19%	10.00%	**1.81%**
2008	0.87	0.83	9.42%	11.12%	4.02%	3.52%	5.02%	10.30%	12.37%	**2.07%**
2009	1.20	1.34	8.48%	11.02%	2.21%	1.71%	3.21%	7.35%	9.04%	**1.69%**
2010	1.39	1.43	9.14%	11.22%	3.84%	3.34%	4.84%	7.51%	9.30%	**1.79%**
2011	1.12	1.08	9.21%	10.04%	3.29%	2.79%	4.29%	8.52%	9.61%	**1.09%**
2012	1.17	1.18	9.10%	9.33%	1.88%	1.38%	2.88%	7.98%	8.35%	**0.37%**
2013	1.56	1.63	8.67%	10.48%	1.76%	1.26%	2.76%	6.02%	7.50%	**1.48%**
2014	1.95	1.50	9.27%	9.64%	3.04%	2.54%	4.04%	6.00%	7.77%	**1.77%**
2015	1.88	1.56	9.69%	9.75%	2.17%	1.67%	3.17%	5.94%	7.39%	**1.45%**
2016	1.89	1.59	9.24%	10.16%	2.27%	1.77%	3.27%	5.72%	7.60%	**1.88%**

VI. The Downside of Globalization: Dealing with Country Risk

- The Default Spread: Most practitioners estimate the equity risk premium for riskier markets by starting with a base premium for a mature market and adding the default spread for the government in the risky market.

  ERP for country = ERP for Mature Market + Default spread for country

  ERP for India = ERP for US + Default Spread for Thailand

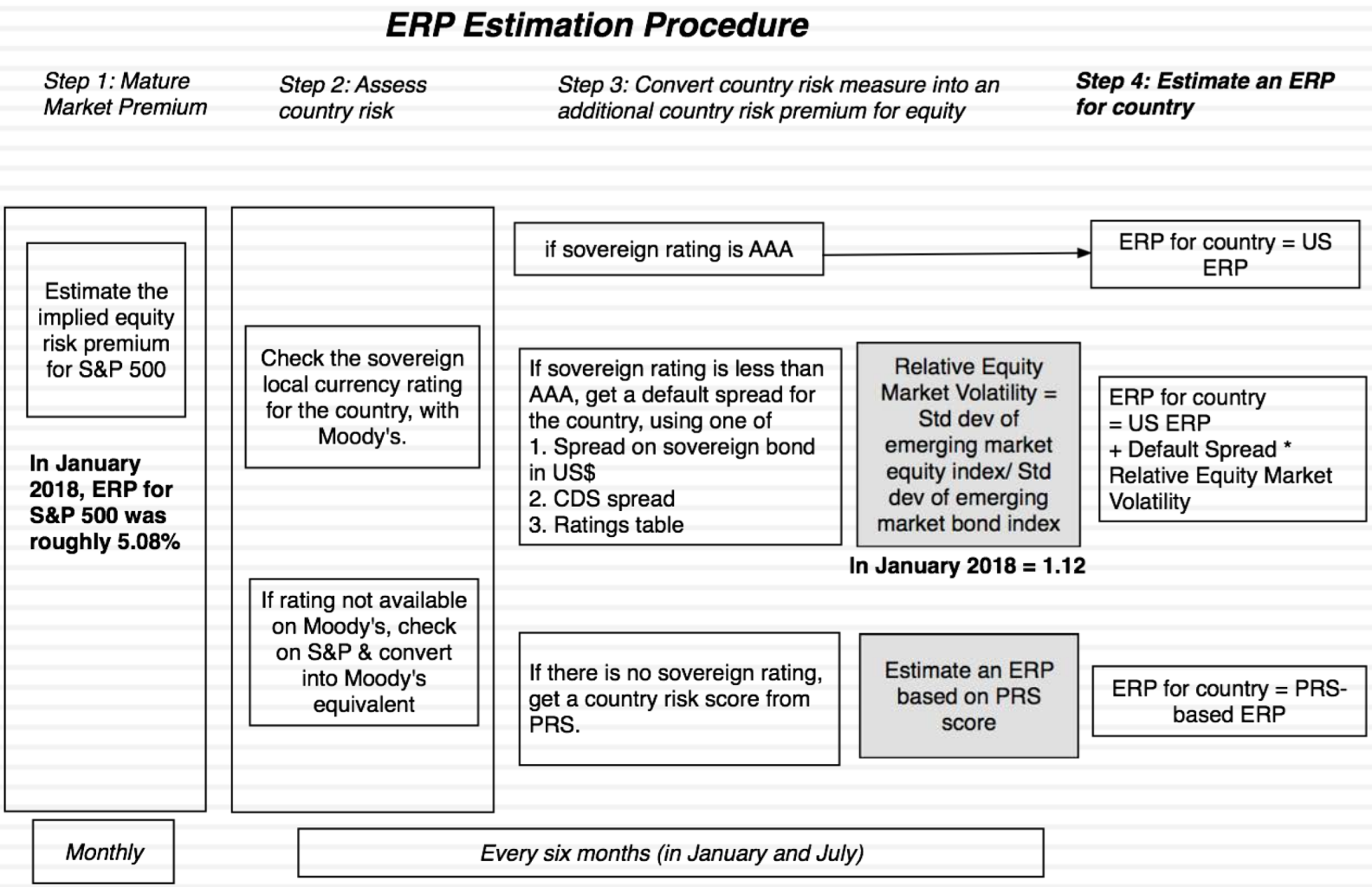
  = 5.08% + 1.64% = 6.72%

- The Melded Default Spread: Equities are riskier than bonds and scaling up the default spread for the higher risk in equities should yield a better estimate of the additional risk for a country:

  ERP for country = ERP for Mature Market + Default spread for country *(Std Deviation of $\text{Equity}_{\text{Country}}$/ Std Deviation of $\text{Govt Bond}_{\text{Country}}$)

  ERP for Poland= 5.08% + 0.87% (14.05%/12.77%)= 6.04%

A Template for Estimating the ERP



ERP : Jan 2018

Andorra	Baa2	7.27%	2.19%
Austria	Aa1	5.54%	0.46%
Belgium	Aa3	5.78%	0.70%
Cyprus	Ba3	9.23%	4.15%
Denmark	Aaa	5.08%	0.00%
Finland	Aa1	5.54%	0.46%
France	Aa2	5.65%	0.57%
Germany	Aaa	5.08%	0.00%
Greece	Caa2	15.46%	10.38%
Guernsey	Aa3	5.78%	0.70%
Iceland	A3	6.46%	1.38%
Ireland	A2	6.06%	0.98%
Isle of Man	Aa2	5.65%	0.57%
Italy	Baa2	7.27%	2.19%
Jersey	Aa3	5.78%	0.70%
Liechtenstein	Aaa	5.08%	0.00%
Luxembourg	Aaa	5.08%	0.00%
Malta	A3	6.46%	1.38%
Netherlands	Aaa	5.08%	0.00%
Norway	Aaa	5.08%	0.00%
Portugal	Ba1	7.96%	2.88%
Spain	Baa2	7.27%	2.19%
Sweden	Aaa	5.08%	0.00%
Switzerland	Aaa	5.08%	0.00%
Turkey	Ba1	7.96%	2.88%
United Kingdom	Aa2	5.65%	0.57%
Western Europe		6.01%	0.93%

Canada	Aaa	5.08%	0.00%
United States	Aaa	5.08%	0.00%
North America		5.08%	0.00%

Caribbean		11.39%	6.31%

Argentina	B2	11.42%	6.34%
Belize	B3	12.58%	7.50%
Bolivia	Ba3	9.23%	4.15%
Brazil	Ba2	8.54%	3.46%
Chile	Aa3	5.78%	0.70%
Colombia	Baa2	7.27%	2.19%
Costa Rica	Ba2	8.54%	3.46%
Ecuador	B3	12.58%	7.50%
El Salvador	Caa1	13.72%	8.64%
Guatemala	Ba1	7.96%	2.88%
Honduras	B1	10.27%	5.19%
Mexico	A3	6.46%	1.38%
Nicaragua	B2	11.42%	6.34%
Panama	Baa2	7.27%	2.19%
Paraguay	Ba1	7.96%	2.88%
Peru	A3	6.46%	1.38%
Suriname	B1	10.27%	5.19%
Uruguay	Baa2	7.27%	2.19%
Venezuela	Caa3	16.60%	11.52%
Latin America		8.63%	3.55%

Angola		11.42%	6.34%
Botswana		6.06%	0.98%
Burkina Faso		11.42%	6.34%
Cameroon		11.42%	6.34%
Cape Verde		11.42%	6.34%
Congo (DR)		12.58%	7.50%
Congo (Rep of)		15.46%	10.38%
Côte d'Ivoire		9.23%	4.15%
Egypt		12.58%	7.50%
Ethiopia		10.27%	5.19%
Gabon		12.58%	7.50%
Ghana		12.58%	7.50%
Kenya		10.27%	5.19%
Morocco		7.96%	2.88%
Mozambique		16.60%	11.52%
Namibia		7.96%	2.88%
Nigeria		11.42%	6.34%
Rwanda		11.42%	6.34%
Senegal		9.23%	4.15%
South Africa		7.62%	2.54%
Swaziland		5.08%	11.42%
Tunisia		10.27%	5.19%
Uganda		11.42%	6.34%
Zambia		12.58%	7.50%
Africa		**10.63%**	**5.58%**

Albania	B1	10.27%	5.19%
Armenia	B1	10.27%	5.19%
Azerbaijan	Ba2	8.54%	3.46%
Belarus	Caa1	13.72%	8.64%
Bosnia	B3	12.58%	7.50%
Bulgaria	Baa2	7.27%	2.19%
Croatia	Ba2	8.54%	3.46%
Czech Republic	A1	5.89%	0.81%
Estonia	A1	5.89%	0.81%
Georgia	Ba2	8.54%	3.46%
Hungary	Baa3	7.62%	2.54%
Kazakhstan	Baa3	7.62%	2.54%
Kyrgyzstan	B2	11.42%	6.34%
Latvia	A3	6.46%	1.38%
Lithuania	A3	6.46%	1.38%
Macedonia	Ba3	9.23%	4.15%
Moldova	B3	12.58%	7.50%
Montenegro	B1	10.27%	5.19%
Poland	A2	6.06%	0.98%
Romania	Baa3	7.62%	2.54%
Russia	Ba1	7.96%	2.88%
Serbia	Ba3	9.23%	4.15%
Slovakia	A2	6.06%	0.98%
Slovenia	Baa1	6.92%	1.84%
Tajikistan	B3	7.96%	2.88%
Ukraine	Caa2	15.46%	10.38%
E. Europe		7.75%	2.69%

Abu Dhabi	Aa2	5.65%	0.57%
Bahrain	B1	10.27%	5.19%
Iraq	Caa1	13.72%	8.64%
Israel	A1	5.89%	0.81%
Jordan	B1	10.27%	5.19%
Kuwait	Aa2	5.65%	0.57%
Lebanon	B3	12.58%	7.50%
Oman	Baa2	7.27%	2.19%
Qatar	Aa3	5.78%	0.70%
Ras Al Khaimah	A2	6.06%	0.98%
Saudi Arabia	A1	5.89%	0.81%
Sharjah	A3	6.46%	1.38%
United Arab Emirates	Aa2	5.65%	0.57%
Middle East		6.69%	1.61%

Country	*PRS*	*ERP*	*CRP*	*Country*	*PRS*	*ERP*	*CRP*
Algeria	62.3	12.58%	7.50%	Malawi	61.3	13.73%	8.65%
Brunei	76.3	6.06%	0.98%	Mali	60.8	13.73%	8.65%
Gambia	59.3	15.46%	10.38%	Myanmar	63.8	12.58%	7.50%
Guinea	58.3	15.46%	10.38%	Niger	53.7	18.91%	13.83%
Guinea-Bissau	63.8	12.58%	7.50%	Sierra Leone	54.3	18.91%	13.83%
Guyana	68.5	9.23%	4.15%	Somalia	52	18.91%	13.83%
Haiti	61.8	13.73%	8.65%	Sudan	48	25.32%	20.24%
Iran	73.3	7.27%	2.19%	Syria	47	25.32%	20.24%
Korea, D.P.R.	56	16.60%	11.52%	Tanzania	63.3	12.58%	7.50%
Liberia	53	18.91%	13.83%	Togo	61	13.73%	8.65%
Libya	62	13.73%	8.65%	Yemen, Republic	49.3	25.32%	20.24%
Madagascar	64.5	11.42%	6.34%	Zimbabwe	58.5	15.46%	10.38%

Bangladesh	Ba3	9.23%	4.15%
Cambodia	B2	11.42%	6.34%
China	A1	5.89%	0.81%
Fiji	Ba3	9.23%	4.15%
Hong Kong	Aa2	5.65%	0.57%
India	Baa2	7.27%	2.19%
Indonesia	Baa3	7.62%	2.54%
Japan	A1	5.89%	0.81%
Korea	Aa2	5.65%	0.57%
Macao	Aa3	5.78%	0.70%
Malaysia	A3	6.46%	1.38%
Mauritius	Baa1	6.92%	1.84%
Mongolia	Caa1	13.72%	8.64%
Pakistan	B3	12.58%	7.50%
Papua New Guinea	B2	11.42%	6.34%
Philippines	Baa2	7.27%	2.19%
Singapore	Aaa	5.08%	0.00%
Sri Lanka	B1	10.27%	5.19%
Taiwan	Aa3	5.78%	0.70%
Thailand	Baa1	6.92%	1.84%
Vietnam	B1	10.27%	5.19%
Asia		6.27%	1.19%

Australia	Aaa	5.08%	0.00%
Cook Islands	B1	10.27%	5.19%
New Zealand	Aaa	5.08%	0.00%
Australia & New Zealand		5.08%	0.00%

Red #: Country risk premium
Regional #: GDP weighted average

VII. And it is not just emerging market companies that are exposed to this risk..

- The "default" approach in valuation has been to assign country risk based upon your country of incorporation. Thus, if you are incorporated in a developed market, the assumption has been that you are not exposed to emerging market risks. If you are incorporated in an emerging market, you are saddled with the entire country risk.
- As companies globalize and look for revenues in foreign markets, this practice will under estimate the costs of equity of developed market companies with significant emerging market risk exposure and over estimate the costs of equity of emerging market companies with significant developed market risk exposure.

One way of dealing with this: Operation-based ERP for Ergis

Country	Revenues	ERP	Weight	Weighted ERP
Poland	345.08 zł	6.06%	46.04%	2.79%
Germany	134.74 zł	5.08%	17.98%	0.91%
France	76.12 zł	5.65%	10.15%	0.57%
Netherlands	30.34 zł	5.08%	4.05%	0.21%
United Kingdom	31.31 zł	5.65%	4.18%	0.24%
Rest of Europe	132.00 zł	6.01%	17.61%	1.06%
Ergis	**749.58 zł**		**100.00%**	**5.78%**

1. By focusing on revenues, are we misestimating country risk exposure?
2. As the company looks to grow in other parts of the world, how do you see this premium evolving?

Natural Resource Twists? Royal Dutch

Country	*Oil & Gas Production*	*% of Total*	*ERP*
Denmark	17396	3.83%	6.20%
Italy	11179	2.46%	9.14%
Norway	14337	3.16%	6.20%
UK	20762	4.57%	6.81%
Rest of Europe	*874*	*0.19%*	*7.40%*
Brunei	823	0.18%	9.04%
Iraq	20009	4.40%	11.37%
Malaysia	22980	5.06%	8.05%
Oman	78404	17.26%	7.29%
Russia	22016	4.85%	10.06%
Rest of Asia & ME	*24480*	*5.39%*	*7.74%*
Oceania	*7858*	*1.73%*	*6.20%*
Gabon	12472	2.75%	11.76%
Nigeria	67832	14.93%	11.76%
Rest of Africa	6159	1.36%	12.17%
USA	104263	22.95%	6.20%
Canada	8599	1.89%	6.20%
Brazil	13307	2.93%	9.60%
Rest of Latin America	*576*	*0.13%*	*10.78%*
Royal Dutch Shell	**454326**	**100.00%**	**8.26%**

An alternate way: Estimating a company's exposure to country risk (Lambda)

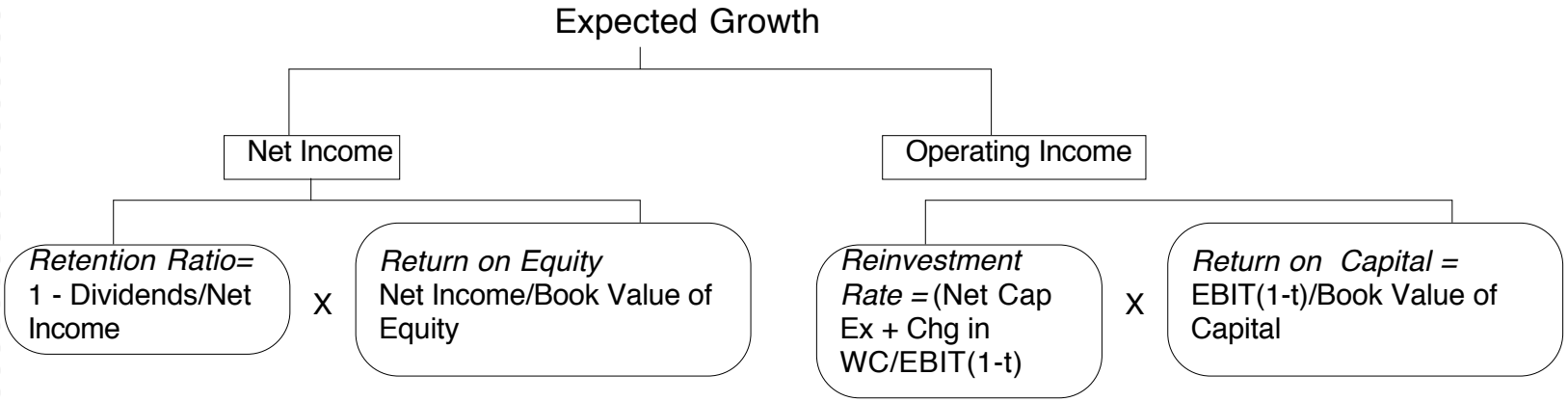
- **Just as beta measures exposure to macro economic risk, lambda measures exposure just to country risk. Like beta, it is scaled around one.**
- The easiest and most accessible data is on revenues. Most companies break their revenues down by region. One simplistic solution would be to do the following:

  $$\text{Lambda} = \%\text{ of revenues domestically}_{\text{firm}} / \%\text{ of revenues domestically}_{\text{average firm}}$$

- In 2008-09, Tata Motors got about 91.37% of its revenues in India and TCS got 7.62%. The average Indian firm gets about 80% of its revenues in India:
  - $\text{Lambda}_{\text{Tata Motors}} = 91\%/80\% = 1.14$
  - The danger of focusing just on revenues is that it misses other exposures to risk (production and operations).

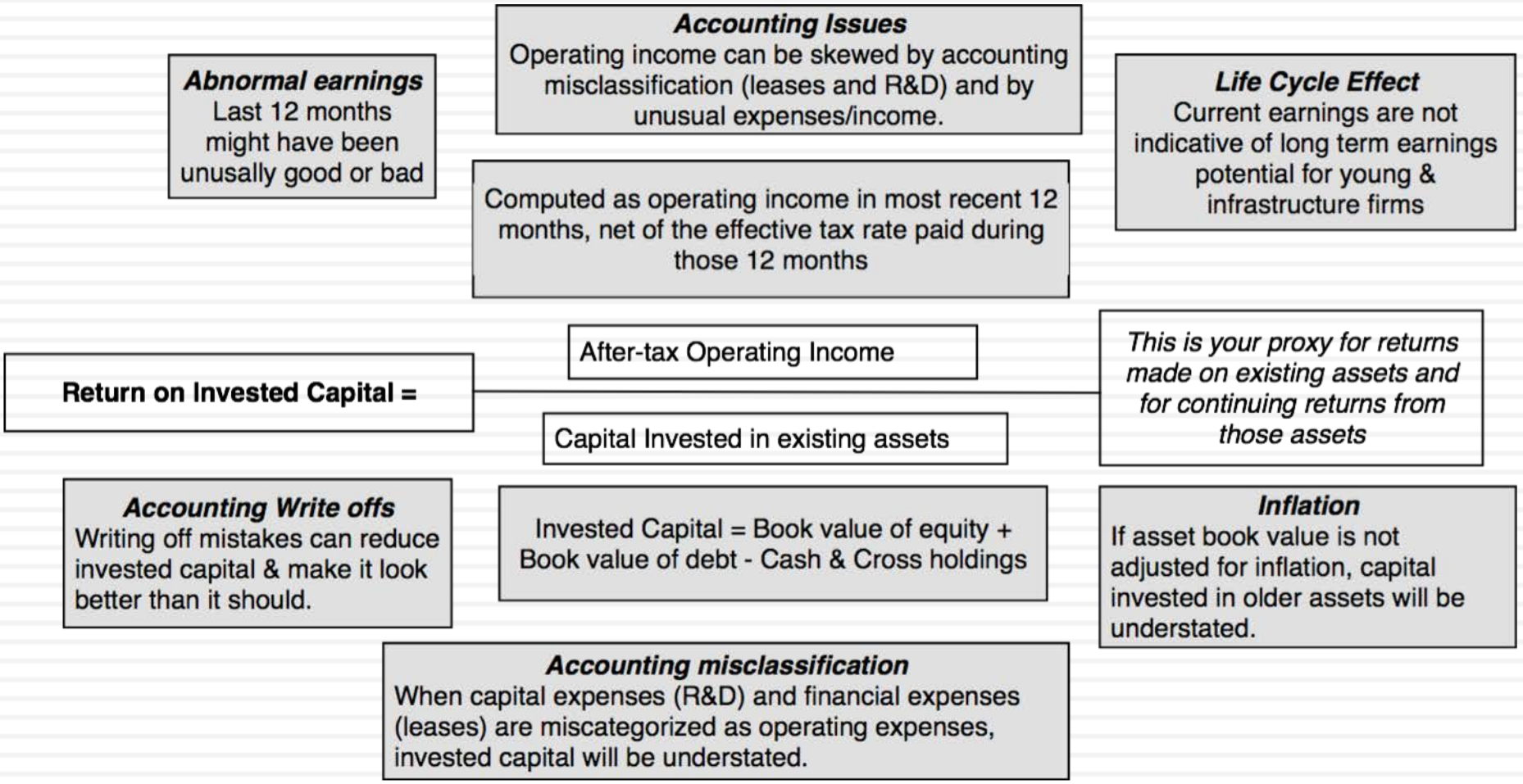
	Tata Motors	*TCS*
% of production/operations in India	High	High
% of revenues in India	91.37% (in 2009) Estimated 70% (in 2010)	7.62%
Lambda	0.80	0.20
Flexibility in moving operations	Low. Significant physical assets.	High. Human capital is mobile.

VIII. Growth has to be earned (not endowed or estimated): Sustainable Growth

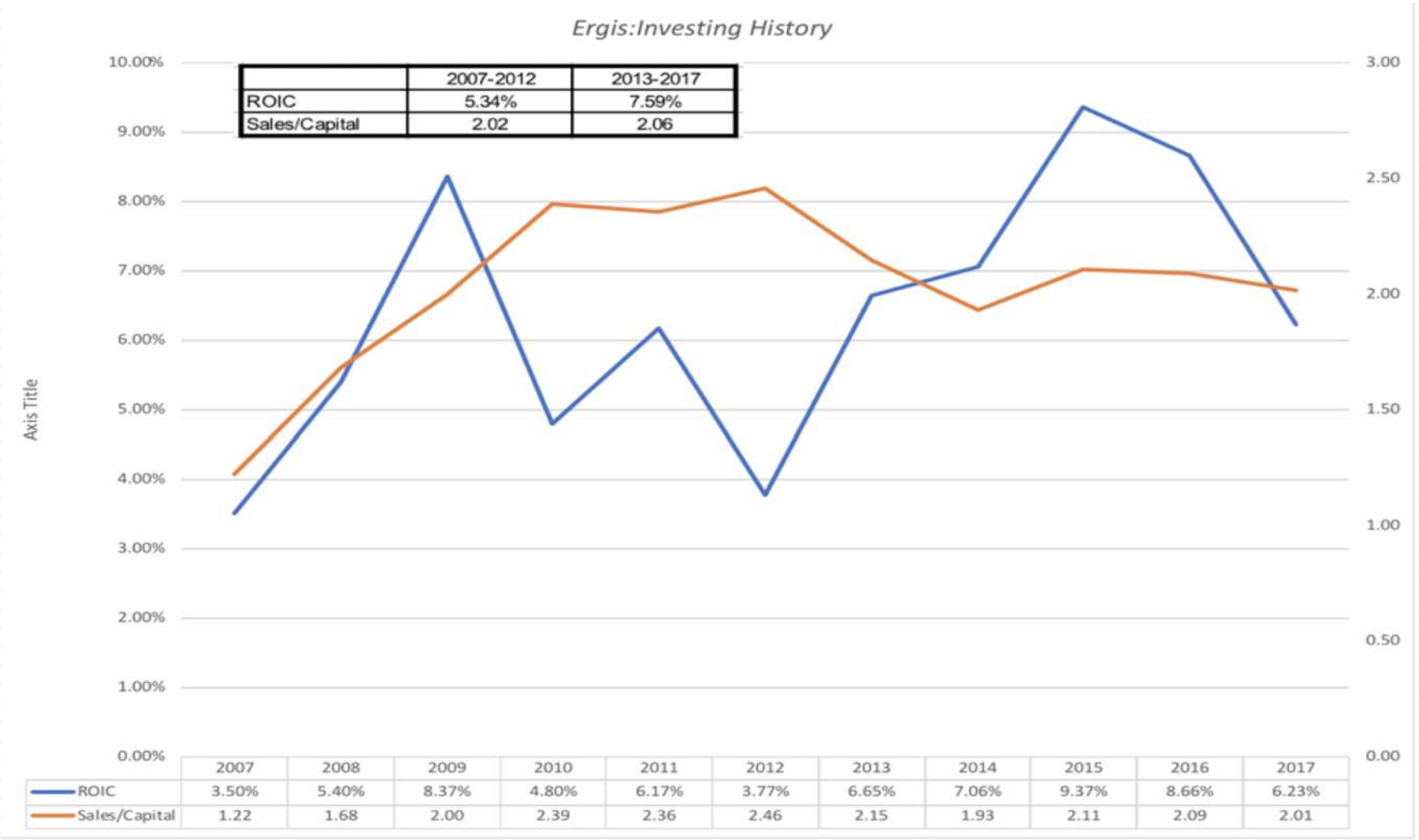


1. No free growth: In the long term, to grow, you have to reinvest.
2. Growth Quality: For a given reinvestment, the higher the return you generate on your reinvestment, the faster you can grow.
3. Scaling up is hard to do.

Measuring Returns: The Quandary



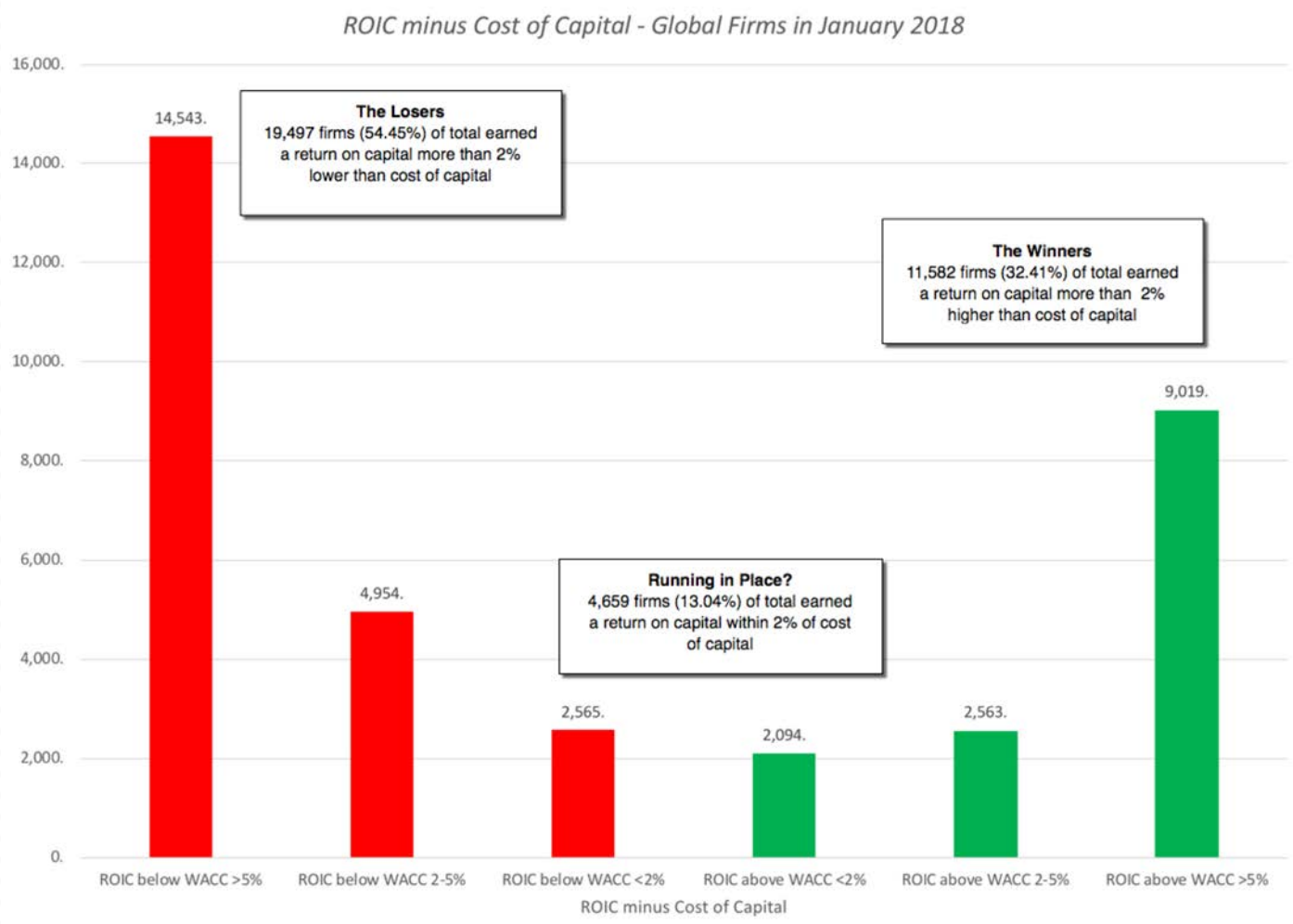
Operating income, Reinvestment & Return on Capital – Ergis



	2007-2012	2013-2017
ROIC	5.34%	7.59%
Sales/Capital	2.02	2.06

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
ROIC	3.50%	5.40%	8.37%	4.80%	6.17%	3.77%	6.65%	7.06%	9.37%	8.66%	6.23%
Sales/Capital	1.22	1.68	2.00	2.39	2.36	2.46	2.15	1.93	2.11	2.09	2.01

Earn at least your cost of capital! But companies seem to have trouble in practice



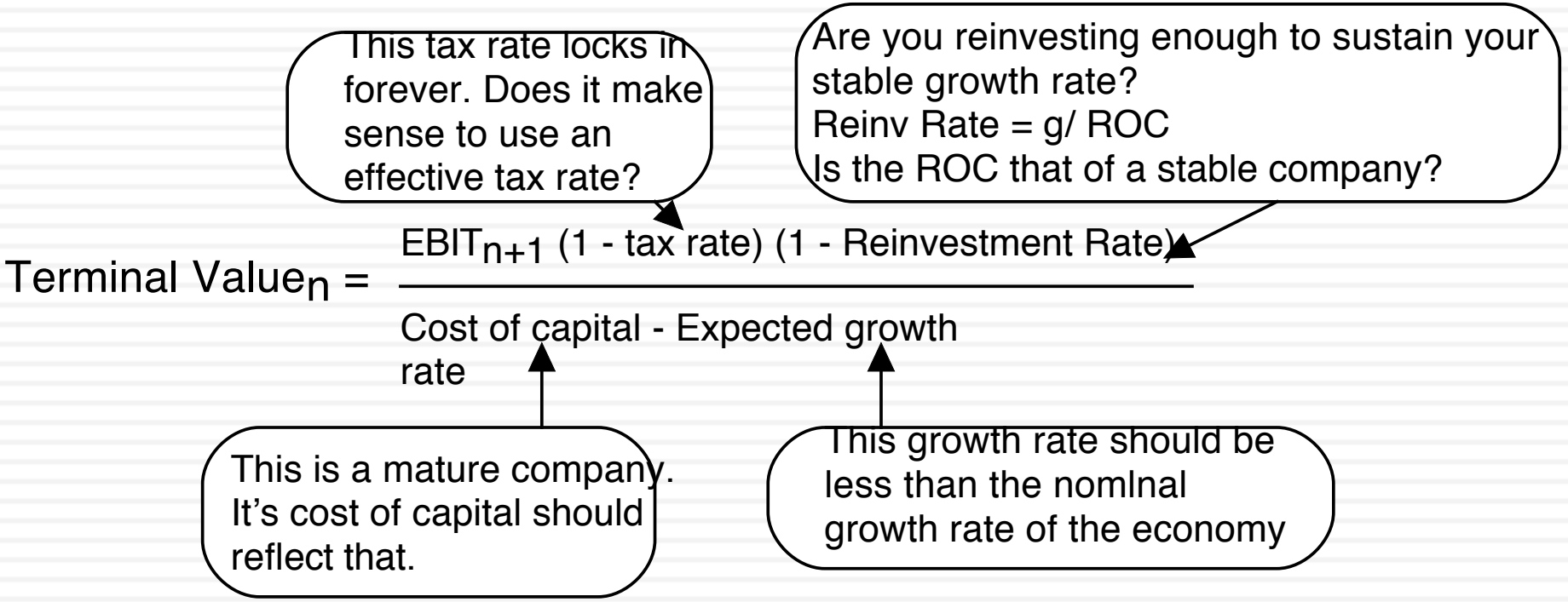
A Regional Breakdown

Sub Group	Number of firms	Cost of Capital	ROIC	ROIC - Cost of Capital	% of firms with ROIC>WACC
Africa and Middle East	1,742	9.38%	7.08%	-2.29%	36.02%
Australia & NZ	1,527	7.67%	4.98%	-2.69%	28.35%
Canada	2,601	7.89%	3.14%	-4.76%	15.88%
China	4,793	8.05%	5.74%	-2.31%	38.84%
EU & Environs	4,812	8.07%	8.88%	0.81%	42.92%
Eastern Europe & Russia	491	9.90%	7.70%	-2.19%	33.98%
India	2,966	9.55%	13.56%	4.01%	39.84%
Japan	3,487	7.83%	7.37%	-0.46%	51.73%
Latin America	748	9.28%	7.90%	-1.38%	42.92%
Small Asia	7,500	9.06%	7.55%	-1.50%	35.18%
UK	1,193	8.04%	8.06%	0.02%	44.42%
United States	6,125	7.54%	10.23%	2.69%	42.40%

A More General Way to Estimate Growth: Top Down Growth

- All of the fundamental growth equations assume that the firm has a return on equity or return on capital it can sustain in the long term.
- When operating income is negative or margins are expected to change over time, we use a three step process to estimate growth:
  - Estimate growth rates in revenues over time
    - Determine the total market (given your business model) and estimate the market share that you think your company will earn.
    - Decrease the growth rate as the firm becomes larger
    - Keep track of absolute revenues to make sure that the growth is feasible
  - Estimate expected operating margins each year
    - Set a target margin that the firm will move towards
    - Adjust the current margin towards the target margin
  - Estimate the capital that needs to be invested to generate revenue growth and expected margins
    - Estimate a sales to capital ratio that you will use to generate reinvestment needs each year.

IX. All good things come to an end..And the terminal value is not an ATM…



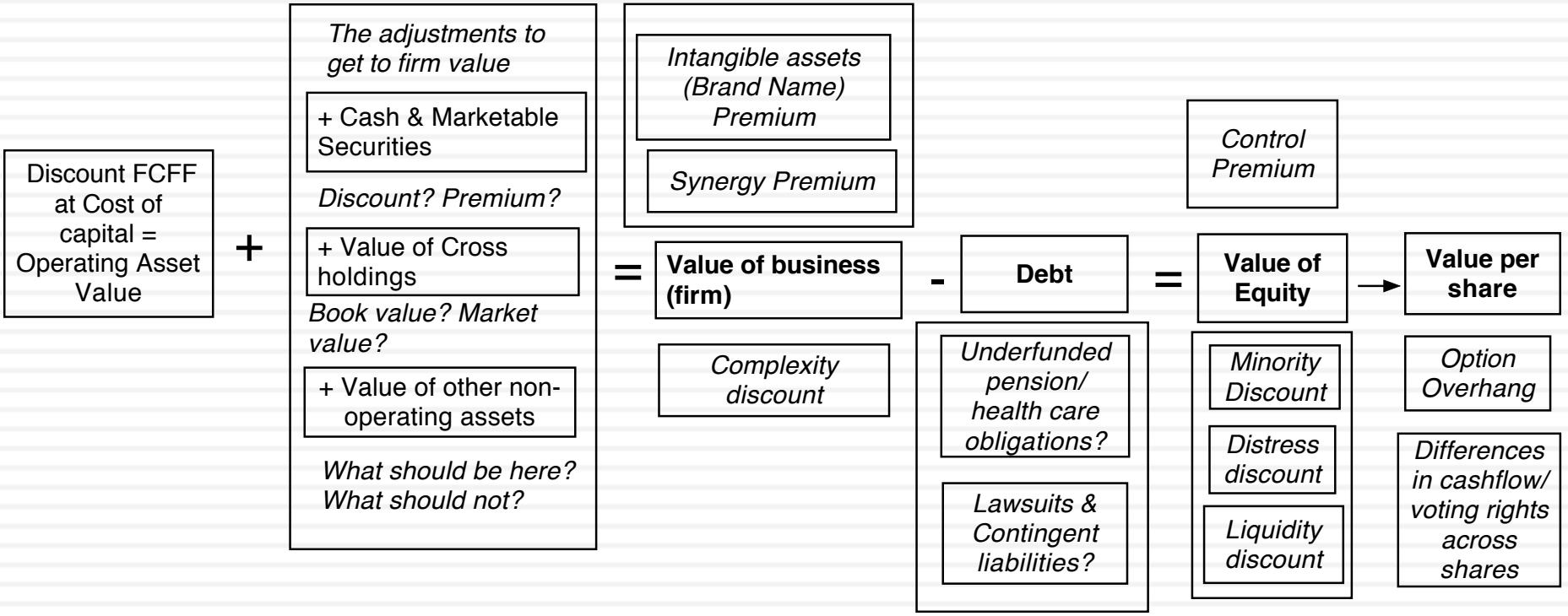
Terminal Value and Growth

Stable Growth Rate	Amgen	Tata Motors	Ergis
0%	$150,652	₹ 435,686	517.34 zl
1%	$154,479	₹ 435,686	517.34 zl
2%	$160,194	₹ 435,686	517.34 zl
3%	$167,784	₹ 435,686	517.34 zl
4%	$179,099	₹ 435,686	
5%		₹ 435,686	
Risk free Rate	**4.78%**	**5.00%**	**2.39%**
Cost of capital	**8.08%**	**10.39%**	**6.89%**
Return on capital	**10.00%**	**10.39%**	**6.89%**

THE LOOSE ENDS IN VALUATION…

Aswath Damodaran

Getting from DCF to value per share: The Loose Ends

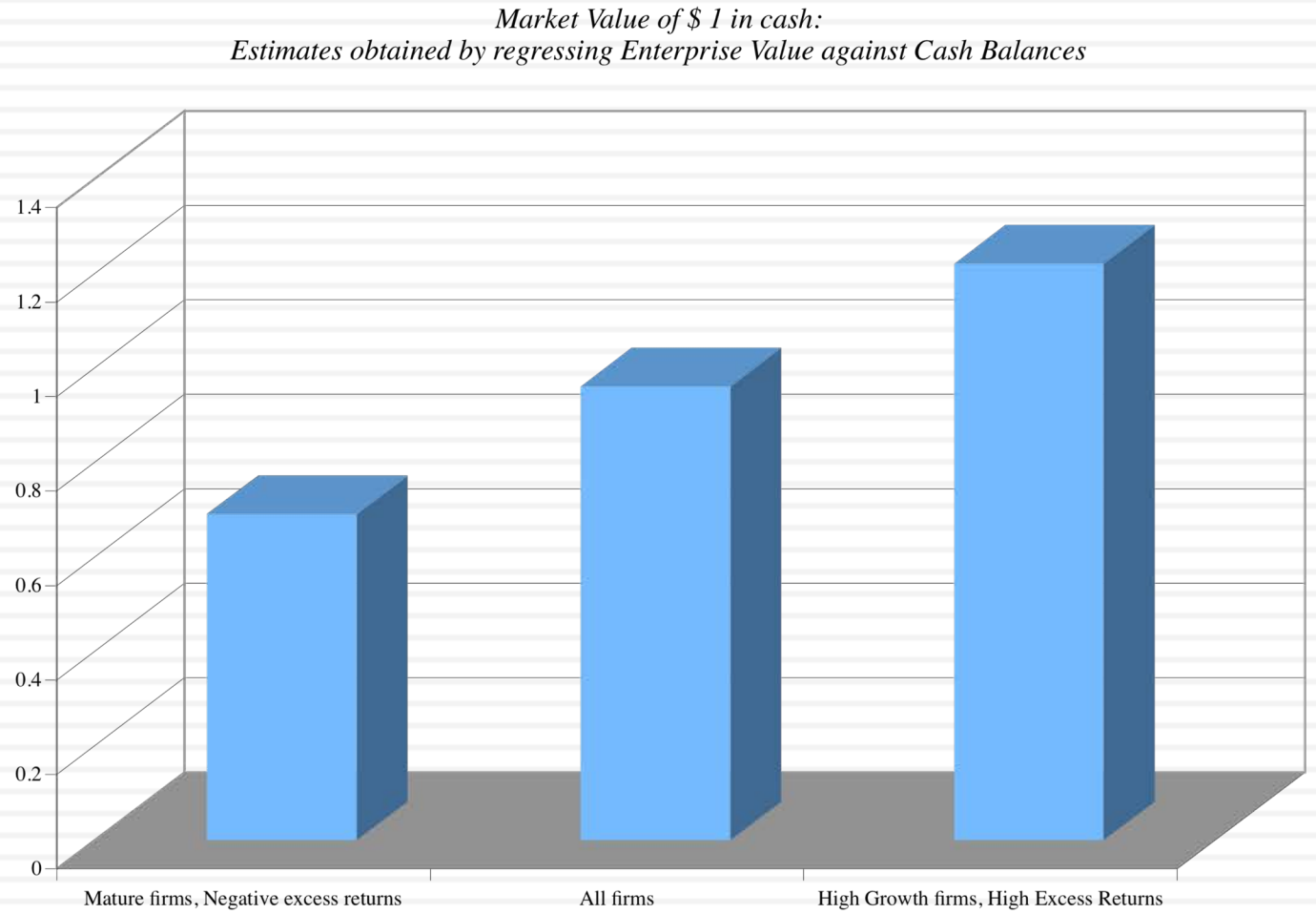


1. The Value of Cash
An Exercise in Cash Valuation

	Company A	*Company B*	*Company C*
Enterprise Value	$ 1 billion	$ 1 billion	$ 1 billion
Cash	$ 100 mil	$ 100 mil	$ 100 mil
Return on Capital	10%	5%	22%
Cost of Capital	10%	10%	12%
Trades in	US	US	Argentina

- In which of these companies is cash most likely to trade at face value, at a discount and at a premium?

Cash: Discount or Premium?



2. Dealing with Holdings in Other firms

- Holdings in other firms can be categorized into
  - Minority passive holdings, in which case only the dividend from the holdings is shown in the balance sheet
  - Minority active holdings, in which case the share of equity income is shown in the income statements
  - Majority active holdings, in which case the financial statements are consolidated.
- We tend to be sloppy in practice in dealing with cross holdings. After valuing the operating assets of a firm, using consolidated statements, it is common to add on the balance sheet value of minority holdings (which are in book value terms) and subtract out the minority interests (again in book value terms), representing the portion of the consolidated company that does not belong to the parent company.

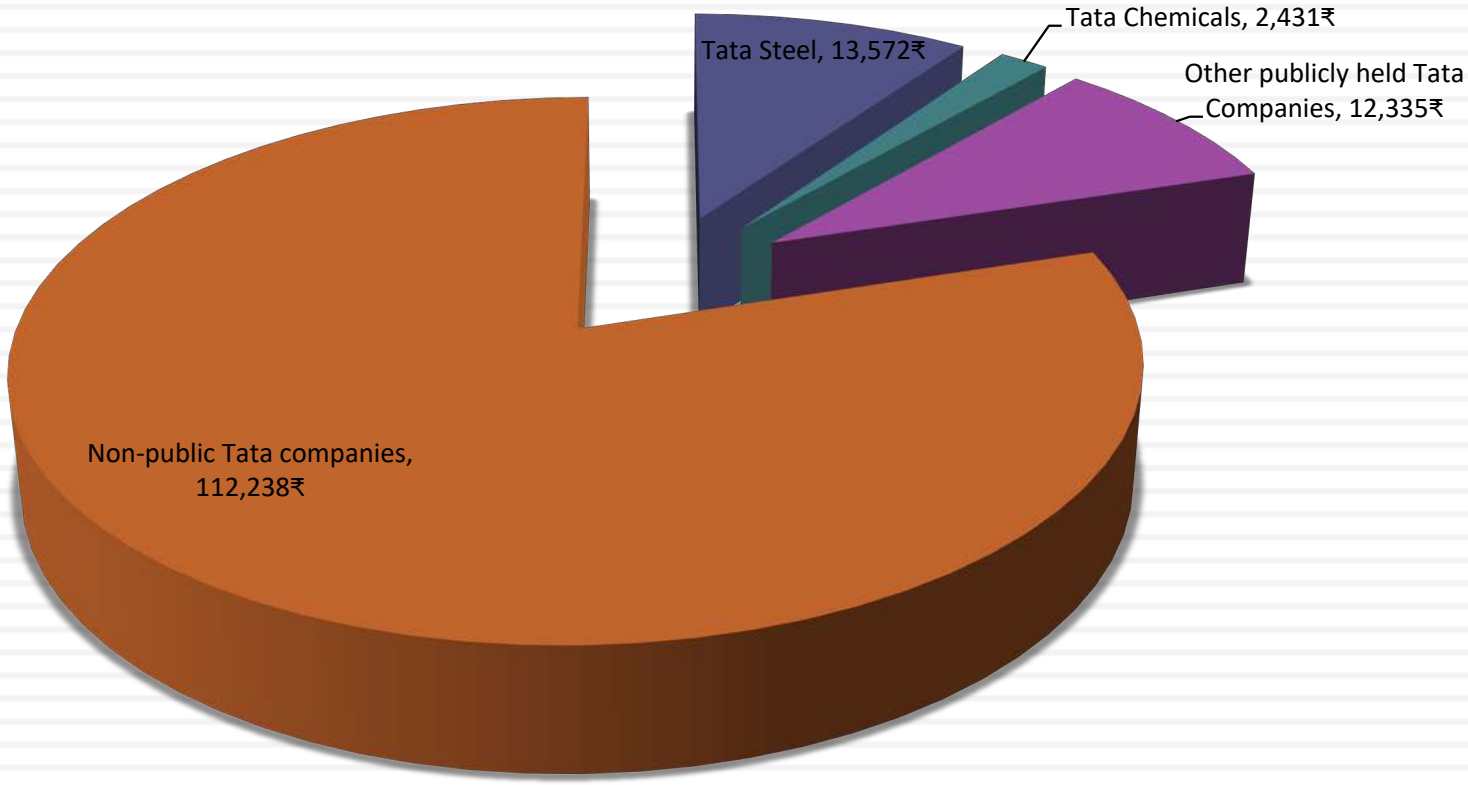
How to value holdings in other firms.. In a perfect world..

- In a perfect world, we would strip the parent company from its subsidiaries and value each one separately. The value of the combined firm will be
  - Value of parent company + Proportion of value of each subsidiary
- To do this right, you will need to be provided detailed information on each subsidiary to estimate cash flows and discount rates.

Two compromise solutions…

- The market value solution: When the subsidiaries are publicly traded, you could use their traded market capitalizations to estimate the values of the cross holdings. You do risk carrying into your valuation any mistakes that the market may be making in valuation.
- The relative value solution: When there are too many cross holdings to value separately or when there is insufficient information provided on cross holdings, you can convert the book values of holdings that you have on the balance sheet (for both minority holdings and minority interests in majority holdings) by using the average price to book value ratio of the sector in which the subsidiaries operate.

Tata Motor's Cross Holdings



3. Other Assets that have not been counted yet..

- Unutilized assets: If you have assets or property that are not being utilized (vacant land, for example), you have not valued it yet. You can assess a market value for these assets and add them on to the value of the firm.
- Overfunded pension plans: If you have a defined benefit plan and your assets exceed your expected liabilities, you could consider the over funding with two caveats:
  - Collective bargaining agreements may prevent you from laying claim to these excess assets.
  - There are tax consequences. Often, withdrawals from pension plans get taxed at much higher rates.
- **Do not double count an asset**. If you count the income from an asset in your cash flows, you cannot count the market value of the asset in your value.

An Uncounted Asset?

Price tag: $200 million

The longtime home of Playboy magazine founder Hugh Hefner is to be sold to Daren Metropoulos, a principal at private-equity firm Metropoulos & Co. PHOTO: GETTY IMAGES

The Real Estate Play!

- Assume that you value a Polish hotel company, with its hotels in Warsaw, as a hotel firm and arrive at a value of 1 billion Zloty. Now assume that the land that the factory sits on is worth 1.5 billion Zloty. What value would you attach to the firm?

a. 1 billion Zloty
b. 1.5 billion Zloty
c. 2.5 billion Zloty

4. A Discount for Complexity: An Experiment

	Company A	Company B
Operating Income	$ 1 billion	$ 1 billion
Tax rate	40%	40%
ROIC	10%	10%
Expected Growth	5%	5%
Cost of capital	8%	8%
Business Mix	Single	Multiple Businesses
Holdings	Simple	Complex
Accounting	Transparent	Opaque

- Which firm would you value more highly?

Measuring Complexity: Volume of Data in Financial Statements

Company	*Number of pages in last 10Q*	*Number of pages in last 10K*
General Electric	65	410
Microsoft	63	218
Wal-mart	38	244
Exxon Mobil	86	332
Pfizer	171	460
Citigroup	252	1026
Intel	69	215
AIG	164	720
Johnson & Johnson	63	218
IBM	85	353

Measuring Complexity: A Complexity Score

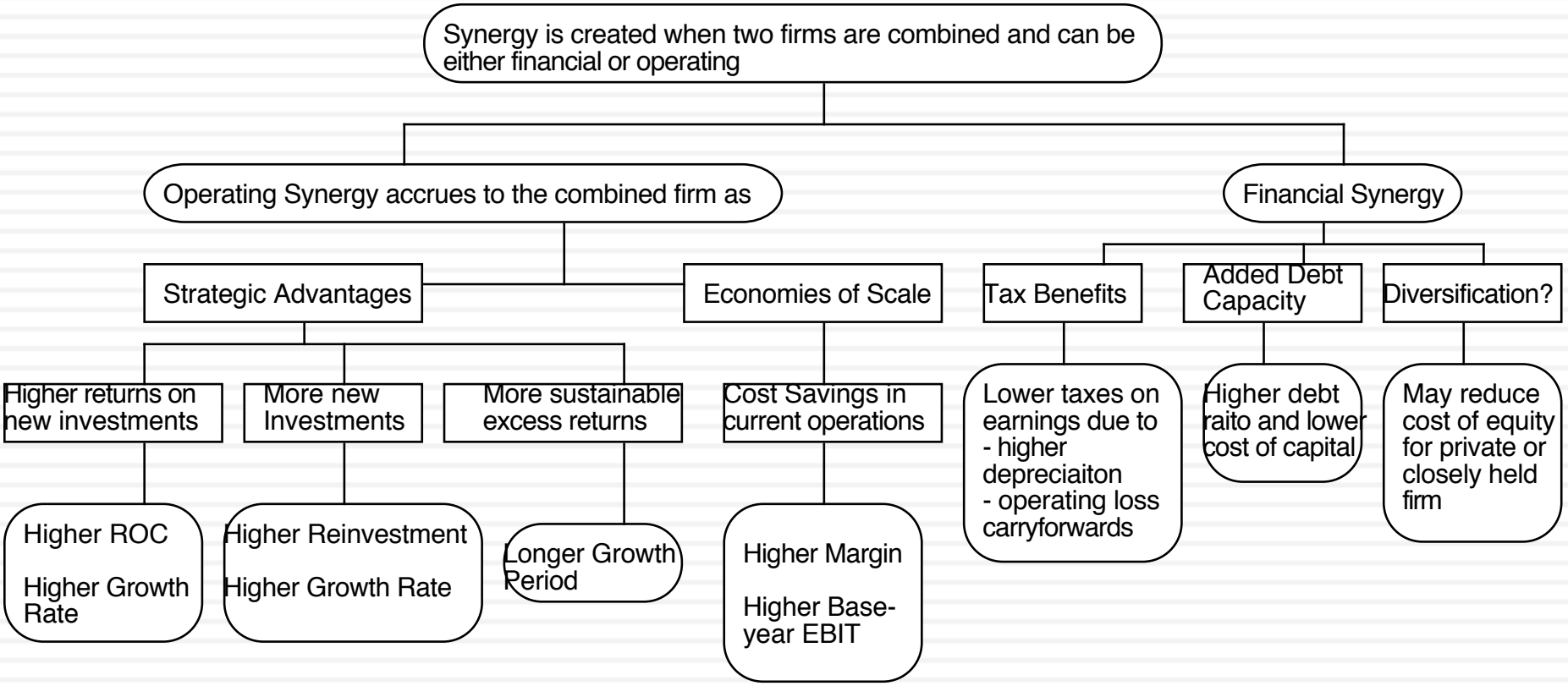
Item	Factors	Follow-up Question	Answer	Weighting factor	Gerdau Score	GE Score
Operating Income	1. Multiple Businesses	Number of businesses (with more than 10% of revenues) =	1	2.00	2	30
	2. One-time income and expenses	Percent of operating income =	10%	10.00	1	0.8
	3. Income from unspecified sources	Percent of operating income =	0%	10.00	0	1.2
	4. Items in income statement that are volatile	Percent of operating income =	15%	5.00	0.75	1
Tax Rate	1. Income from multiple locales	Percent of revenues from non-domestic locales =	70%	3.00	2.1	1.8
	2. Different tax and reporting books	Yes or No	No	Yes=3	0	3
	3. Headquarters in tax havens	Yes or No	No	Yes=3	0	0
	4. Volatile effective tax rate	Yes or No	Yes	Yes=2	2	0
Capital Expenditures	1. Volatile capital expenditures	Yes or No	Yes	Yes=2	2	2
	2. Frequent and large acquisitions	Yes or No	Yes	Yes=4	4	4
	3. Stock payment for acquisitions and investments	Yes or No	No	Yes=4	0	4
Working capital	1. Unspecified current assets and current liabilities	Yes or No	No	Yes=3	0	0
	2. Volatile working capital items	Yes or No	Yes	Yes=2	2	2
Expected Growth rate	1. Off-balance sheet assets and liabilities (operating leases and R&D)	Yes or No	No	Yes=3	0	3
	2. Substantial stock buybacks	Yes or No	No	Yes=3	0	3
	3. Changing return on capital over time	Is your return on capital volatile?	Yes	Yes=5	5	5
	4. Unsustainably high return	Is your firm's ROC much higher than industry average?	No	Yes=5	0	0
Cost of capital	1. Multiple businesses	Number of businesses (more than 10% of revenues) =	1	1.00	1	20
	2. Operations in emerging markets	Percent of revenues=	50%	5.00	2.5	2.5
	3. Is the debt market traded?	Yes or No	No	No=2	2	0
	4. Does the company have a rating?	Yes or No	Yes	No=2	0	0
	5. Does the company have off-balance sheet debt?	Yes or No	No	Yes=5	0	5
No-operating assets	Minority holdings as percent of book assets	Minority holdings as percent of book assets	0%	20.00	0	0.8
Firm to Equity value	Consolidation of subsidiaries	Minority interest as percent of book value of equity	63%	20.00	12.6	1.2
Per share value	Shares with different voting rights	Does the firm have shares with different voting rights?	Yes	Yes = 10	10	0
	Equity options outstanding	Options outstanding as percent of shares	0%	10.00	0	0.2
		Complexity Score =			48.95	90.55

Dealing with Complexity

- In Discounted Cashflow Valuation
  - The Aggressive Analyst: Trust the firm to tell the truth and value the firm based upon the firm's statements about their value.
  - The Conservative Analyst: Don't value what you cannot see.
  - The Compromise: Adjust the value for complexity
    - Adjust cash flows for complexity
    - Adjust the discount rate for complexity
    - Adjust the expected growth rate/ length of growth period
    - Value the firm and then discount value for complexity
- In relative valuation
  - In a relative valuation, you may be able to assess the price that the market is charging for complexity:
  - With the hundred largest market cap firms, for instance:

PBV = 0.65 + 15.31 ROE – 0.55 Beta + 3.04 Expected growth rate – 0.003 # Pages in 10K

5. The Value of Synergy



Valuing Synergy

(1) the firms involved in the merger are valued independently, by discounting expected cash flows to each firm at the weighted average cost of capital for that firm.

(2) the value of the combined firm, with no synergy, is obtained by adding the values obtained for each firm in the first step.

(3) The effects of synergy are built into expected growth rates and cashflows, and the combined firm is re-valued with synergy.

Value of Synergy = Value of the combined firm, with synergy - Value of the combined firm, without synergy

Inbev + SAB Miller: Where's the synergy?

	Inbev	*SABMiller*	*Combined firm (status quo)*	*Combined firm (synergy)*
Levered Beta	0.85	0.8289	0.84641	0.84641
Pre-tax cost of debt	3.0000%	3.2000%	3.00%	3.00%
Effective tax rate	18.00%	26.36%	19.92%	19.92%
Debt to Equity Ratio	30.51%	23.18%	29.71%	29.71%
Revenues	$45,762.00	$22,130.00	$67,892.00	$67,892.00
Operating Margin	32.28%	19.97%	28.27%	30.00%
Operating Income (EBIT)	$14,771.97	$4,419.36	$19,191.33	$20.368
After-tax return on capital	12.10%	12.64%	11.68%	12.00%
Reinvestment Rate =	50.99%	33.29%	43.58%	50.00%
Expected Growth Rate	6.17%	4.21%	5.09%	6.00%

The value of synergy

	Inbev	*SABMiller*	*Combined firm (status quo)*	*Combined firm (synergy)*
Cost of Equity =	8.93%	9.37%	9.12%	9.12%
After-tax cost of debt =	2.10%	2.24%	2.10%	2.10%
Cost of capital =	7.33%	8.03%	7.51%	7.51%
After-tax return on capital =	12.10%	12.64%	11.68%	12.00%
Reinvestment Rate =	50.99%	33.29%	43.58%	50.00%
Expected growth rate=	6.17%	4.21%	5.09%	6.00%
Value of firm				
PV of FCFF in high growth =	$28,733	$9,806	$38,539	$39,151
Terminal value =	$260,982	$58,736	$319,717	$340,175
Value of operating assets =	$211,953	$50,065	$262,018	$276,610

Value of synergy = 276,610 – 262,018 = 14,592 million

6. Brand name, great management, superb product …Are we short changing intangibles?

- There is often a temptation to add on premiums for intangibles. Here are a few examples.
  - Brand name
  - Great management
  - Loyal workforce
  - Technological prowess
- There are two potential dangers:
  - For some assets, the value may already be in your value and adding a premium will be double counting.
  - For other assets, the value may be ignored but incorporating it will not be easy.

Valuing Brand Name

	Coca Cola	With Cott Margins
Current Revenues =	$21,962.00	$21,962.00
Length of high-growth period	10	10
Reinvestment Rate =	50%	50%
Operating Margin (after-tax)	15.57%	5.28%
Sales/Capital (Turnover ratio)	1.34	1.34
Return on capital (after-tax)	20.84%	7.06%
Growth rate during period (g) =	10.42%	3.53%
Cost of Capital during period =	7.65%	7.65%
Stable Growth Period		
Growth rate in steady state =	4.00%	4.00%
Return on capital =	7.65%	7.65%
Reinvestment Rate =	52.28%	52.28%
Cost of Capital =	7.65%	7.65%
Value of Firm =	$79,611.25	$15,371.24

Valuing a Franchise: Star Wars

	Add-on $ per Box Office $
Streaming/Video	$1.20
Toys & Merchandise	$2.00
Books/eBooks	$0.20
Gaming	$0.50
Other	$0.50

Add on $ per box office $

Star Wars Franchise Valuation: December 2015

Main Movies
World Box office of $1.5 billion, adjusted for 2% inflation.

Spin Off Movies
World Box office is 50% of main movies.

	Main Star Wars Movies			*Star Wars Spin offs*		
	Star Wars VII	*Star Wars VIII*	*Star Wars IX*	*Rogue One*	*Hans Solo?*	*Boba Fett?*
Years from now	0.0	2.0	4.0	1.0	3.0	5.0
Movies - Revenues	$2,000	$2,081	$2,165	$1,020	$1,061	$1,104
Streaming/Video - Revenues	$2,400	$2,497	$2,598	$1,224	$1,273	$1,325
Toys & Merchandise - Revenues	$4,000	$4,162	$4,330	$2,040	$2,122	$2,208
Books/eBooks - Revenues	$400	$416	$433	$204	$212	$221
Gaming - Revenues	$1,000	$1,040	$1,082	$510	$531	$552
Other - Revenues	$1,000	$1,040	$1,082	$510	$531	$552
Total - Revenues	$10,800	$11,236	$11,690	$5,508	$5,731	$5,962
After-tax Operating Income (movies)	$ 282	$ 293	$ 305	$ 144	$ 150	$ 156
After-tax Operating Income (non-movies)	$ 924	$ 961	$ 1,000	$ 471	$ 490	$ 510
Present Value	$ 1,206	$ 1,083	$ 973	$ 572	$ 514	$ 461

Operating Margin
20.14% for movies
15% for non-movies
30% tax rate

Discounted back @ 7.61% cost of capital of entertainment companies

Value of new Star Wars movies =	$4,809
Value of continuing income =	$5,163
Value of Star Wars =	$9,972

Assumes that revenues from add ons continue after 2020, growing at 2% a year, with 15% operating margin

7. Be circumspect about defining debt for cost of capital purposes…

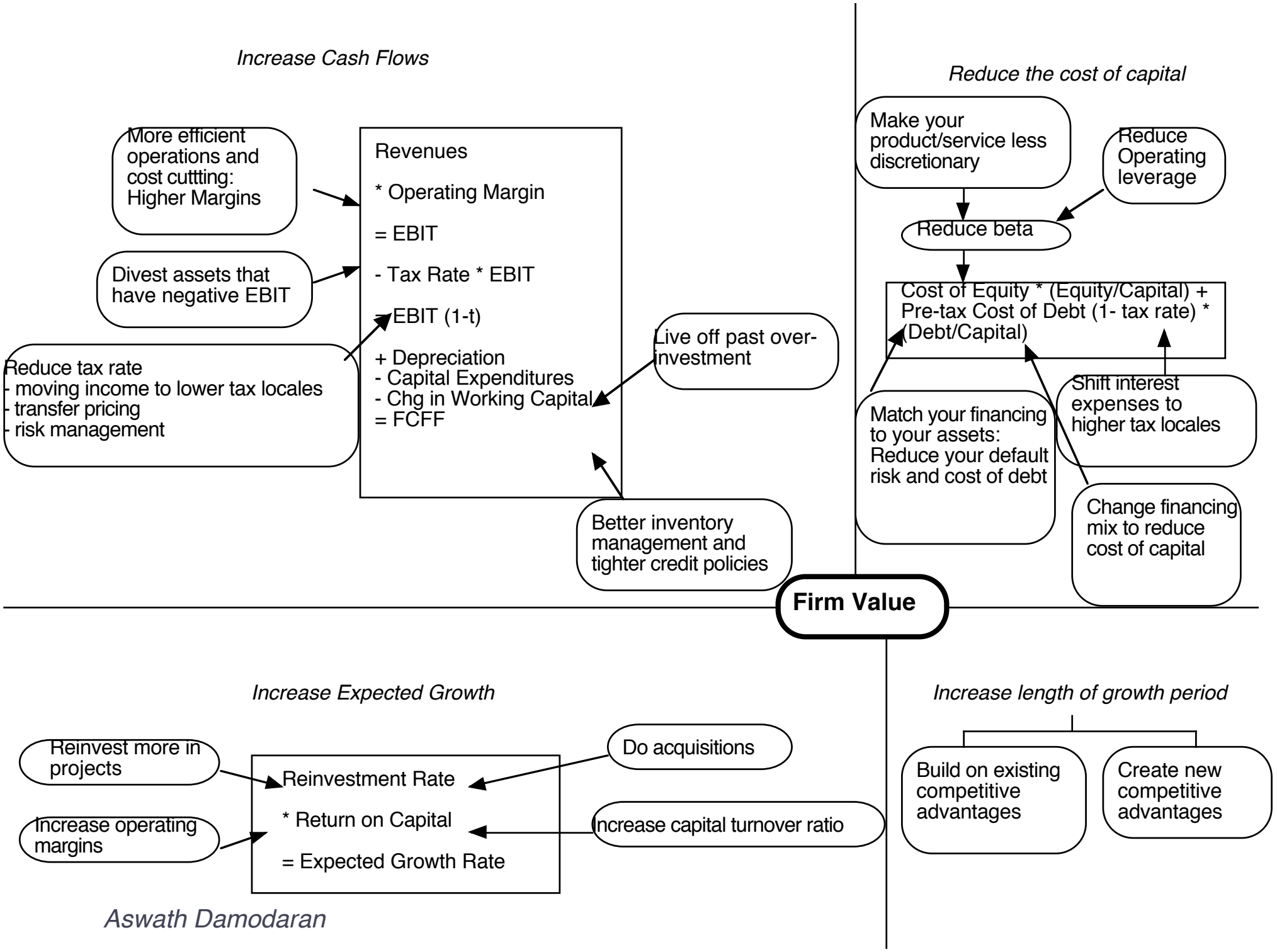
- General Rule: Debt generally has the following characteristics:
  - Commitment to make fixed payments in the future
  - The fixed payments are tax deductible
  - Failure to make the payments can lead to either default or loss of control of the firm to the party to whom payments are due.
- Defined as such, debt should include
  - All interest bearing liabilities, short term as well as long term
  - All leases, operating as well as capital
- Debt should not include
  - Accounts payable or supplier credit

But should consider other potential liabilities when getting to equity value…

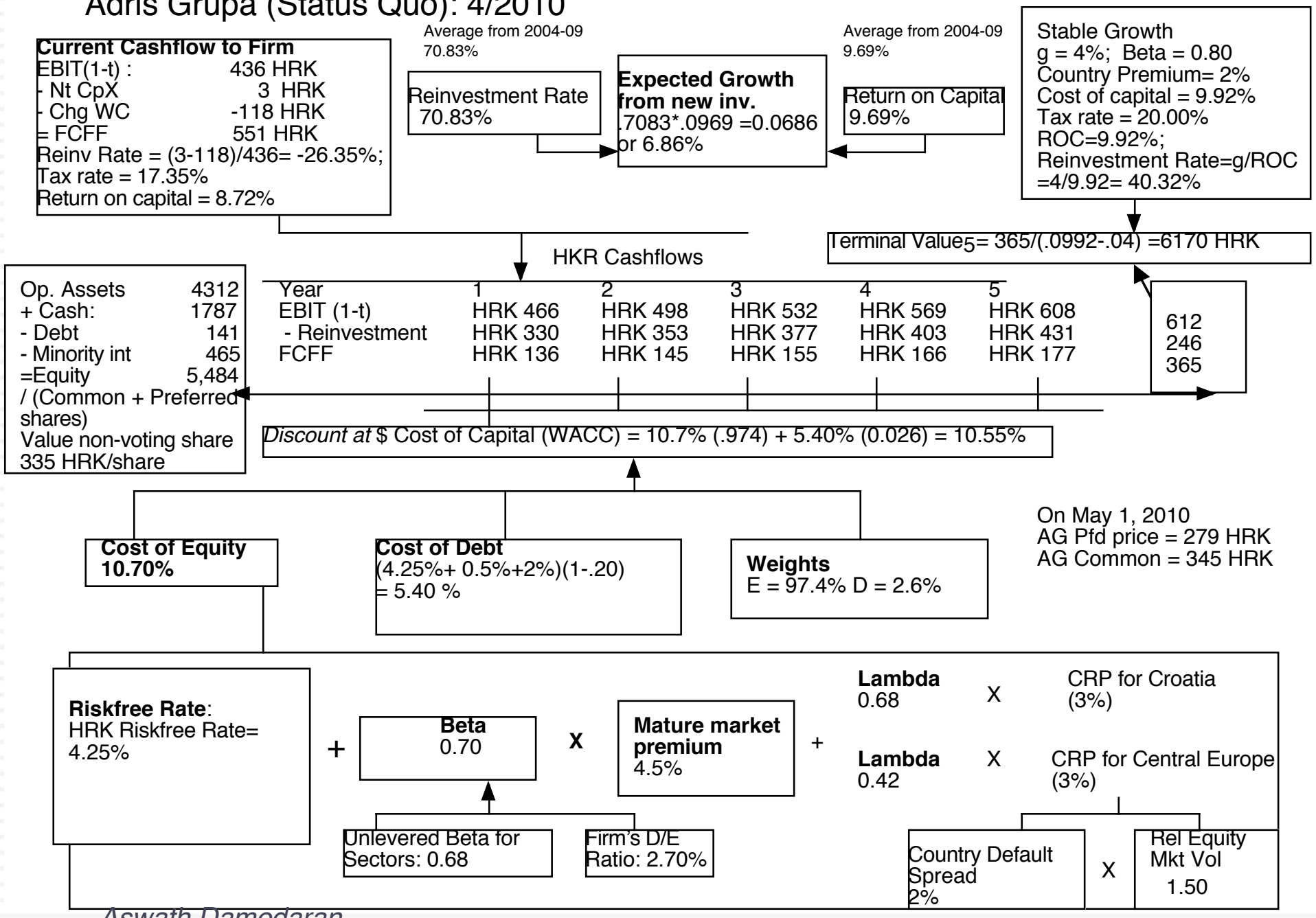
- If you have under funded pension fund or health care plans, you should consider the under funding at this stage in getting to the value of equity.
  - If you do so, you should not double count by also including a cash flow line item reflecting cash you would need to set aside to meet the unfunded obligation.
  - You should not be counting these items as debt in your cost of capital calculations….
- If you have contingent liabilities - for example, a potential liability from a lawsuit that has not been decided - you should consider the expected value of these contingent liabilities
  - Value of contingent liability = Probability that the liability will occur * Expected value of liability

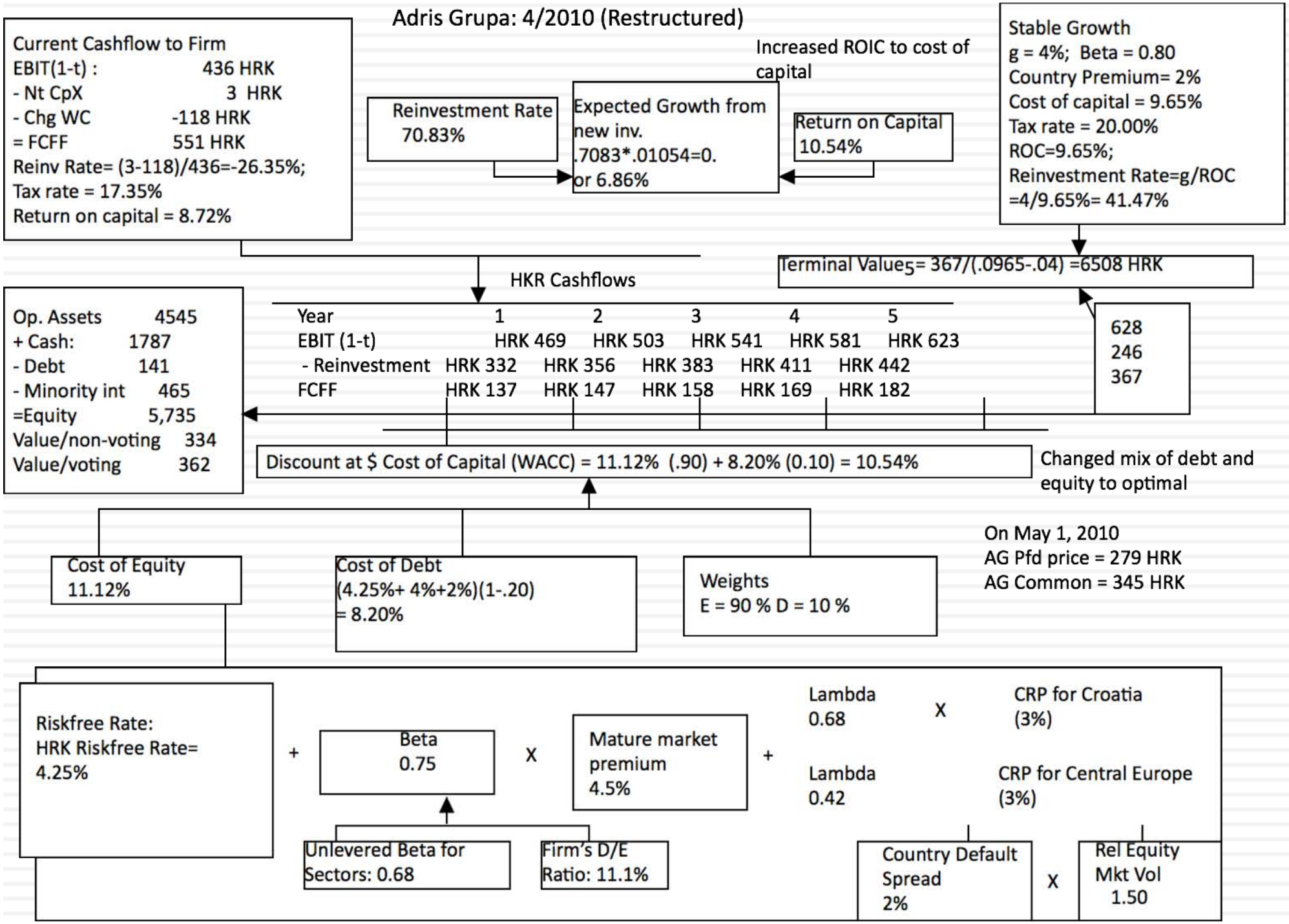
8. The Value of Control

- The value of the control premium that will be paid to acquire a block of equity will depend upon two factors -
  - Probability that control of firm will change: This refers to the probability that incumbent management will be replaced. this can be either through acquisition or through existing stockholders exercising their muscle.
  - Value of Gaining Control of the Company: The value of gaining control of a company arises from two sources - the increase in value that can be wrought by changes in the way the company is managed and run, and the side benefits and perquisites of being in control
  - Value of Gaining Control = Present Value (Value of Company with change in control - Value of company without change in control) + Side Benefits of Control


Increase Cash Flows
More efficient operations and cost cuttting: Higher Margins
Divest assets that have negative EBIT
Reduce tax rate
- moving income to lower tax locales
- transfer pricing
- risk management
Revenues
* Operating Margin
= EBIT
- Tax Rate * EBIT
= EBIT (1-t)
+ Depreciation
- Capital Expenditures
- Chg in Working Capital
= FCFF
Live off past over-investment
Better inventory management and tighter credit policies
Reduce the cost of capital
Make your product/service less discretionary
Reduce Operating leverage
Reduce beta
Cost of Equity * (Equity/Capital) + Pre-tax Cost of Debt (1- tax rate) * (Debt/Capital)
Match your financing to your assets: Reduce your default risk and cost of debt
Shift interest expenses to higher tax locales
Change financing mix to reduce cost of capital
Firm Value
Increase Expected Growth
Reinvest more in projects
Increase operating margins
Reinvestment Rate
* Return on Capital
= Expected Growth Rate
Do acquisitions
Increase capital turnover ratio
Increase length of growth period
Build on existing competitive advantages
Create new competitive advantages
Aswath Damodaran

Adris Grupa (Status Quo): 4/2010




Adris Grupa: 4/2010 (Restructured)
Current Cashflow to Firm
EBIT(1-t) : 436 HRK
- Nt CpX 3 HRK
- Chg WC -118 HRK
= FCFF 551 HRK
Reinv Rate= (3-118)/436=-26.35%;
Tax rate = 17.35%
Return on capital = 8.72%
Reinvestment Rate 70.83%
Expected Growth from new inv. .7083*.01054=0. or 6.86%
Return on Capital 10.54%
Increased ROIC to cost of capital
Stable Growth
g = 4%; Beta = 0.80
Country Premium= 2%
Cost of capital = 9.65%
Tax rate = 20.00%
ROC=9.65%;
Reinvestment Rate=g/ROC =4/9.65%= 41.47%
Terminal Value5= 367/(.0965-.04) =6508 HRK
HKR Cashflows
Year 1 2 3 4 5
EBIT (1-t) HRK 469 HRK 503 HRK 541 HRK 581 HRK 623
- Reinvestment HRK 332 HRK 356 HRK 383 HRK 411 HRK 442
FCFF HRK 137 HRK 147 HRK 158 HRK 169 HRK 182
628
246
367
Op. Assets 4545
+ Cash: 1787
- Debt 141
- Minority int 465
=Equity 5,735
Value/non-voting 334
Value/voting 362
Discount at $ Cost of Capital (WACC) = 11.12% (.90) + 8.20% (0.10) = 10.54%
Changed mix of debt and equity to optimal
On May 1, 2010
AG Pfd price = 279 HRK
AG Common = 345 HRK
Cost of Equity 11.12%
Cost of Debt (4.25%+ 4%+2%)(1-.20) = 8.20%
Weights E = 90 % D = 10 %
Riskfree Rate: HRK Riskfree Rate= 4.25%
+
Beta 0.75
X
Mature market premium 4.5%
+
Lambda 0.68
X
CRP for Croatia (3%)
Lambda 0.42
CRP for Central Europe (3%)
Unlevered Beta for Sectors: 0.68
Firm's D/E Ratio: 11.1%
Country Default Spread 2%
X
Rel Equity Mkt Vol 1.50

Value of Control and the Value of Voting Rights

- Adris Grupa has two classes of shares outstanding: 9.616 million voting shares and 6.748 million non-voting shares.
- To value a non-voting share, we assume that all non-voting shares essentially have to settle for status quo value. All shareholders, common and preferred, get an equal share of the status quo value.

  Status Quo Value of Equity = 5,484 million HKR

  Value for a non-voting share = 5484/(9.616+6.748) = 334 HKR/share
- To value a voting share, we first value control in Adris Grup as the difference between the optimal and the status quo value:

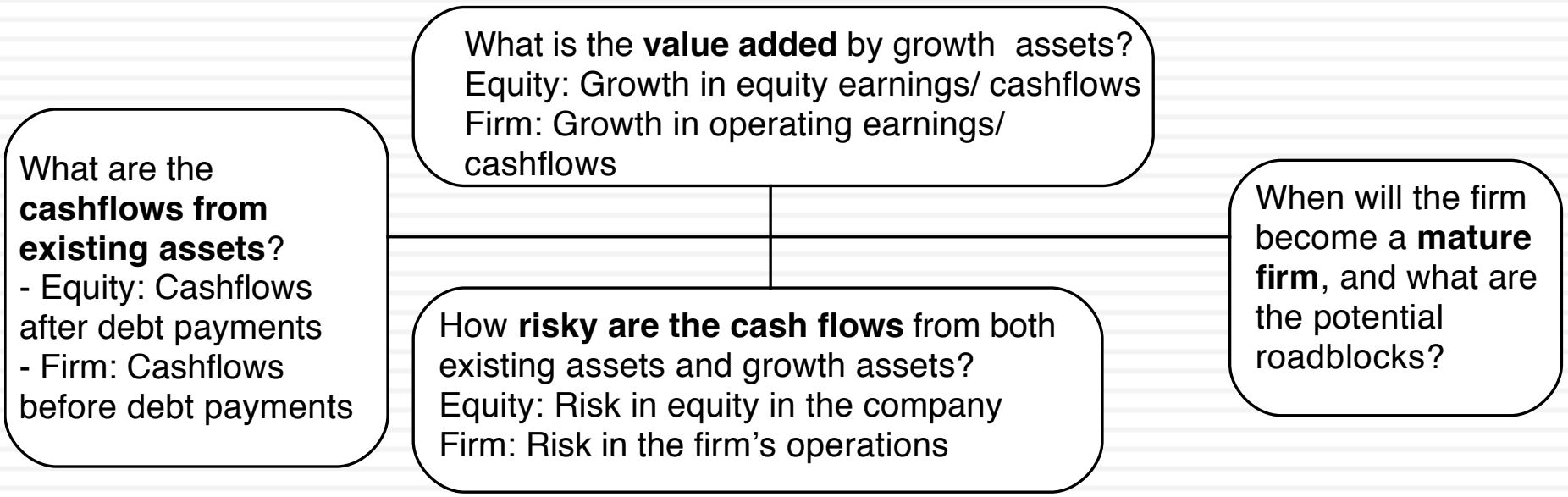
  Value of control at Adris Grupa = 5,735 – 5484 = 249 million HKR
- If you assume a 100% probability of change occurring, the value per voting share can be written as:

  Value per voting share =334 HKR + 249/9.616 = 362 HKR
- If the probability of control changing is only 40%, the expected value of control and value per voting share can be written as follows:
  - Expected value of control = 249 (.4) = 99.6 million HKR
  - Value per voting share = 334 HKR + 99.6/9.616 = 344 HKR

Aswath Damodaran

THE DARK SIDE OF VALUATION: VALUING DIFFICULT-TO-VALUE COMPANIES

The fundamental determinants of value…



The Dark Side of Valuation…

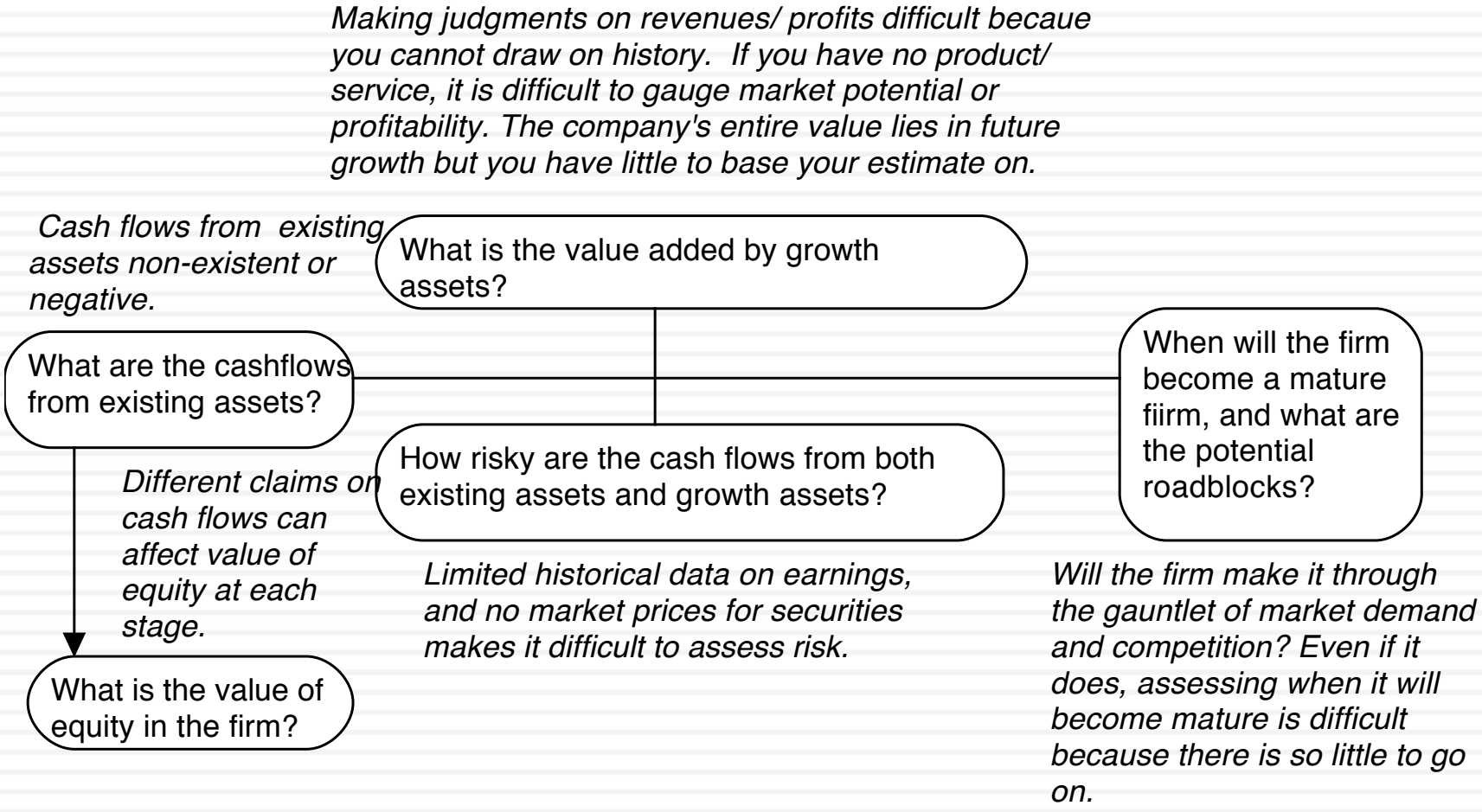
- Valuing stable, money making companies with consistent and clear accounting statements, a long and stable history and lots of comparable firms is easy to do.
- The true test of your valuation skills is when you have to value "difficult" companies. In particular, the challenges are greatest when valuing:
  - Young companies, early in the life cycle, in young businesses
  - Companies that don't fit the accounting mold
  - Companies that face substantial truncation risk (default or nationalization risk)

Difficult to value companies…

- Across the life cycle:
  - Young, growth firms: Limited history, small revenues in conjunction with big operating losses and a propensity for failure make these companies tough to value.
  - Mature companies in transition: When mature companies change or are forced to change, history may have to be abandoned and parameters have to be reestimated.
  - Declining and Distressed firms: A long but irrelevant history, declining markets, high debt loads and the likelihood of distress make them troublesome.
- Across sectors
  - Financial service firms: Opacity of financial statements and difficulties in estimating basic inputs leave us trusting managers to tell us what's going on.
  - Commodity and cyclical firms: Dependence of the underlying commodity prices or overall economic growth make these valuations susceptible to macro factors.
  - Firms with intangible assets: Accounting principles are left to the wayside on these firms.
- Across the ownership cycle
  - Privately owned businesses: Exposure to firm specific risk and illiquidity bedevil valuations.
  - Venture Capital (VC) and private equity: Different equity investors, with different perceptions of risk.
  - Closely held public firms: Part private and part public, sharing the troubles of both.

I. The challenge with young companies…

Figure 5.2: Estimation Issues - Young and Start-up Companies



Upping the ante.. Young companies in young businesses…

- When valuing a business, we generally draw on three sources of information
  - The firm's current financial statement
    - How much did the firm sell?
    - How much did it earn?
  - The firm's financial history, usually summarized in its financial statements.
    - How fast have the firm's revenues and earnings grown over time?
    - What can we learn about cost structure and profitability from these trends?
    - Susceptibility to macro-economic factors (recessions and cyclical firms)
  - The industry and comparable firm data
    - What happens to firms as they mature? (Margins.. Revenue growth… Reinvestment needs… Risk)
- It is when valuing these companies that you find yourself tempted by the dark side, where
  - "Paradigm shifts" happen…
  - New metrics are invented …
  - The story dominates and the numbers lag…

Amazon in January 2000

Current Revenue $ 1,117

Current Margin: -36.71%

EBIT -410m

From previous years

NOL: 500 m

Sales to capital ratio and expected margin are retail industry average numbers

Sales Turnover Ratio: 3.00

Revenue Growth: 42%

Competitive Advantages

Expected Margin: -> 10.00%

Stable Growth

Stable Revenue Growth: 6%

Stable Operating Margin: 10.00%

Stable ROC=20% Reinvest 30% of EBIT(1-t)

Terminal Value= 1881/(.0961-.06) =52,148

Revenue Growth	150.00%	100.00%	75.00%	50.00%	30.00%	25.20%	20.40%	15.60%	10.80%	6.00%
Revenues	$ 2,793	$ 5,585	$ 9,774	$ 14,661	$ 19,059	$ 23,862	$ 28,729	$ 33,211	$ 36,798	$ 39,006
Operating Margin	-13.35%	-1.68%	4.16%	7.08%	8.54%	9.27%	9.64%	9.82%	9.91%	9.95%
EBIT	-$373	-$94	$407	$1,038	$1,628	$2,212	$2,768	$3,261	$3,646	$3,883
EBIT(1-t)	-$373	-$94	$407	$871	$1,058	$1,438	$1,799	$2,119	$2,370	$2,524
- Reinvestment	$600	$967	$1,420	$1,663	$1,543	$1,688	$1,721	$1,619	$1,363	$961
FCFF	-$931	-$1,024	-$989	-$758	-$408	-$163	$177	$625	$1,174	$1,788
	1	2	3	4	5	6	7	8	9	10

Term. Year

6%
$ 41,346
10.00%
$4,135
$2,688
$155
$1,881

Forever

Cost of Equity	12.90%	12.90%	12.90%	12.90%	12.90%	12.42%	11.94%	11.46%	10.98%	10.50%
Cost of Debt	8.00%	8.00%	8.00%	8.00%	8.00%	7.80%	7.75%	7.67%	7.50%	7.00%
After-tax cost of debt	8.00%	8.00%	8.00%	6.71%	5.20%	5.07%	5.04%	4.98%	4.88%	4.55%
Cost of Capital	12.84%	12.84%	12.84%	12.83%	12.81%	12.13%	11.62%	11.08%	10.49%	9.61%

Value of Op Assets	$ 15,170
+ Cash	$ 26
= Value of Firm	$15,196
- Value of Debt	$ 349
= Value of Equity	$14,847
- Equity Options	$ 2,892
Value per share	$ 35.08

All existing options valued as options, using current stock price of $84.

Amazon was trading at $84 in January 2000.

Cost of Equity
12.90%

Used average interest coverage ratio over next 5 years to get BBB rating.

Cost of Debt
6.5%+1.5%=8.0%
Tax rate = 0% -> 35%

Weights
Debt= 1.2% -> 15%

Pushed debt ratio to retail industry average of 15%.

Dot.com retailers for firrst 5 years
Convetional retailers after year 5

Riskfree Rate:
T. Bond rate = 6.5%

+ **Beta**
1.60 -> 1.00

X **Risk Premium**
4%

Internet/ Retail

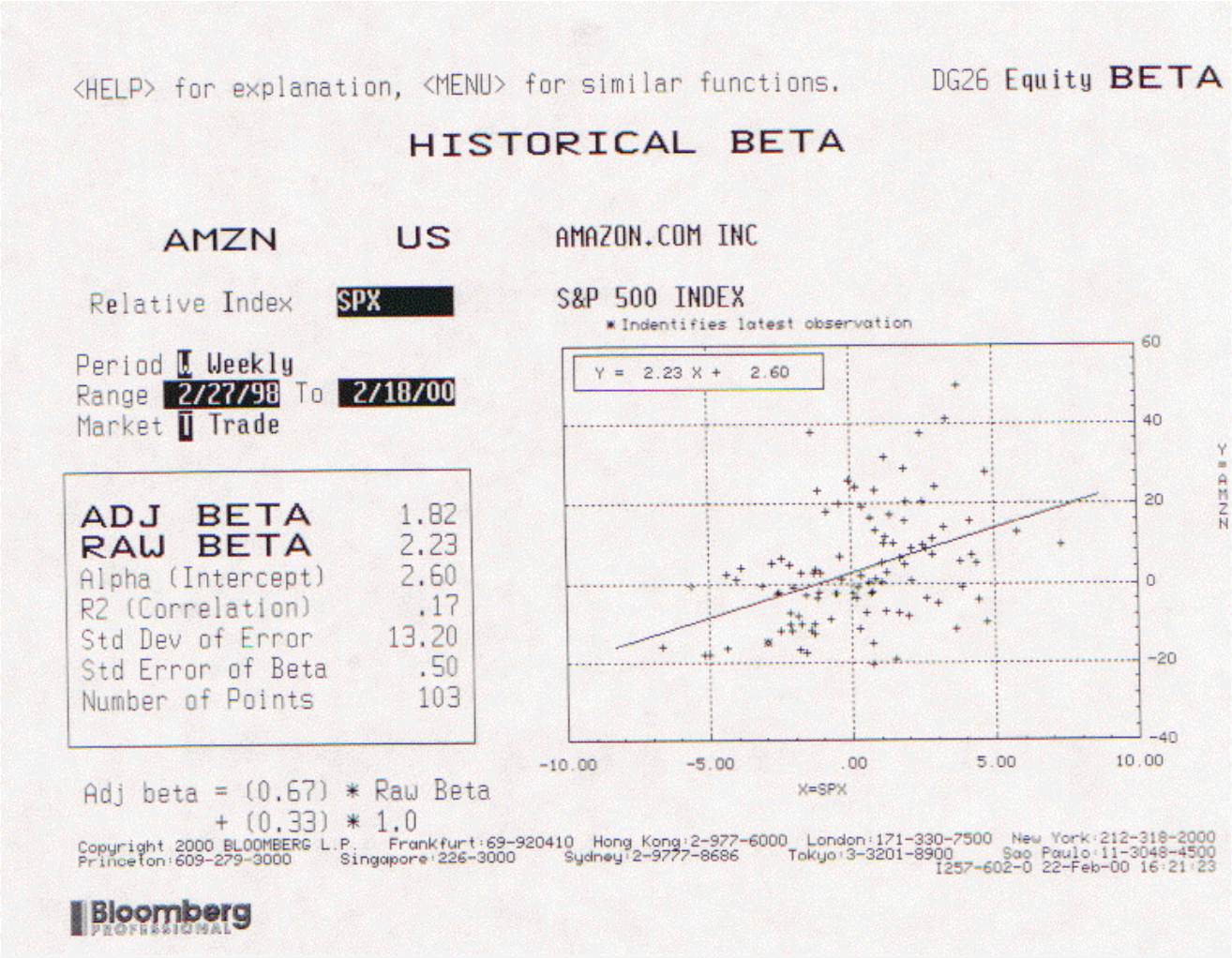
Operating Leverage

Current D/ E: 1.21%

Base Equity Premium

Country Risk Premium

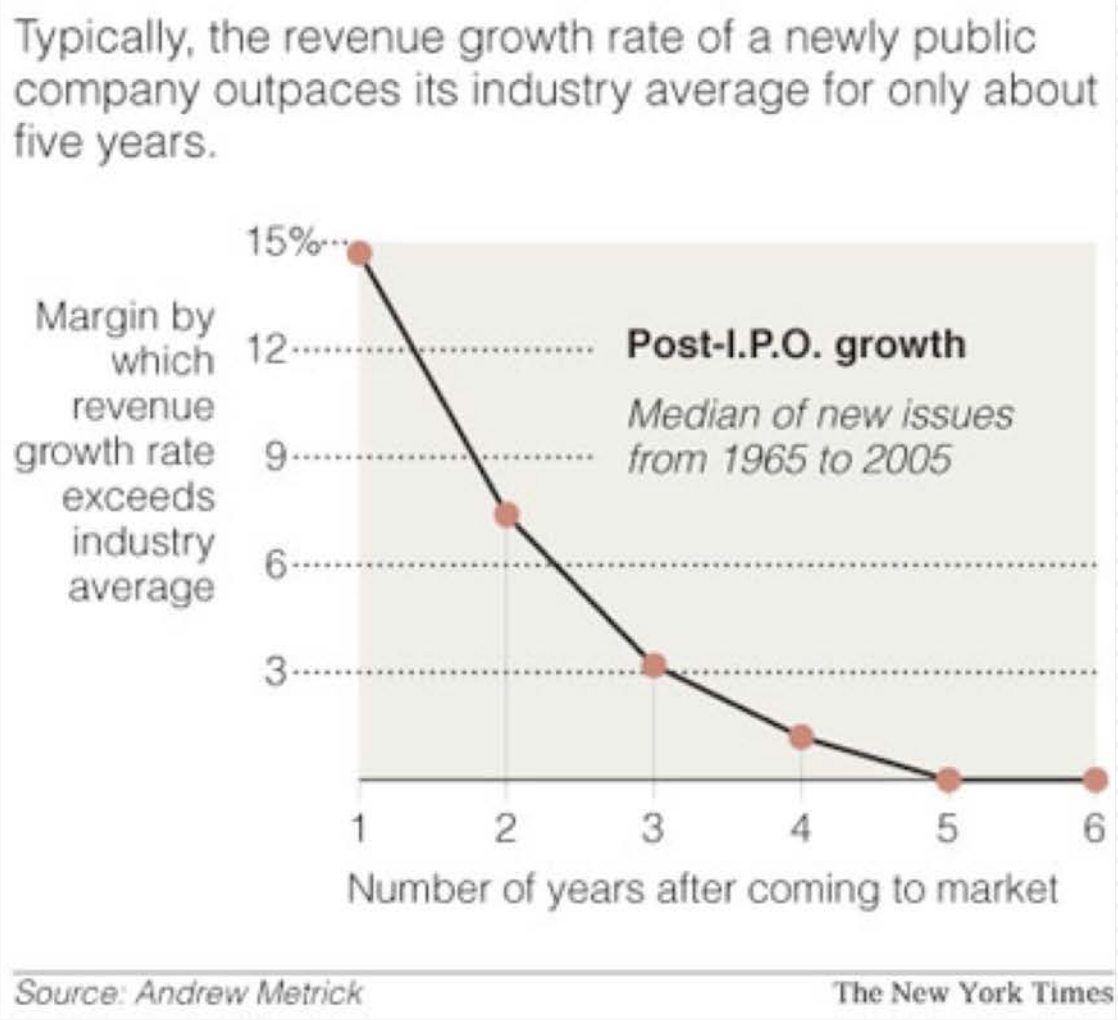
Lesson 1: Don't trust regression betas….



Lesson 2: Work backwards and keep it simple…

Year	Revenue Growth	Sales	Operating Margin	EBIT	EBIT (1-t)
Tr 12 mths		$1,117	-36.71%	-$410	-$410
1	150.00%	$2,793	-13.35%	-$373	-$373
2	100.00%	$5,585	-1.68%	-$94	-$94
3	75.00%	$9,774	4.16%	$407	$407
4	50.00%	$14,661	7.08%	$1,038	$871
5	30.00%	$19,059	8.54%	$1,628	$1,058
6	25.20%	$23,862	9.27%	$2,212	$1,438
7	20.40%	$28,729	9.64%	$2,768	$1,799
8	15.60%	$33,211	9.82%	$3,261	$2,119
9	10.80%	$36,798	9.91%	$3,646	$2,370
10	6.00%	$39,006	9.95%	$3,883	$2,524
TY	6.00%	$41,346	10.00%	$4,135	$2,688

Lesson 3: Scaling up is hard to do…



Lesson 4: Don't forget to pay for growth…

Year	Revenues	Δ Revenue	Sales/Cap	Δ Investment	Invested Capital	EBIT (1-t)	Imputed ROC
Tr 12 mths	$1,117				$ 487	-$410	
1	$2,793	$1,676	3.00	$559	$ 1,045	-$373	-76.62%
2	$5,585	$2,793	3.00	$931	$ 1,976	-$94	-8.96%
3	$9,774	$4,189	3.00	$1,396	$ 3,372	$407	20.59%
4	$14,661	$4,887	3.00	$1,629	$ 5,001	$871	25.82%
5	$19,059	$4,398	3.00	$1,466	$ 6,467	$1,058	21.16%
6	$23,862	$4,803	3.00	$1,601	$ 8,068	$1,438	22.23%
7	$28,729	$4,868	3.00	$1,623	$ 9,691	$1,799	22.30%
8	$33,211	$4,482	3.00	$1,494	$ 11,185	$2,119	21.87%
9	$36,798	$3,587	3.00	$1,196	$ 12,380	$2,370	21.19%
10	$39,006	$2,208	3.00	$736	$ 13,116	$2,524	20.39%
TY	$41,346	$2,340	NA		Assumed to be =		20.00%

Lesson 5: There are always scenarios where the market price can be justified…

Compounded annual Revenue Growth rate	Target pre-tax Operating Margin				
	6%	8%	10%	12%	14%
30%	$ (1.94)	$ 2.95	$ 7.84	$ 12.71	$ 17.57
35%	$ 1.41	$ 8.37	$ 15.33	$ 22.27	$ 29.21
40%	$ 6.10	$ 15.93	$ 25.74	$ 35.54	$ 45.34
45%	$ 12.59	$ 26.34	$ 40.05	$ 53.77	$ 67.48
50%	$ 21.47	$ 40.50	$ 59.52	$ 78.53	$ 97.54
55%	$ 33.47	$ 59.60	$ 85.72	$ 111.84	$ 137.95
60%	$ 49.53	$ 85.10	$ 120.66	$ 156.22	$ 191.77

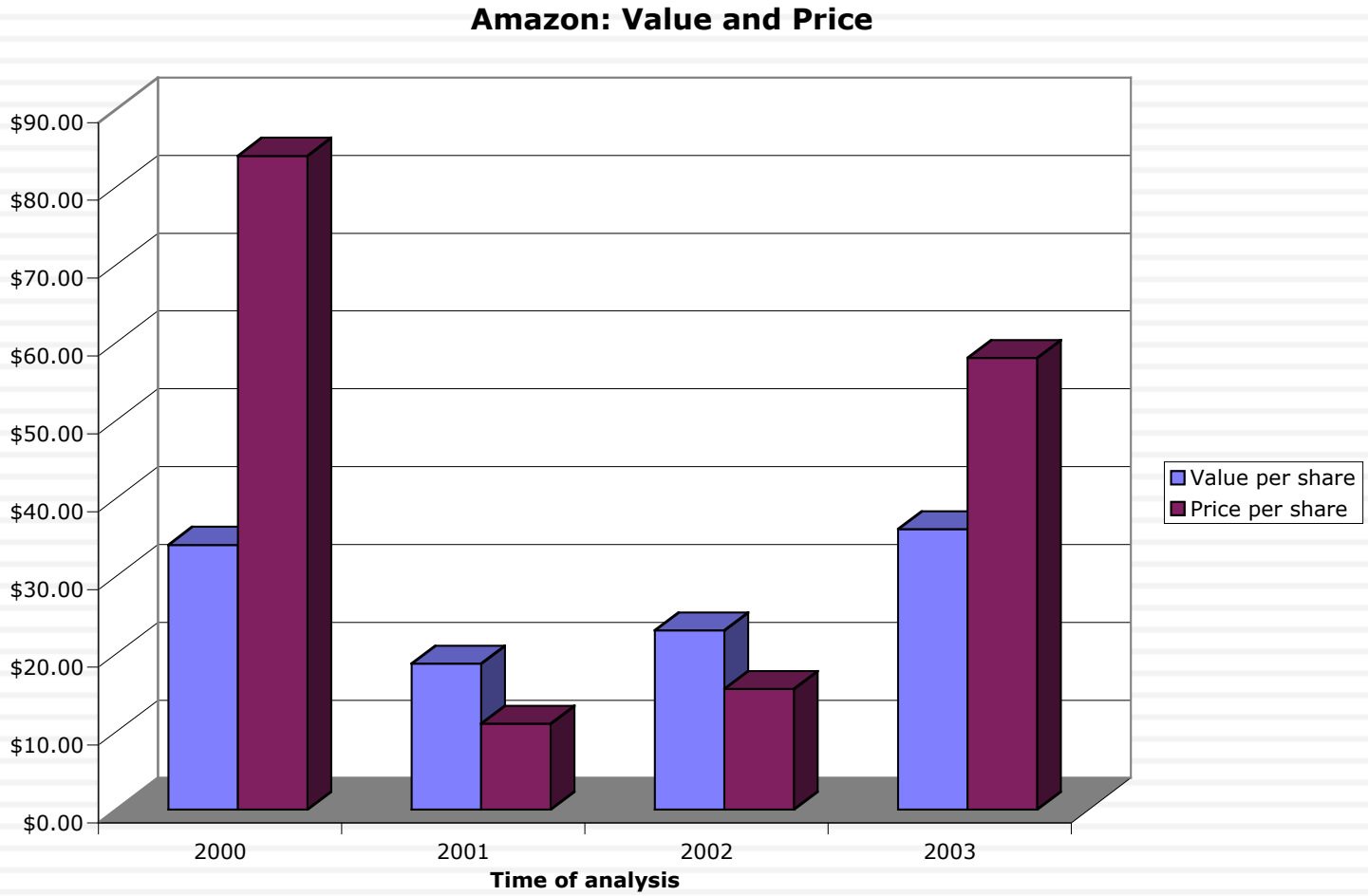
Lesson 6: Don't forget to mop up…

- Watch out for "other" equity claims: If you buy equity in a young, growth company, watch out for other (often hidden) claims on the equity that don't take the form of common shares. In particular, watch for options granted to managers, employees, venture capitalists and others (you will be surprised…).
  - Value these options as options (not at exercise value)
  - Take into consideration expectations of future option grants when computing expected future earnings/cash flows.
- Not all shares are equal: If there are differences in cash flow claims (dividends or liquidation) or voting rights across shares, value these differences.
  - Voting rights matter even at well run companies

Lesson 7: You will be wrong 100% of the time… and it really is not (always) your fault…

- No matter how careful you are in getting your inputs and how well structured your model is, your estimate of value will change both as new information comes out about the company, the business and the economy.
- As information comes out, you will have to adjust and adapt your model to reflect the information. Rather than be defensive about the resulting changes in value, recognize that this is the essence of risk.
- A test: If your valuations are unbiased, you should find yourself increasing estimated values as often as you are decreasing values. In other words, there should be equal doses of good and bad news affecting valuations (at least over time).

And the market is often "more wrong"….



Valuing an IPO

- Valuation issues:
  - Use of the proceeds from the offering: The proceeds from the offering can be held as cash by the firm to cover future investment needs, paid to existing equity investors who want to cash out or used to pay down debt.
  - Warrants/ Special deals with prior equity investors: If venture capitalists and other equity investors from earlier iterations of fund raising have rights to buy or sell their equity at pre-specified prices, it can affect the value per share offered to the public.
- Pricing issues:
  - Institutional set-up: Most IPOs are backed by investment banking guarantees on the price, which can affect how they are priced.
  - Follow-up offerings: The proportion of equity being offered at initial offering and subsequent offering plans can affect pricing.

Alibaba: Pre-IPO valuation - September 2, 2014 (in US $)

	T12M	2012-13
Revenues	$9,268	$4,821
Operating Income	$4,702	$1,777
Effective tax rate	11.92%	
Operating Margin	50.73%	

Revenue growth of **25%** a year for 5 years, tapering down to 2.63% in year 10

Pre-tax operating margin decreases to 40% over time & tax rate rises to 25%

Sales to capital ratio maintained at 2.00

Stable Growth
g = 2.41%
Cost of capital = 8%
ROC= 8%;
Reinvestment Rate= 2.41%/8% = 30.125%

Terminal Value$_{10}$= 10,353/(.08-0241) = $185,198

	1	2	3	4	5	6	7	8	9	10
Revenue growth rate	25.00%	25.00%	25.00%	25.00%	25.00%	20.48%	15.96%	11.45%	6.93%	2.41%
Revenues	$ 11,585	$ 14,481	$ 18,101	$ 22,626	$ 28,283	$ 34,075	$ 39,515	$ 44,038	$ 47,089	$ 48,224
EBIT (Operating) margi	49.66%	48.59%	47.51%	46.44%	45.37%	44.29%	43.22%	42.15%	41.07%	40.00%
EBIT (Operating incom	$ 5,753	$ 7,035	$ 8,600	$ 10,507	$ 12,831	$ 15,093	$ 17,078	$ 18,560	$ 19,341	$ 19,290
Tax rate	11.92%	11.92%	11.92%	11.92%	11.92%	14.54%	17.15%	19.77%	22.38%	25.00%
EBIT(1-t)	$ 5,067	$ 6,197	$ 7,575	$ 9,255	$ 11,301	$ 12,899	$ 14,149	$ 14,891	$ 15,012	$ 14,467
- Reinvestment	$ 1,158	$ 1,448	$ 1,810	$ 2,263	$ 2,828	$ 2,896	$ 2,720	$ 2,261	$ 1,525	$ 567
FCFF	$ 3,908	$ 4,749	$ 5,765	$ 6,992	$ 8,473	$ 10,002	$ 11,429	$ 12,630	$ 13,486	$ 13,900

Term yr
EBIT (1-t) $14,816
- Reinv 4,463
FCFF 10,353

Operating assets	$137,386
+ Cash	9330
- Debt	10068
+ Equity investments	2,087
+ Alipay provision	3,000
+ IPO Proceeds (est)	20,000
- Options	696
Value of equity	161,039
Value per share	$65.98

Cost of capital = 8.90% (.943) + 3.00% (.057) = 8.56%

Cost of capital decreases to 8% from years 6-10

Cost of Equity
8.90%

Cost of Debt
4% (1-.25) = 3.00%

Weights
E = 94.3% D = 5.7%

Riskfree Rate:
Riskfree rate = 2.41%

+

Beta
1.092

Unlevered Beta: 1.044 (70% advertising, 30% online retailing)

D/E = 6.07%

X

ERP
5.94%

China	90.29%	5.90%
Global	9.71%	6.35%
Alibaba	100.00%	5.94%

Two days after this valuation, the company (and its bankers) valued itself at about $155 billion and the shares at $63 apiece. The offering price was raised to $69 and the opening price was $93/share.

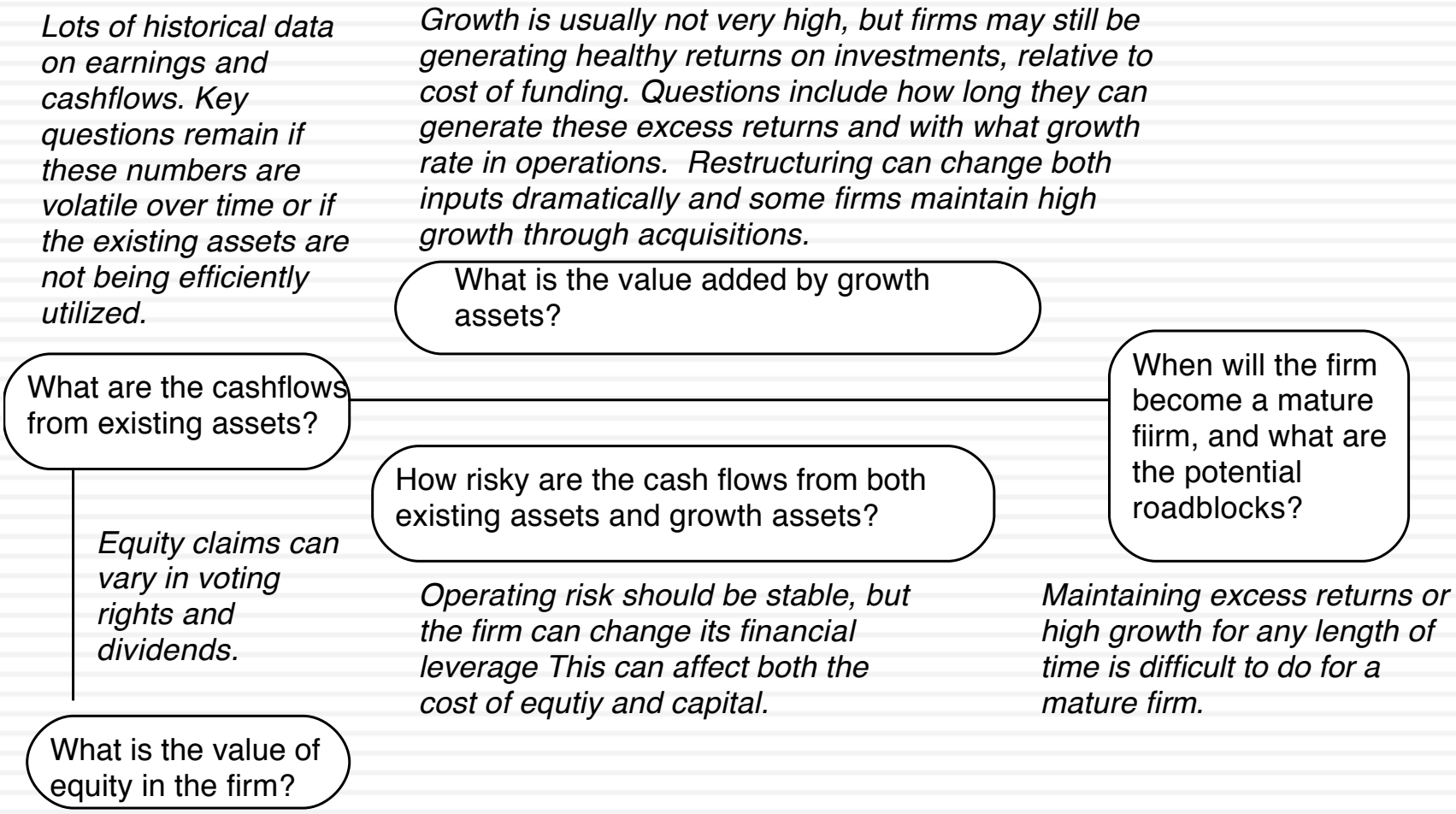
Aswath Damodaran

II. Mature Companies in transition..

- Mature companies are generally the easiest group to value. They have long, established histories that can be mined for inputs. They have investment policies that are set and capital structures that are stable, thus making valuation more grounded in past data.
- However, this stability in the numbers can mask real problems at the company. The company may be set in a process, where it invests more or less than it should and does not have the right financing mix. In effect, the policies are consistent, stable and bad.
- If you expect these companies to change or as is more often the case to have change thrust upon them,

The perils of valuing mature companies…

Figure 7.1: Estimation Issues - Mature Companies



Hormel Foods: The Value of Control Changing

Hormel Foods sells packaged meat and other food products and has been in existence as a publicly traded company for almost 80 years. In 2008, the firm reported after-tax operating income of $315 million, reflecting a compounded growth of 5% over the previous 5 years.

The Status Quo

Run by existing management, with conservative reinvestment policies (reinvestment rate = 14.34% and debt ratio = 10.4%.

Anemic growth rate and short growth period, due to reinvestment policy

Low debt ratio affects cost of capital

Year	Operating income after taxes	Expected growth rate	ROC	Reinvestment Rate	Reinvestment	FCFF	Cost of capital	Present Value
Trailing 12 months	$315							
1	$324	2.75%	14.34%	19.14%	$62	$262	6.79%	$245
2	$333	2.75%	14.34%	19.14%	$64	$269	6.79%	$236
3	$342	2.75%	14.34%	19.14%	$65	$276	6.79%	$227
Beyond	$350	2.35%	7.23%	32.52%	$114	$4,840	7.23%	$3,974
Value of operating assets								$4,682
(Add) Cash								$155
(Subtract) Debt								$491
(Subtract) Management Options								$53
Value of equity in common stock								$4,293
Value per share								$31.91

New and better management

More aggressive reinvestment which increases the reinvestment rate (to 40%) and tlength of growth (to 5 years), and higher debt ratio (20%).

Operating Restructuring (1)

Expected growth rate = ROC * Reinvestment Rate
Expected growth rae (status quo) = 14.34% * 19.14% = 2.75%
Expected growth rate (optimal) = 14.00% * 40% = 5.60%
ROC drops, reinvestment rises and growth goes up.

Financial restructuring (2)

Cost of capital = Cost of equity (1-Debt ratio) + Cost of debt (Debt ratio)
Status quo = 7.33% (1-.104) + 3.60% (1-.40) (.104) = 6.79%
Optimal = 7.75% (1-.20) + 3.60% (1-.40) (.20) = 6.63%
Cost of equity rises but cost of capital drops.

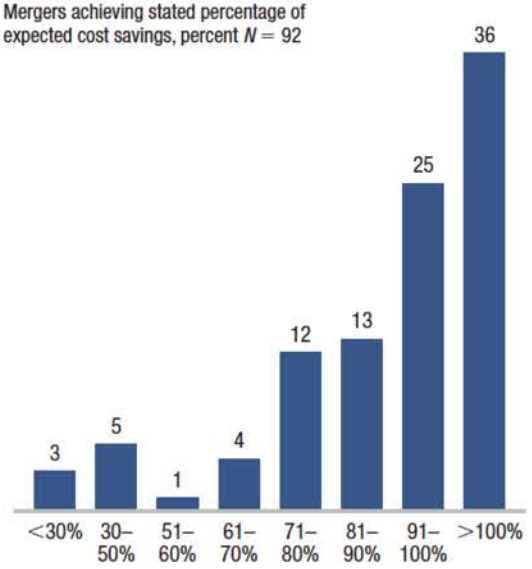
Year	Operating income after taxes	Expected growth rate	ROC	Reinvestment Rate	Reinvestment	FCFF	Cost of capital	Present Value
Trailing 12 months	$315							
1	$333	5.60%	14.00%	40.00%	$133	$200	6.63%	$187
2	$351	5.60%	14.00%	40.00%	$141	$211	6.63%	$185
3	$371	5.60%	14.00%	40.00%	$148	$223	6.63%	$184
4	$392	5.60%	14.00%	40.00%	$260	$235	6.63%	$182
5	$414	5.60%	14.00%	40.00%	$223	$248	6.63%	$180
Beyond	$423	2.35%	6.74%	34.87%	$148	$6,282	6.74%	$4,557
Value of operating assets								$5,475
(Add) Cash								$155
(Subtract) Debt								$491
(Subtract) Management Options								$53
Value of equity in common stock								$5,085
Value per share								$37.80

Probability of management change = 10% (3)
Expected value =$31.91 (.90) + $37.80 (.10) = $32.50 (4)

Lesson 1: Cost cutting and increased efficiency are easier accomplished on paper than in practice…

Cost-synergy estimation is better, but there are patterns emerging in the errors

Mergers achieving stated percentage of expected cost savings, percent $N = 92$



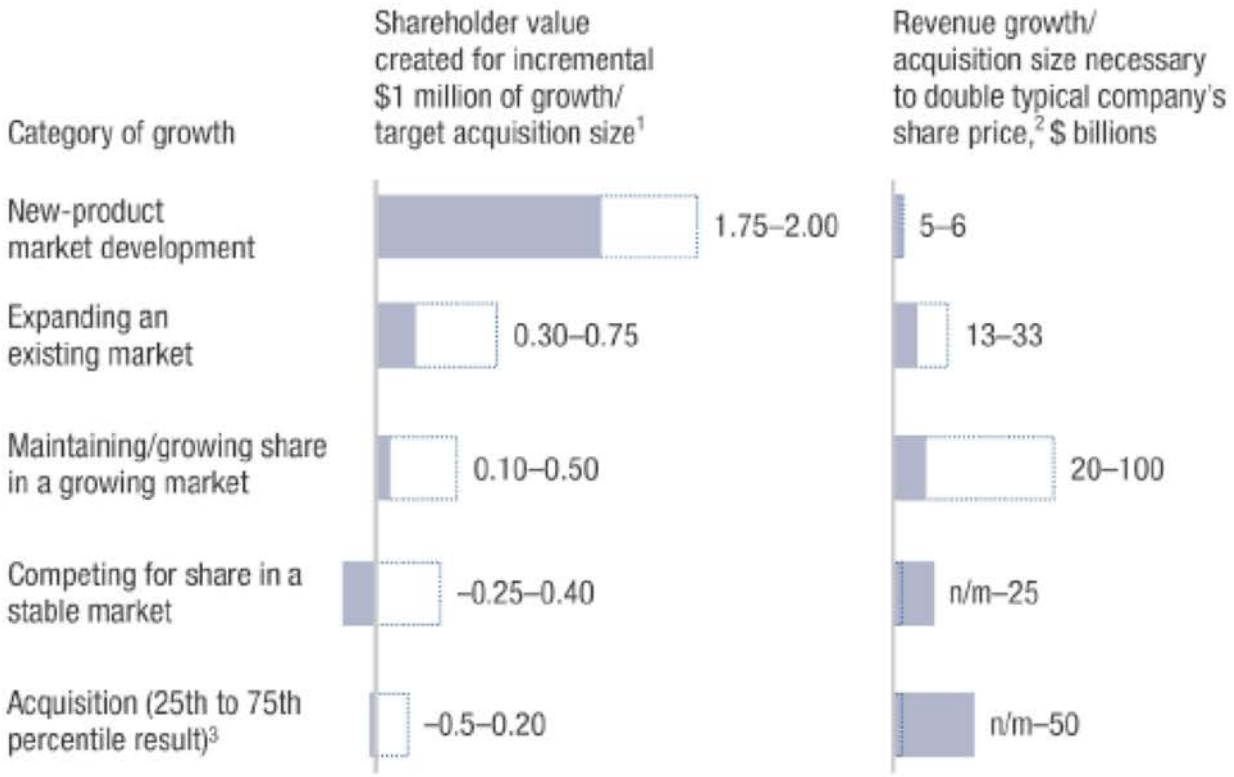
Typical sources of estimation error

- Underestimating one-time costs
- Using benchmarks from noncomparable situations
- Not sanity-checking management estimates against precedent transactions
- Failing to ground estimates in bottom-up analysis (e.g., location-by-location review of overlaps

Source: McKinsey (2002) Postmerger Management Practice client survey; client case studies

Lesson 2: Increasing growth is not always an option (or at least not a good option)

Modes of organic growth vary in value creation intensity—consumer goods industry



Lesson 3: Financial leverage is a double-edged sword..

Exhibit 7.1: Optimal Financing Mix: Hormel Foods in January 2009

As debt ratio increases, equity becomes riskier.(higher beta) and cost of equity goes up. (1)

As firm borrows more money, its ratings drop and cost of debt rises (2)

Debt Ratio	Beta	Cost of Equity	Bond Rating	Interest rate on debt	Tax Rate	Cost of Debt (after-tax)	WACC	Firm Value (G)
0%	0.78	7.00%	AAA	3.60%	40.00%	2.16%	7.00%	$4,523
10%	0.83	7.31%	AAA	3.60%	40.00%	2.16%	6.80%	$4,665
10.39%	**0.83**	**7.33%**	**AAA**	**3.60%**	**40.00%**	**2.16%**	**6.79%**	**$4,680**
20%	0.89	7.70%	AAA	3.60%	40.00%	2.16%	6.59%	$4,815
30%	0.97	8.20%	A+	4.60%	40.00%	2.76%	6.57%	$4,834
40%	1.09	8.86%	A-	5.35%	40.00%	3.21%	6.60%	$4,808
50%	1.24	9.79%	B+	8.35%	40.00%	5.01%	7.40%	$4,271
60%	1.47	11.19%	B-	10.85%	40.00%	6.51%	8.38%	$3,757
70%	1.86	13.52%	CCC	12.35%	40.00%	7.41%	9.24%	$3,398
80%	2.70	18.53%	CC	14.35%	38.07%	8.89%	10.81%	$2,892
90%	5.39	34.70%	CC	14.35%	33.84%	9.49%	12.01%	$2,597

Current Cost of Capital

Optimal: Cost of capital lowest between 20 and 30%.

Debt ratio is percent of overall market value of firm that comes from debt financing.

At debt ratios > 80%, firm does not have enough operating income to cover interest expenses. Tax rate goes down to reflect lost tax benefits. (3)

As cost of capital drops, firm value rises (as operating cash flows remain unchanged)

III. Dealing with decline and distress…

Historial data often reflects flat or declining revenues and falling margins. Investments often earn less than the cost of capital.

Growth can be negative, as firm sheds assets and shrinks. As less profitable assets are shed, the firm's remaining assets may improve in quality.

What is the value added by growth assets?

What are the cashflows from existing assets?

When will the firm become a mature fiirm, and what are the potential roadblocks?

How risky are the cash flows from both existing assets and growth assets?

Underfunded pension obligations and litigation claims can lower value of equity. Liquidation preferences can affect value of equity

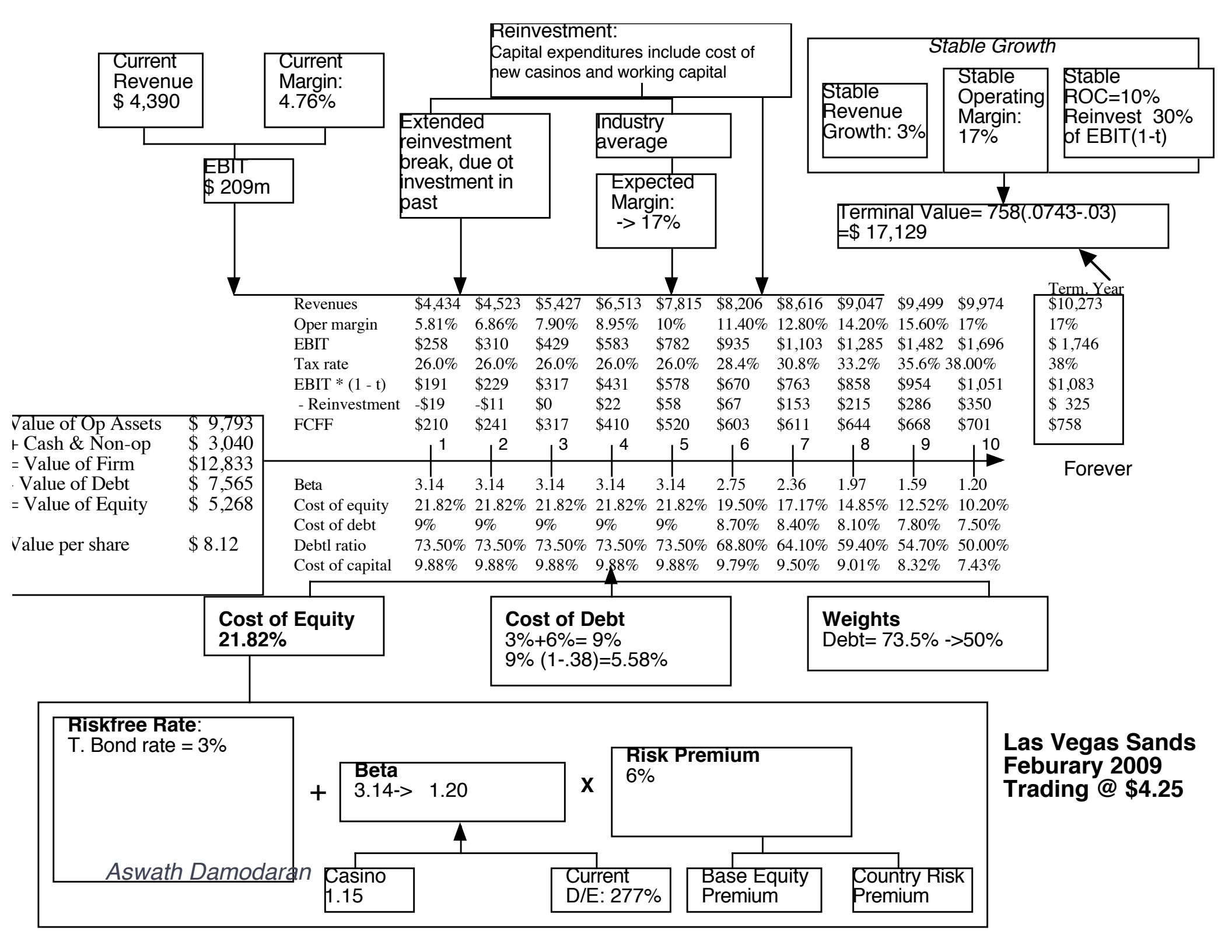
What is the value of equity in the firm?

Depending upon the risk of the assets being divested and the use of the proceeds from the divestuture (to pay dividends or retire debt), the risk in both the firm and its equity can change.

There is a real chance, especially with high financial leverage, that the firm will not make it. If it is expected to survive as a going concern, it will be as a much smaller entity.

Dealing with the "downside" of Distress

- A DCF valuation values a firm as a going concern. If there is a significant likelihood of the firm failing before it reaches stable growth and if the assets will then be sold for a value less than the present value of the expected cashflows (a distress sale value), DCF valuations will understate the value of the firm.
- Value of Equity= DCF value of equity (1 - Probability of distress) + Distress sale value of equity (Probability of distress)
- There are three ways in which we can estimate the probability of distress:
  - Use the bond rating to estimate the cumulative probability of distress over 10 years
  - Estimate the probability of distress with a probit
  - Estimate the probability of distress by looking at market value of bonds..
- The distress sale value of equity is usually best estimated as a percent of book value (and this value will be lower if the economy is doing badly and there are other firms in the same business also in distress).


Current Revenue $ 4,390
Current Margin: 4.76%
EBIT $ 209m
Reinvestment: Capital expenditures include cost of new casinos and working capital
Extended reinvestment break, due ot investment in past
Industry average
Expected Margin: -> 17%
Stable Growth
Stable Revenue Growth: 3%
Stable Operating Margin: 17%
Stable ROC=10% Reinvest 30% of EBIT(1-t)
Terminal Value= 758(.0743-.03) =$ 17,129
Term. Year
Revenues $4,434 $4,523 $5,427 $6,513 $7,815 $8,206 $8,616 $9,047 $9,499 $9,974 $10,273
Oper margin 5.81% 6.86% 7.90% 8.95% 10% 11.40% 12.80% 14.20% 15.60% 17% 17%
EBIT $258 $310 $429 $583 $782 $935 $1,103 $1,285 $1,482 $1,696 $ 1,746
Tax rate 26.0% 26.0% 26.0% 26.0% 26.0% 28.4% 30.8% 33.2% 35.6% 38.00% 38%
EBIT * (1 - t) $191 $229 $317 $431 $578 $670 $763 $858 $954 $1,051 $1,083
- Reinvestment -$19 -$11 $0 $22 $58 $67 $153 $215 $286 $350 $ 325
FCFF $210 $241 $317 $410 $520 $603 $611 $644 $668 $701 $758
1 2 3 4 5 6 7 8 9 10
Forever
Value of Op Assets $ 9,793
+ Cash & Non-op $ 3,040
= Value of Firm $12,833
- Value of Debt $ 7,565
= Value of Equity $ 5,268
Value per share $ 8.12
Beta 3.14 3.14 3.14 3.14 3.14 2.75 2.36 1.97 1.59 1.20
Cost of equity 21.82% 21.82% 21.82% 21.82% 21.82% 19.50% 17.17% 14.85% 12.52% 10.20%
Cost of debt 9% 9% 9% 9% 9% 8.70% 8.40% 8.10% 7.80% 7.50%
Debtl ratio 73.50% 73.50% 73.50% 73.50% 73.50% 68.80% 64.10% 59.40% 54.70% 50.00%
Cost of capital 9.88% 9.88% 9.88% 9.88% 9.88% 9.79% 9.50% 9.01% 8.32% 7.43%
Cost of Equity 21.82%
Cost of Debt 3%+6%= 9% 9% (1-.38)=5.58%
Weights Debt= 73.5% ->50%
Riskfree Rate: T. Bond rate = 3%
+
Beta 3.14-> 1.20
X
Risk Premium 6%
Casino 1.15
Current D/E: 277%
Base Equity Premium
Country Risk Premium
Aswath Damodaran
Las Vegas Sands
Feburary 2009
Trading @ $4.25

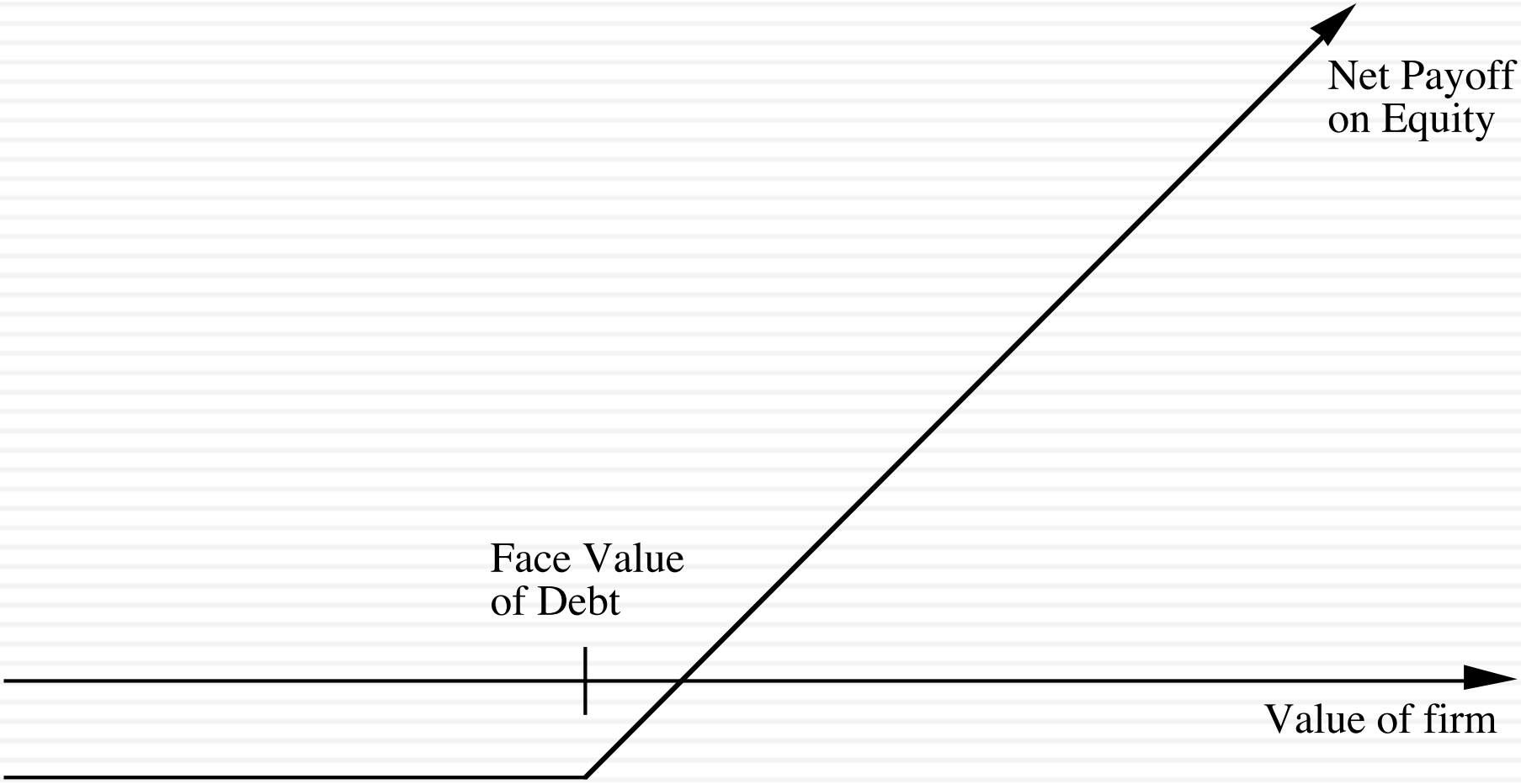
Adjusting the value of LVS for distress..

- In February 2009, LVS was rated B+ by S&P. Historically, 28.25% of B+ rated bonds default within 10 years. LVS has a 6.375% bond, maturing in February 2015 (7 years), trading at $529. If we discount the expected cash flows on the bond at the riskfree rate, we can back out the probability of distress from the bond price:

$$529 = \sum_{t=1}^{t=7} \frac{63.75(1-\Pi_{Distress})^t}{(1.03)^t} + \frac{1000(1-\Pi_{Distress})^7}{(1.03)^7}$$

- Solving for the probability of bankruptcy, we get:
- $\pi_{Distress}$ = Annual probability of default = 13.54%
  - Cumulative probability of surviving 10 years = (1 - .1354)10 = 23.34%
  - Cumulative probability of distress over 10 years = 1 - .2334 = .7666 or 76.66%
- If LVS is becomes distressed:
  - Expected distress sale proceeds = $2,769 million < Face value of debt
  - Expected equity value/share = $0.00
- Expected value per share = $8.12 (1 - .7666) + $0.00 (.7666) = $1.92

The “sunny” side of distress: Equity as a call option to liquidate the firm



Application to valuation: A simple example

- Assume that you have a firm whose assets are currently valued at $100 million and that the standard deviation in this asset value is 40%.
- Further, assume that the face value of debt is $80 million (It is zero coupon debt with 10 years left to maturity).
- If the ten-year treasury bond rate is 10%,
  - how much is the equity worth?
  - What should the interest rate on debt be?

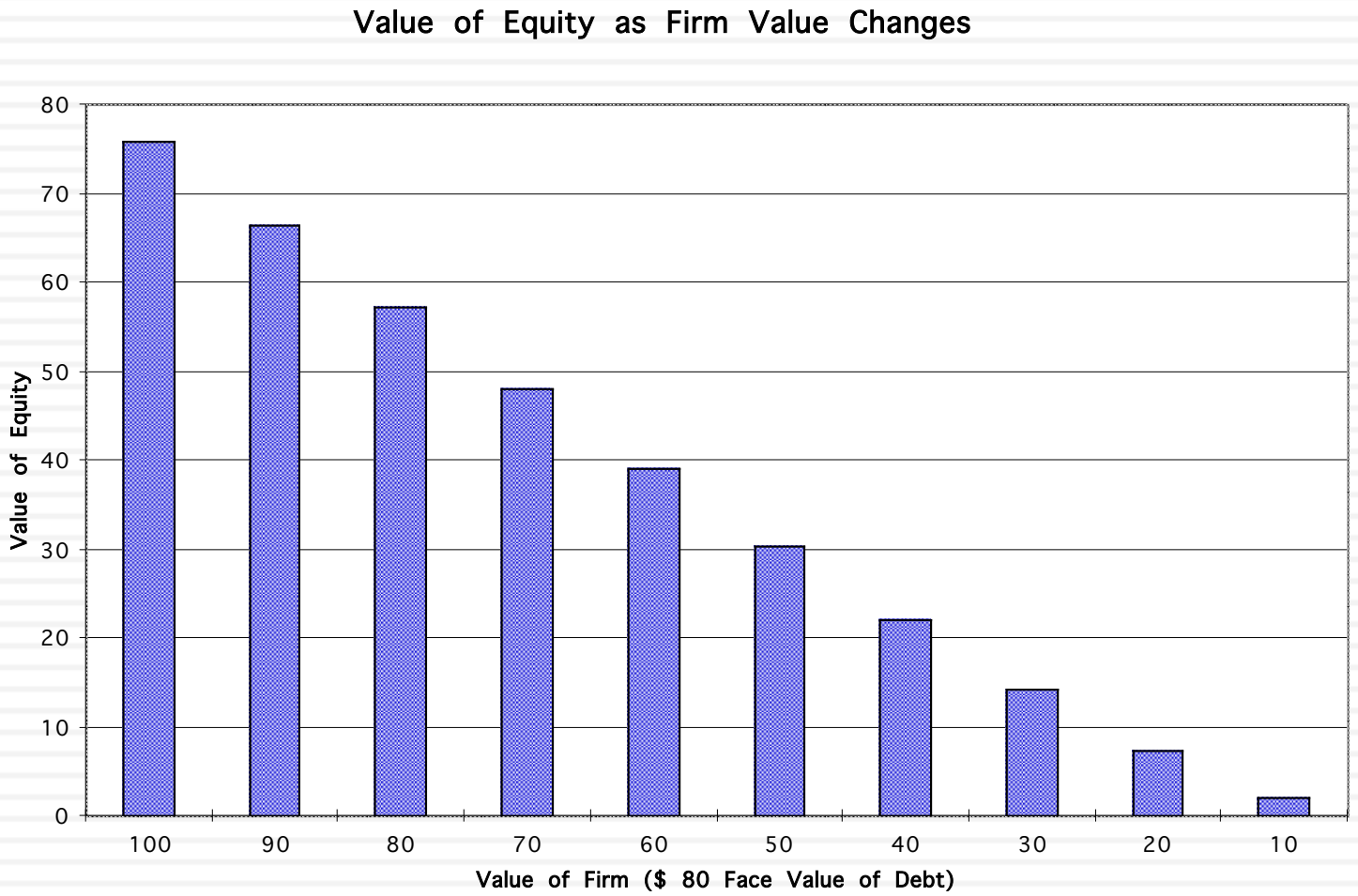
Model Parameters & Valuation

- The inputs
  - Value of the underlying asset = S = Value of the firm = $ 100 million
  - Exercise price = K = Face Value of outstanding debt = $ 80 million
  - Life of the option = t = Life of zero-coupon debt = 10 years
  - Variance in the value of the underlying asset = σ^2 = Variance in firm value = 0.16
  - Riskless rate = r = Treasury bond rate corresponding to option life = 10%
- The output
  - The Black-Scholes model provides the following value for the call:
    - d1 = 1.5994 N(d1) = 0.9451
    - d2 = 0.3345 N(d2) = 0.6310
  - Value of the call = 100 (0.9451) - 80 $\exp^{(-0.10)(10)}$ (0.6310) = $75.94 million
  - Value of the outstanding debt = $100 - $75.94 = $24.06 million
  - Interest rate on debt = ($ 80 / $24.06)$^{1/10}$ -1 = 12.77%

Firm value drops..

- Assume now that a catastrophe wipes out half the value of this firm (the value drops to $ 50 million), while the face value of the debt remains at $ 80 million.
- The inputs
  - Value of the underlying asset = S = Value of the firm = $ 50 million
  - All the other inputs remain unchanged
- The output
  - Based upon these inputs, the Black-Scholes model provides the following value for the call:
    - d1 = 1.0515 N(d1) = 0.8534
    - d2 = -0.2135 N(d2) = 0.4155
  - Value of the call = 50 (0.8534) - 80 $\exp^{(-0.10)(10)}$ (0.4155) = $30.44 million
  - Value of the bond= $50 - $30.44 = $19.56 million

Equity value persists .. As firm value declines..



IV. Valuing Financial Service Companies

Existing assets are usually financial assets or loans, often marked to market. Earnings do not provide much information on underlying risk.

Defining capital expenditures and working capital is a challenge.Growth can be strongly influenced by regulatory limits and constraints. Both the amount of new investments and the returns on these investments can change with regulatory changes.

What is the value added by growth assets?

What are the cashflows from existing assets?

When will the firm become a mature fiirm, and what are the potential roadblocks?

How risky are the cash flows from both existing assets and growth assets?

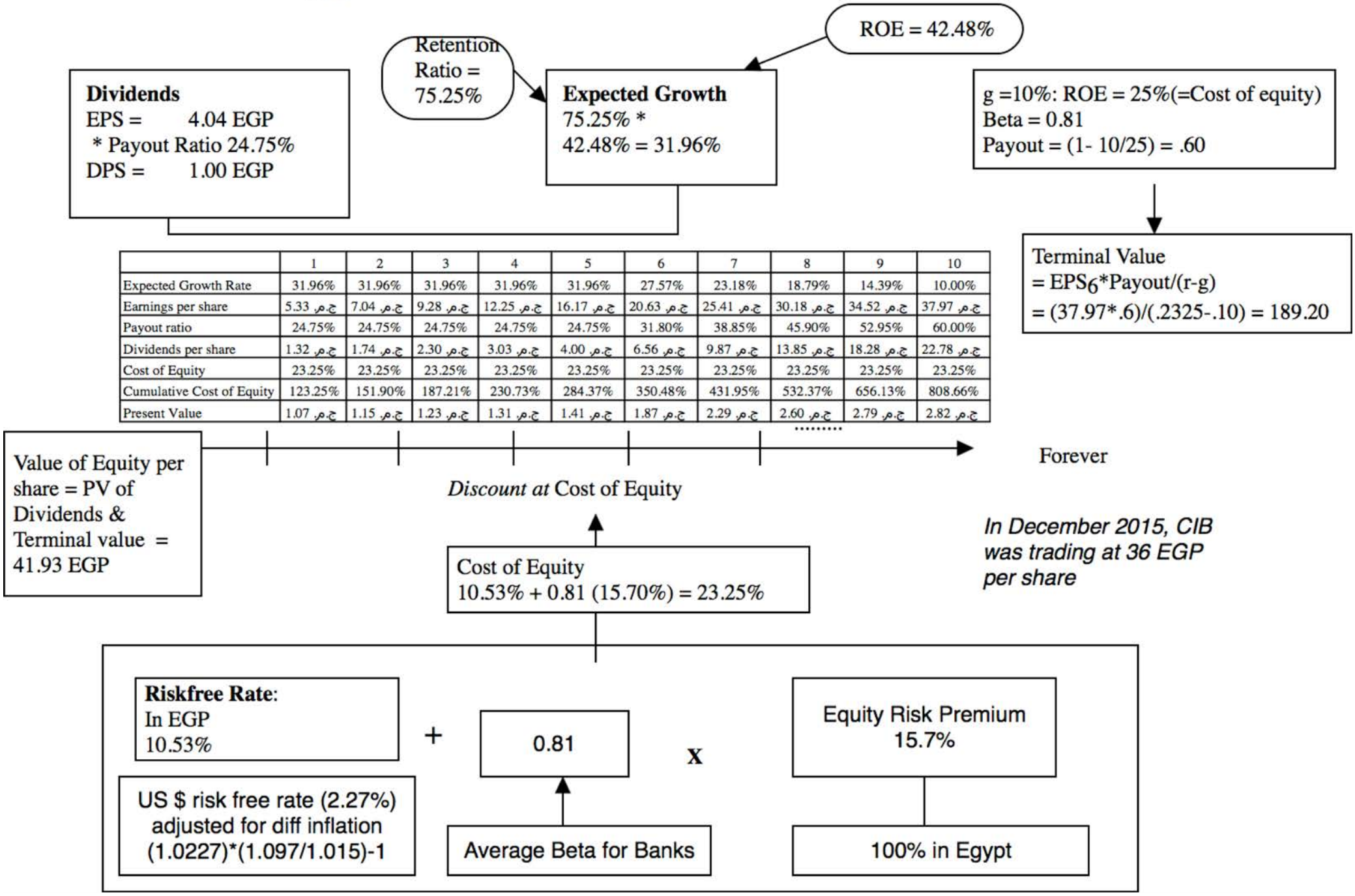
Preferred stock is a significant source of capital.

What is the value of equity in the firm?

For financial service firms, debt is raw material rather than a source of capital. It is not only tough to define but if defined broadly can result in high financial leverage, magnifying the impact of small operating risk changes on equity risk.

In addition to all the normal constraints, financial service firms also have to worry about maintaining capital ratios that are acceptable ot regulators. If they do not, they can be taken over and shut down.

CIB Egypt in December 2015
Valuation in Egyptian Pounds



	1	2	3	4	5	6	7	8	9	10
Expected Growth Rate	31.96%	31.96%	31.96%	31.96%	31.96%	27.57%	23.18%	18.79%	14.39%	10.00%
Earnings per share	5.33 ج.م	7.04 ج.م	9.28 ج.م	12.25 ج.م	16.17 ج.م	20.63 ج.م	25.41 ج.م	30.18 ج.م	34.52 ج.م	37.97 ج.م
Payout ratio	24.75%	24.75%	24.75%	24.75%	24.75%	31.80%	38.85%	45.90%	52.95%	60.00%
Dividends per share	1.32 ج.م	1.74 ج.م	2.30 ج.م	3.03 ج.م	4.00 ج.م	6.56 ج.م	9.87 ج.م	13.85 ج.م	18.28 ج.م	22.78 ج.م
Cost of Equity	23.25%	23.25%	23.25%	23.25%	23.25%	23.25%	23.25%	23.25%	23.25%	23.25%
Cumulative Cost of Equity	123.25%	151.90%	187.21%	230.73%	284.37%	350.48%	431.95%	532.37%	656.13%	808.66%
Present Value	1.07 ج.م	1.15 ج.م	1.23 ج.م	1.31 ج.م	1.41 ج.م	1.87 ج.م	2.29 ج.م	2.60 ج.م	2.79 ج.م	2.82 ج.م

Lesson 1: Financial service companies are opaque…

- With financial service firms, we enter into a Faustian bargain. They tell us very little about the quality of their assets (loans, for a bank, for instance are not broken down by default risk status) but we accept that in return for assets being marked to market (by accountants who presumably have access to the information that we don't have).
- In addition, estimating cash flows for a financial service firm is difficult to do. So, we trust financial service firms to pay out their cash flows as dividends. Hence, the use of the dividend discount model.

Lesson 2: For financial service companies, book value matters…

- The book value of assets and equity is mostly irrelevant when valuing non-financial service companies. After all, the book value of equity is a historical figure and can be nonsensical. (The book value of equity can be negative and is so for more than a 1000 publicly traded US companies)
- With financial service firms, book value of equity is relevant for two reasons:
  - Since financial service firms mark to market, the book value is more likely to reflect what the firms own right now (rather than a historical value)
  - The regulatory capital ratios are based on book equity. Thus, a bank with negative or even low book equity will be shut down by the regulators.
- From a valuation perspective, it therefore makes sense to pay heed to book value. In fact, you can argue that reinvestment for a bank is the amount that it needs to add to book equity to sustain its growth ambitions and safety requirements:
  - FCFE = Net Income – Reinvestment in regulatory capital (book equity)

Deutsche Bank: A Crisis Valuation (October 2016)

Risk adjusted assets grows at inflation rate of 1% a year forever.

Tier 1 capital ratio increases to 15.67%, the 75th percentile for all banks

Expected DOJ fine of $10 billions lower Tier 1 capital today

Common Equity increases in tandem with Tier 1 capital

Cost of equity starts at 10.2% (75th percentile of banks) & decreases after year 5 to 9.44% (median across banks).

	Current	1	2	3	4	5	6	7	8	9	10
Risk Adjusted Assets	$ 445,570	$ 450,026	$ 454,526	$ 459,071	$ 463,662	$ 468,299	$ 472,982	$ 477,711	$ 482,488	$ 487,313	$ 492,186
Tier 1 Capital Ratio	12.41%	13.74%	13.95%	14.17%	14.38%	14.60%	14.81%	15.03%	15.24%	15.46%	15.67%
Tier 1 Capital (Risk Adjusted Assets * T	$55,282	$61,834	$63,427	$65,045	$66,690	$68,361	$70,059	$71,784	$73,537	$75,317	$77,126
Change in regulatory capital (Tier 1)		$6,552	$1,593	$1,619	$1,645	$1,671	$1,698	$1,725	$1,753	$1,780	$1,809
Book Equity	$64,609	$71,161	$72,754	$74,372	$76,017	$77,688	$79,386	$81,111	$82,864	$84,644	$86,453
Expected ROE	-13.70%	-7.18%	-2.84%	0.06%	1.99%	5.85%	6.568%	7.286%	8.004%	8.722%	9.440%
Net Income (Book Equity * ROE)	$ (8,851)	$ (5,111)	$ (2,065)	$ 43	$ 1,512	$ 4,545	$ 5,214	$ 5,910	$ 6,632	$ 7,383	$ 8,161
- Investment in Regulatory Capital		$ 6,552	$ 1,593	$ 1,619	$ 1,645	$ 1,671	$ 1,698	$ 1,725	$ 1,753	$ 1,780	$ 1,809
FCFE		$ (11,663)	$ (3,658)	$ (1,576)	$ (133)	$ 2,874	$ 3,516	$ 4,185	$ 4,880	$ 5,602	$ 6,352
Terminal value of equity											$87,317
Present value		$ (10,583)	$ (3,012)	$ (1,178)	$ (90)	$ 1,768	$ 1,966	$ 2,129	$ 2,262	$ 2,370	$ 36,207
Cost of equity	10.20%	10.20%	10.20%	10.20%	10.20%	10.20%	10.048%	9.896%	9.744%	9.592%	9.440%
Cumulative Cost of equity		1.1020	1.2144	1.3383	1.4748	1.6252	1.7885	1.9655	2.1570	2.3639	2.5871
Value of equity today =	$31,838.74										
Number of shares outstanding =	1386.00										
DCF Value per share =	**$ 22.97**										
Probability of equity wipeout	10.00%										
Adjusted value per share =	**$ 20.67**										
Stock price on October 3, 2016=	**$ 13.33**										

Value per share adjusted for probability of catastrophic failure (bailout) resulting in complete loss of equity.

Return on equity increases to 5.85% (25th percentile of banks) in year 5 and 9,44% (cost of equity) in year 10

Aswath Damodaran

V. Valuing cyclical and commodity companies

Company growth often comes from movements in the economic cycle, for cyclical firms, or commodity prices, for commodity companies.

What is the value added by growth assets?

What are the cashflows from existing assets?

When will the firm become a mature fiirm, and what are the potential roadblocks?

How risky are the cash flows from both existing assets and growth assets?

Historial revenue and earnings data are volatile, as the economic cycle and commodity prices change.

Primary risk is from the economy for cyclical firms and from commodity price movements for commodity companies. These risks can stay dormant for long periods of apparent prosperity.

For commodity companies, the fact that there are only finite amounts of the commodity may put a limit on growth forever. For cyclical firms, there is the peril that the next recession may put an end to the firm.

Valuing a Cyclical Company - Toyota in Early 2009

Year	Revenues	Operating Incor	EBITDA	Operating Marg
FY1 1992	¥10,163,380	¥218,511	¥218,511	2.15%
FY1 1993	¥10,210,750	¥181,897	¥181,897	1.78%
FY1 1994	¥9,362,732	¥136,226	¥136,226	1.45%
FY1 1995	¥8,120,975	¥255,719	¥255,719	3.15%
FY1 1996	¥10,718,740	¥348,069	¥348,069	3.25%
FY1 1997	¥12,243,830	¥665,110	¥665,110	5.43%
FY1 1998	¥11,678,400	¥779,800	¥1,382,950	6.68%
FY1 1999	¥12,749,010	¥774,947	¥1,415,997	6.08%
FY1 2000	¥12,879,560	¥775,982	¥1,430,982	6.02%
FY1 2001	¥13,424,420	¥870,131	¥1,542,631	6.48%
FY1 2002	¥15,106,300	¥1,123,475	¥1,822,975	7.44%
FY1 2003	¥16,054,290	¥1,363,680	¥2,101,780	8.49%
FY1 2004	¥17,294,760	¥1,666,894	¥2,454,994	9.64%
FY1 2005	¥18,551,530	¥1,672,187	¥2,447,987	9.01%
FY1 2006	¥21,036,910	¥1,878,342	¥2,769,742	8.93%
FY1 2007	¥23,948,090	¥2,238,683	¥3,185,683	9.35%
FY1 2008	¥26,289,240	¥2,270,375	¥3,312,775	8.64%
FY 2009 (Estin	¥22,661,325	¥267,904	¥1,310,304	1.18%
		¥1,306,867		7.33%

Normalized Earnings (1)

As a cyclical company, Toyota's earnings have been volatile and 2009 earnings reflect the troubled global economy. We will assume that when economic growth returns, the operating margin for Toyota will revert back to the historical average.

Normalized Operating Income = Revenues in 2009 * Average Operating Margin (98--09)
= 22661 * .0733 =1660.7 billion yen

In early 2009, Toyota Motors had the highest market share in the sector. However, the global economic recession in 2008-09 had pulled earnings down.

Normalized Return on capital and Reinvestment (2)

Once earnings bounce back to normal, we assume that Toyota will be able to earn a return on capital equal to its cost of capital (5.09%). This is a sector, where earning excess returns has proved to be difficult even for the best of firms.

To sustain a 1.5% growth rate, the reinvestment rate has to be:

Reinvestment rate = 1.5%/5.09%
= 29.46%

Operating Assets	19,640
+ Cash	2,288
+ Non-operating assets	6,845
- Debt	11,862
- Minority Interests	583
Value of Equity / No of shares	/3,448
Value per share	¥4735

$$\text{Value of operating assets} = \frac{1660.7\ (1.015)\ (1-\ .407)\ (1-\ .2946)}{(.0509\ -\ .015)} = 19{,}640 \text{ billion}$$

Normalized Cost of capital (3)

The cost of capital is computed using the average beta of automobile companies (1.10), and Toyota's cost of debt (3.25%) and debt ratio (52.9% debt ratio. We use the Japanese marginal tax rate of 40.7% for computing both the after-tax cost of debt and the after-tax operating income

Cost of capital = 8.65% (.471) + 3.25% (1-.407) (.529) = 5.09%

Stable Growth (4)

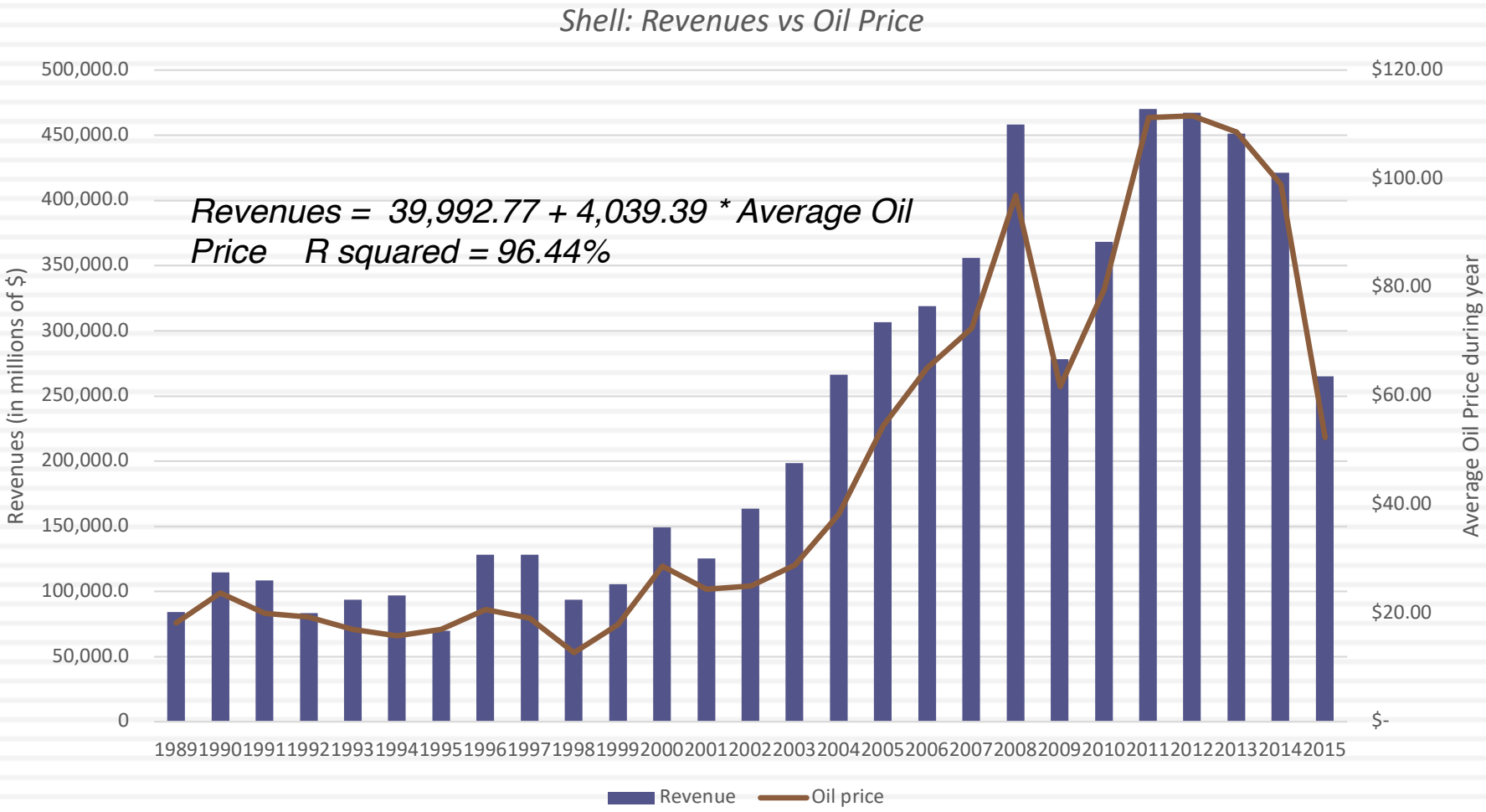
Once earnings are normalized, we assume that Toyota, as the largest market-share company, will be able to maintain only stable growth (1.5% in Yen terms)

Aswath Damodaran

Lesson 1: With “macro” companies, it is easy to get lost in “macro” assumptions…

- With cyclical and commodity companies, it is undeniable that the value you arrive at will be affected by your views on the economy or the price of the commodity.
- Consequently, you will feel the urge to take a stand on these macro variables and build them into your valuation. Doing so, though, will create valuations that are jointly impacted by your views on macro variables and your views on the company, and it is difficult to separate the two.
- The best (though not easiest) thing to do is to separate your macro views from your micro views. Use current market based numbers for your valuation, but then provide a separate assessment of what you think about those market numbers.

Shell's Revenues & Oil Prices



Shell: A "Oil Price" Neutral Valuation: March 2016

Revenue calculated from prevailing oil price of $40/barrel in March 2016
Revenue = 39992.77+4039.40*$40 = $201,569

Compounded revenue growth of 3.91% a year, based on Shell's historical revenue growth rate from 2000 to 2015

	Base Year	1	2	3	4	5	Terminal Year
Revenues	$ 201,569	$ 209,450	$ 217,639	$ 226,149	$ 234,991	$ 244,180	$ 249,063
Operating Margin	3.01%	6.18%	7.76%	8.56%	8.95%	9.35%	9.35%
Operating Income	$ 6,065.00	$ 12,942.85	$ 16,899.10	$ 19,352.39	$ 21,040.39	$ 22,830.80	$ 23,287.41
Effective tax rate	30.00%	30.00%	30.00%	30.00%	30.00%	30.00%	30.00%
AT Operating Income	$ 4,245.50	$ 9,060.00	$ 11,829.37	$ 13,546.68	$ 14,728.27	$ 15,981.56	$ 16,301.19
+ Depreciation	$ 26,714.00	$ 27,759	$ 28,844	$ 29,972	$ 31,144	$ 32,361	
- Cap Ex	$ 31,854.00	$ 33,099	$ 34,394	$ 35,738	$ 37,136	$ 38,588	
- Chg in WC		$ 472.88	$ 491.37	$ 510.58	$ 530.55	$ 551.29	
FCFF		$ 3,246.14	$ 5,788.19	$ 7,269.29	$ 8,205.44	$ 9,203.68	$ 13,011.34
Terminal Value						$ 216,855.71	
Return on capital							12.37%
Cost of Capital		9.91%	9.91%	9.91%	9.91%	9.91%	8.00%
Cumulated Discount Factor		1.0991	1.2080	1.3277	1.4593	1.6039	
Present Value		$ 2,953.45	$ 4,791.47	$ 5,474.95	$ 5,622.81	$ 140,940.73	
Value of Operating Assets	$ 159,783.41						
+ Cash	$ 31,752.00						
+ Cross Holdings	$ 33,566.00						
- Debt	$ 58,379.00						
- Minority Interets	$ 1,245.00						
Value of Equity	$ 165,477.41						
Number of shares	4209.7						
Value per share	$ 39.31						

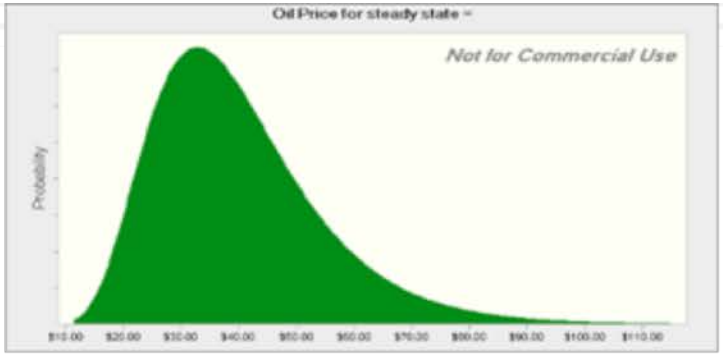
Operating margin converges on Shell's historical average margin of 9.35% from 200-2015

Return on capital reverts and stays at Shell's historic average of 12.37% from 200-2015

Added long term investments in joint ventures and subtracted out minority interest in consolidated holdings.

Lesson 2: Use probabilistic tools to assess value as a function of macro variables…

- If there is a key macro variable affecting the value of your company that you are uncertain about (and who is not), why not quantify the uncertainty in a distribution (rather than a single price) and use that distribution in your valuation.
- That is exactly what you do in a Monte Carlo simulation, where you allow one or more variables to be distributions and compute a distribution of values for the company.
- With a simulation, you get not only everything you would get in a standard valuation (an estimated value for your company) but you will get additional output (on the variation in that value and the likelihood that your firm is under or over valued)

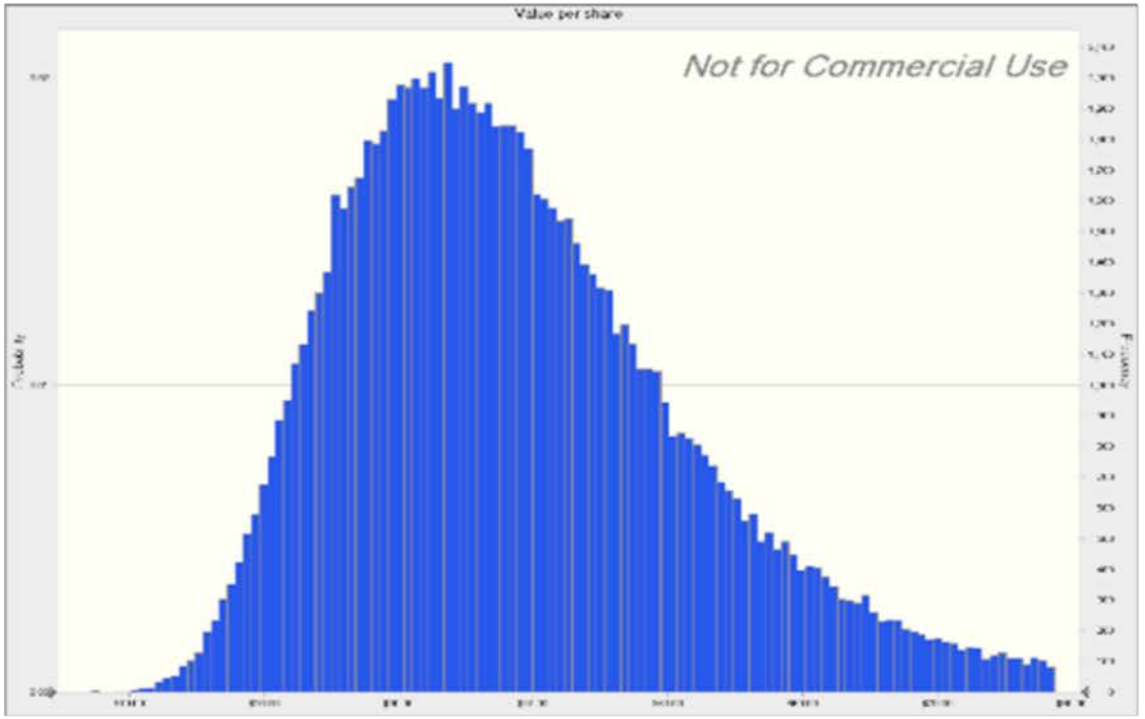


Revenue calculated from the oil price drawn from distribution
Revenue = 39992.77+4039.40*Oil Price/Barrel

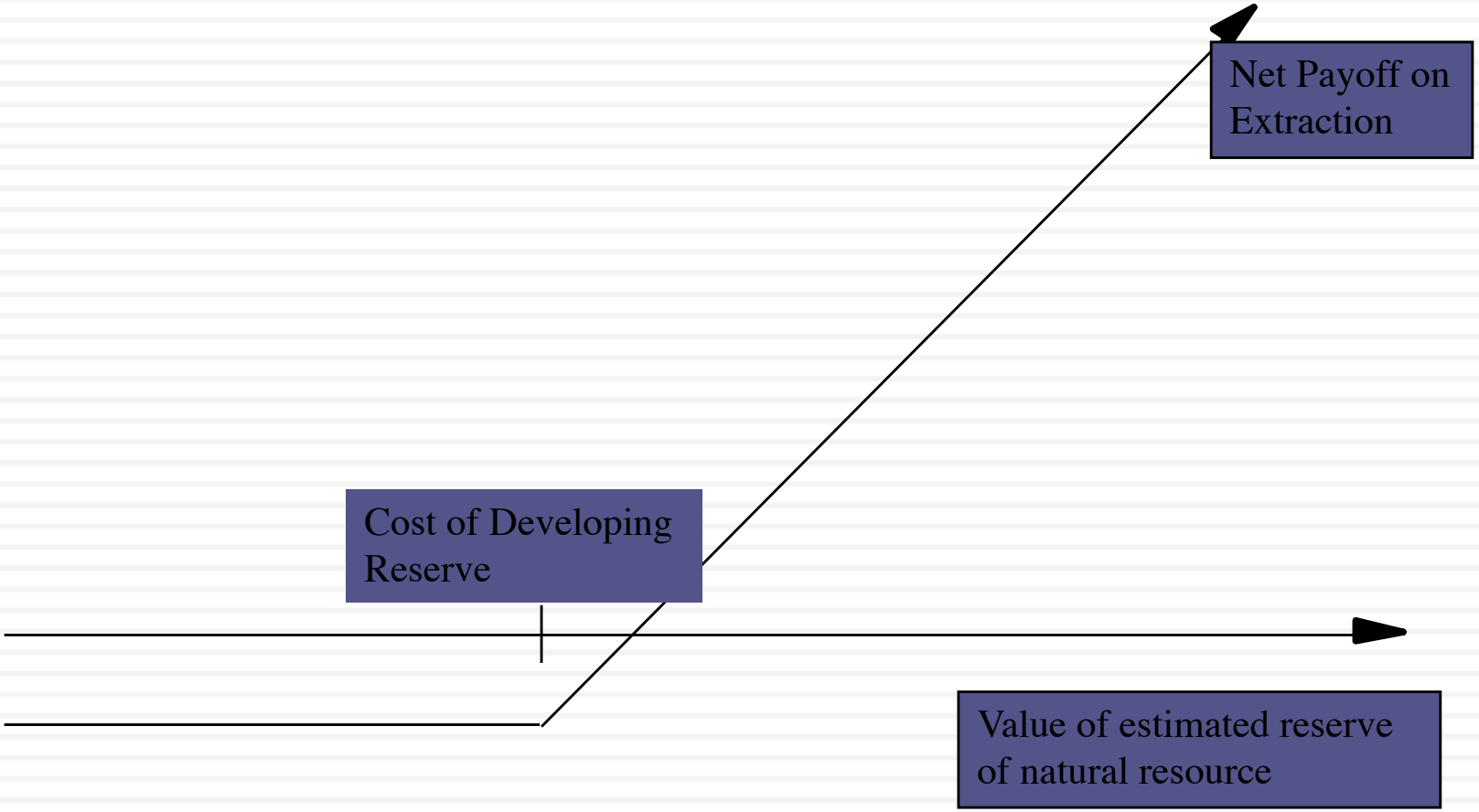
Pre-tax Operating Income based on revenue & selected margin
Pre-tax Operating Income = Revenues * Operating Margin

Value Shell based on operating income, assuming other assumptions (tax rate, revenue growth, cost of capital

Percentiles:	Forecast values
0%	$6.55
10%	$23.90
20%	$27.73
30%	$30.89
40%	$33.88
50%	$36.99
60%	$40.28
70%	$44.22
80%	$49.24
90%	$57.49
100%	$197.11



The optionality in commodities: Undeveloped reserves as an option



Valuing Gulf Oil

- Gulf Oil was the target of a takeover in early 1984 at $70 per share (It had 165.30 million shares outstanding, and total debt of $9.9 billion).
  - It had estimated reserves of 3038 million barrels of oil and the average cost of developing these reserves was estimated to be $10 a barrel in present value dollars (The development lag is approximately two years).
  - The average relinquishment life of the reserves is 12 years.
  - The price of oil was $22.38 per barrel, and the production cost, taxes and royalties were estimated at $7 per barrel.
  - The bond rate at the time of the analysis was 9.00%.
  - Gulf was expected to have net production revenues each year of approximately 5% of the value of the developed reserves. The variance in oil prices is 0.03.

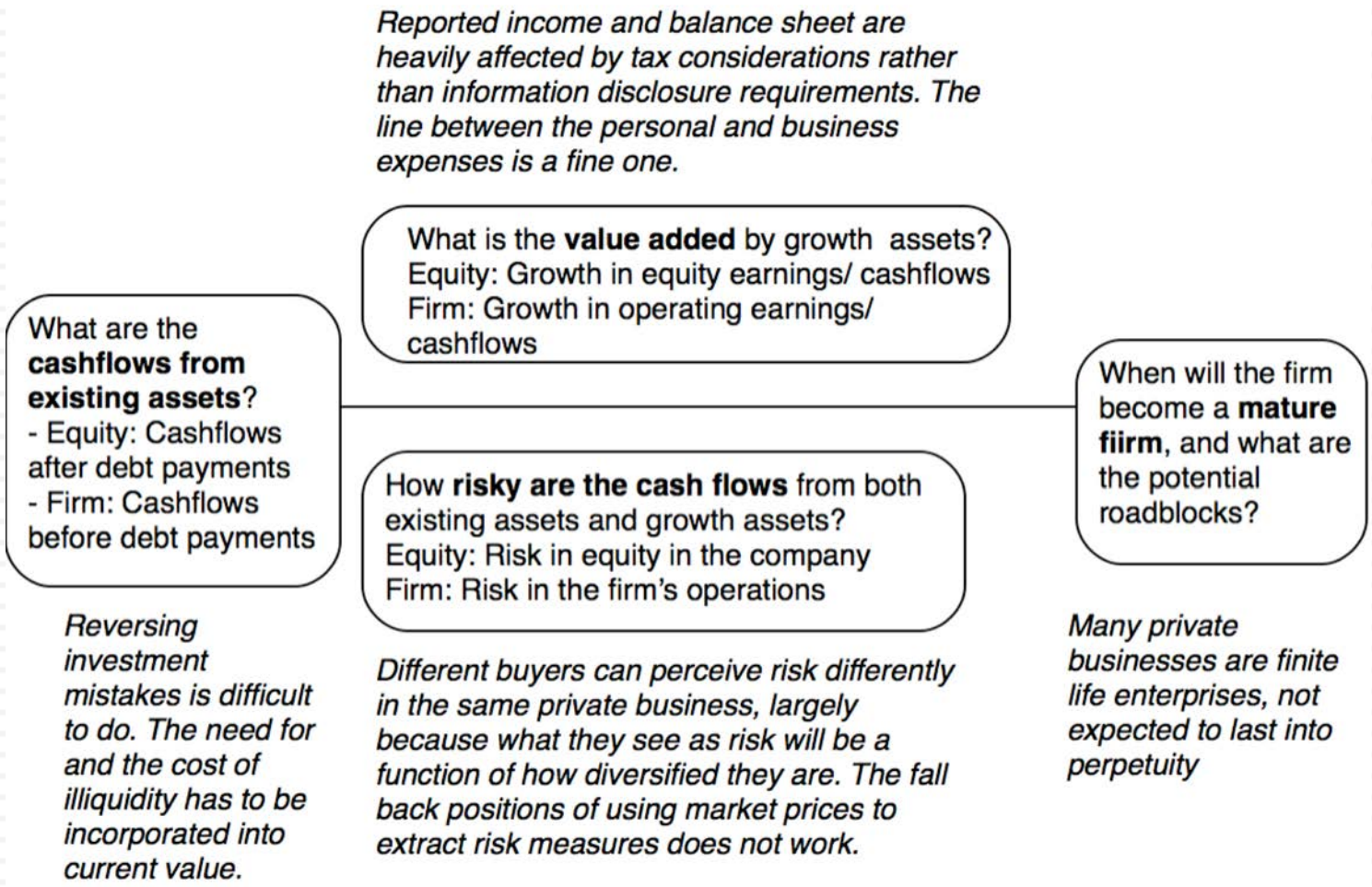
Valuing Undeveloped Reserves

- Inputs for valuing undeveloped reserves
  - Value of underlying asset = Value of estimated reserves discounted back for period of development lag= 3038 * ($ 22.38 - $7) / 1.05^2 = $42,380.44
  - Exercise price = Estimated development cost of reserves = 3038 * $10 = $30,380 million
  - Time to expiration = Average length of relinquishment option = 12 years
  - Variance in value of asset = Variance in oil prices = 0.03
  - Riskless interest rate = 9%
  - Dividend yield = Net production revenue/ Value of developed reserves = 5%
- Based upon these inputs, the Black-Scholes model provides the following value for the call:
  - d1 = 1.6548 N(d1) = 0.9510
  - d2 = 1.0548 N(d2) = 0.8542
- Call Value= 42,380.44 $\exp^{(-0.05)(12)}$ (0.9510) -30,380 ($\exp^{(-0.09)(12)}$ (0.8542) = $ 13,306 million

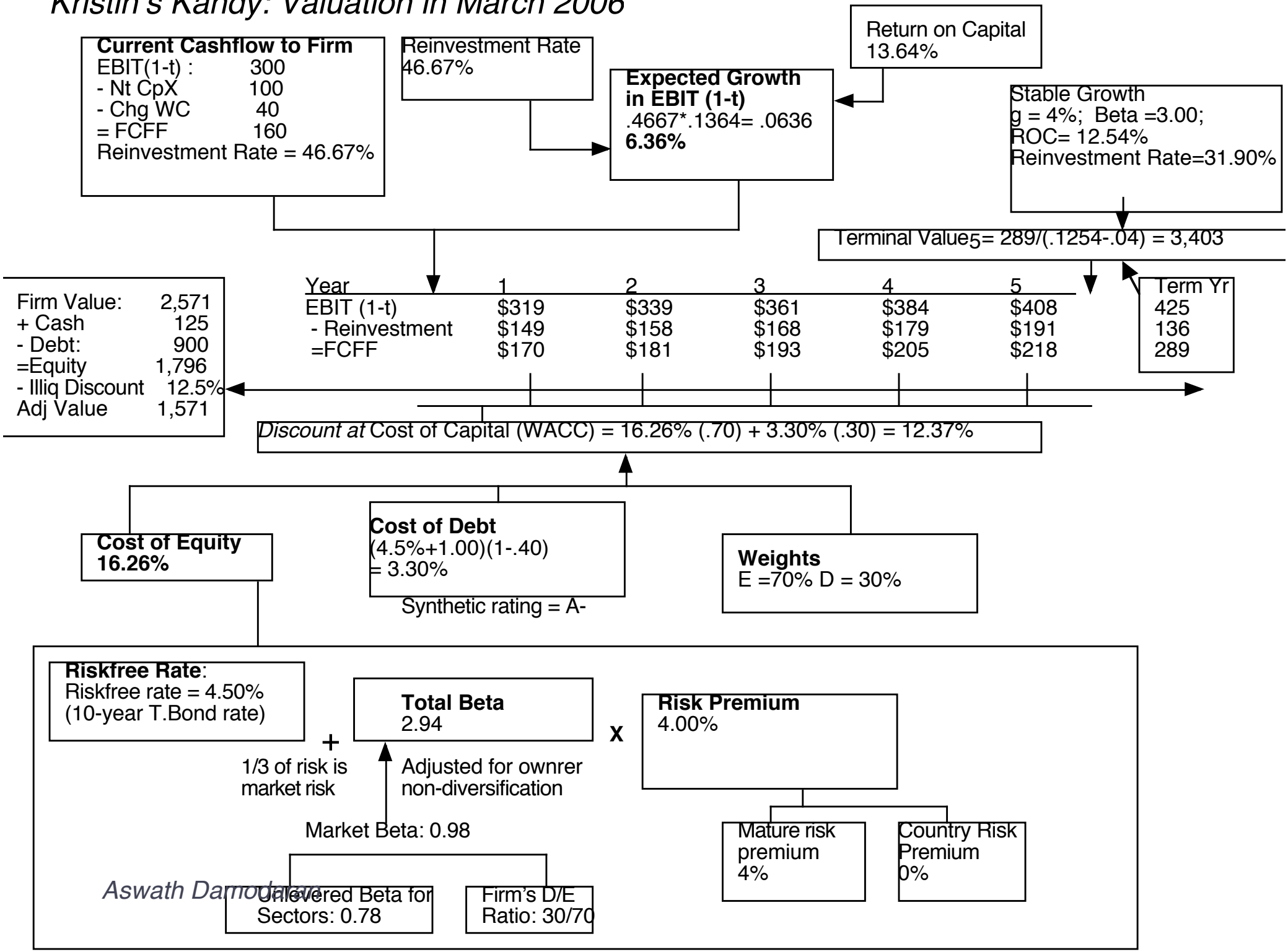
The composite value…

- In addition, Gulf Oil had free cashflows to the firm from its oil and gas production of $915 million from already developed reserves and these cashflows are likely to continue for ten years (the remaining lifetime of developed reserves).
- The present value of these developed reserves, discounted at the weighted average cost of capital of 12.5%, yields:
  - Value of already developed reserves = $915 (1 - 1.125^{-10})/.125 = \$5065.83$
- Adding the value of the developed and undeveloped reserves
  - Value of undeveloped reserves = $ 13,306 million
  - Value of production in place = $ 5,066 million
  - Total value of firm = $ 18,372 million
  - Less Outstanding Debt = $ 9,900 million
  - Value of Equity = $ 8,472 million
  - Value per share = $ 8,472/165.3 = $51.25

VII. Valuing Companies across the ownership cycle



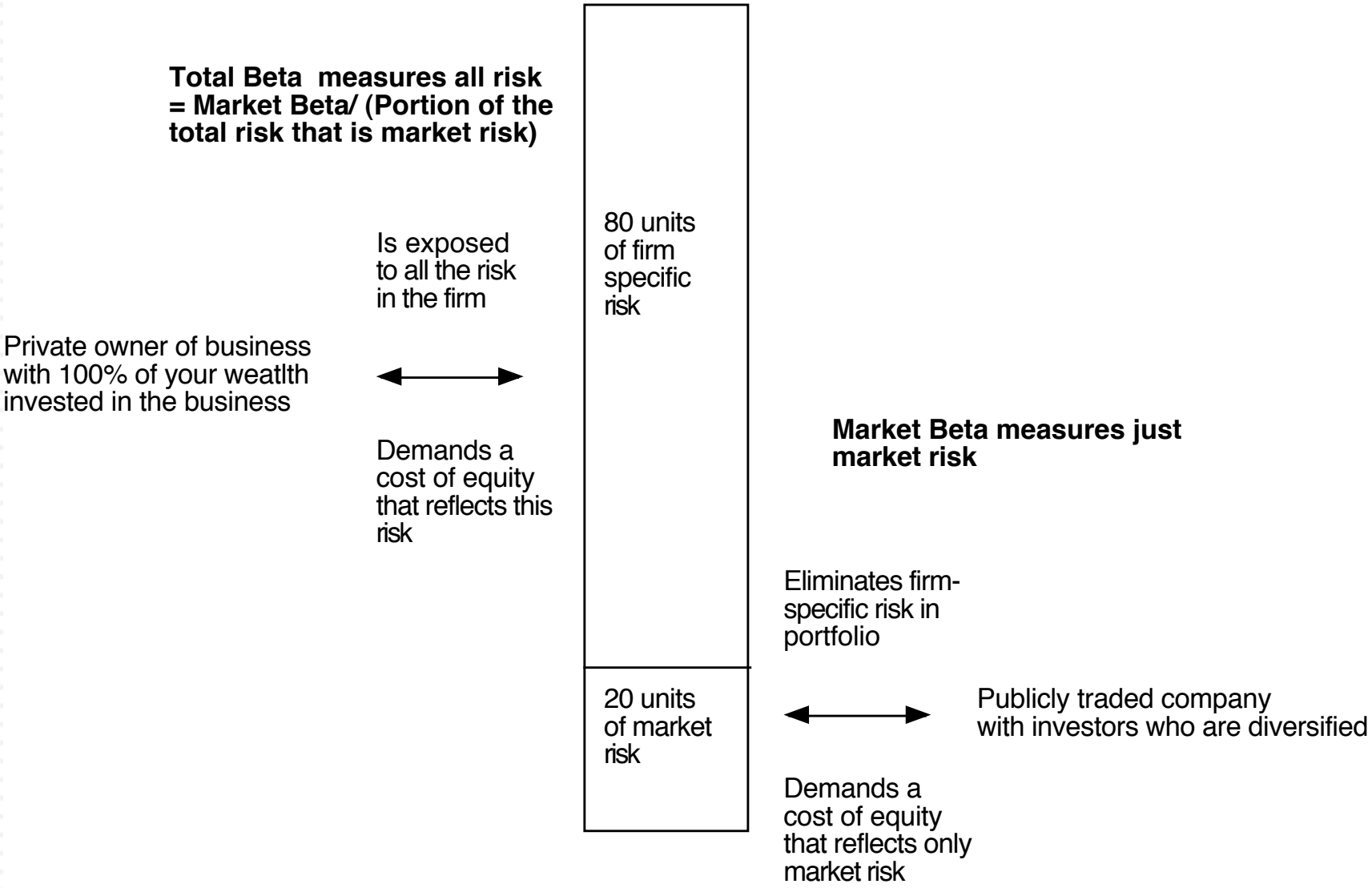
Kristin's Kandy: Valuation in March 2006



Lesson 1: In private businesses, risk in the eyes of the "beholder" (buyer)

Private business owner with entire wealth invested in the business	Venture capitalist, with multiple holdings in the sector.	Public company investor with diversified portfolio
Exposed to all risk in the company. Total beta measures exposure to total risk. Total Beta = Market Beta/ Correlation of firm with market	Partially diversified. Diversify away some firm specific risk but not all. Beta will fall berbetween total and market beta.	Firm-specific risk is diversified away. Market or macro risk exposure captured in a market beta or betas.

Private Owner versus Publicly Traded Company Perceptions of Risk in an Investment



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
- To estimate the beta for Kristin Kandy, we begin with the bottom-up unlevered beta of food processing companies:
  - Unlevered beta for publicly traded food processing companies = 0.78
  - Average correlation of food processing companies with market = 0.333
  - Unlevered total beta for Kristin Kandy = 0.78/0.333 = 2.34
  - Debt to equity ratio for Kristin Kandy = 0.3/0.7 (assumed industry average)
  - Total Beta = 2.34 (1- (1-.40)(30/70)) = 2.94
  - Total Cost of Equity = 4.50% + 2.94 (4%) = 16.26%

Lesson 2: With financials, trust but verify..

- Different Accounting Standards: The accounting statements for private firms are often based upon different accounting standards than public firms, which operate under much tighter constraints on what to report and when to report.
- Intermingling of personal and business expenses: In the case of private firms, some personal expenses may be reported as business expenses.
- Separating "Salaries" from "Dividends": It is difficult to tell where salaries end and dividends begin in a private firm, since they both end up with the owner.
- The Key Person issue: In some private businesses, with a personal component, the cashflows may be intertwined with the owner being part of the business.

Lesson 3: Illiquidity is a clear and present danger..

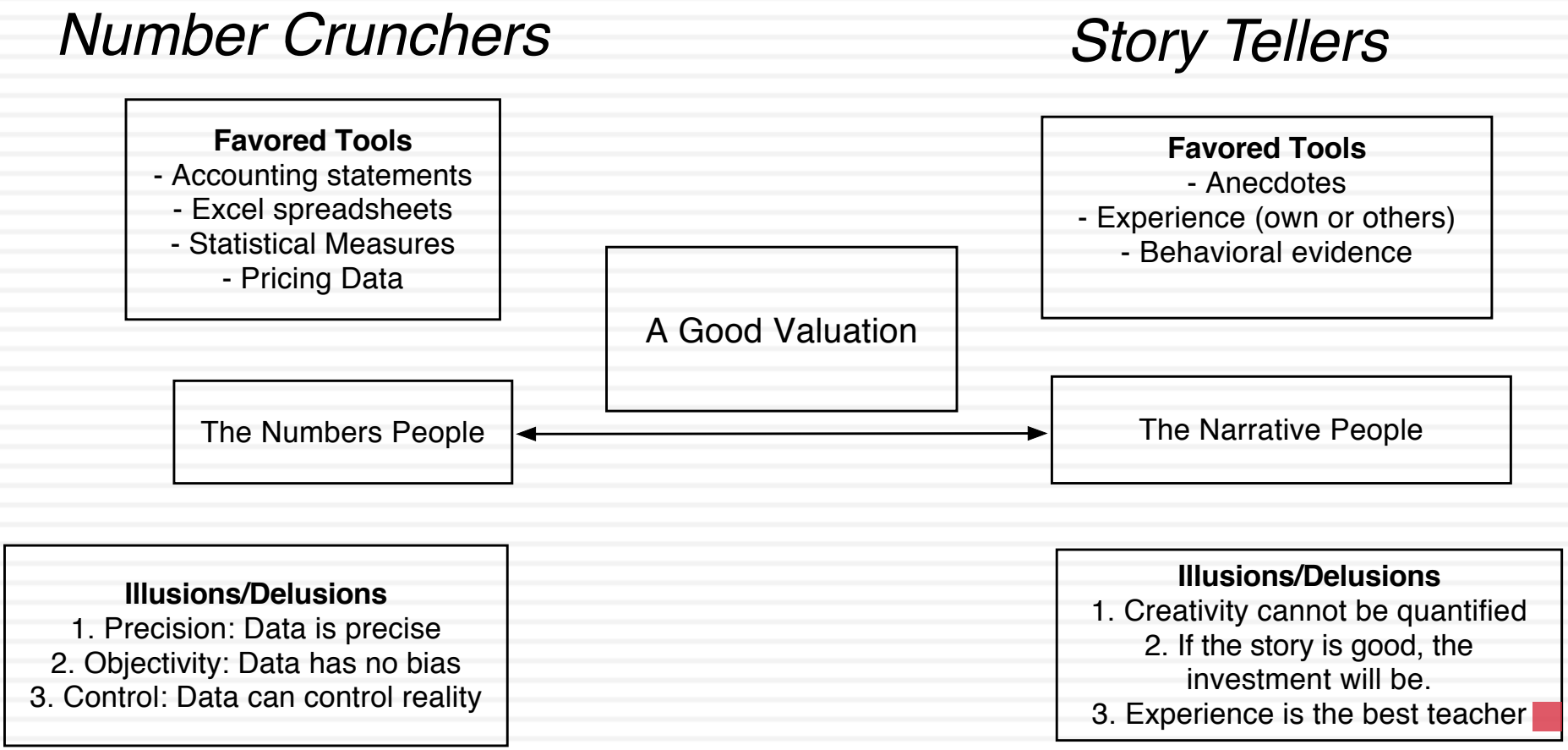
- In private company valuation, illiquidity is a constant theme. All the talk, though, seems to lead to a rule of thumb. The illiquidity discount for a private firm is between 20-30% and does not vary across private firms.
- But illiquidity should vary across:
  - Companies: Healthier and larger companies, with more liquid assets, should have smaller discounts than money-losing smaller businesses with more illiquid assets.
  - Time: Liquidity is worth more when the economy is doing badly and credit is tough to come by than when markets are booming.
  - Buyers: Liquidity is worth more to buyers who have shorter time horizons and greater cash needs than for longer term investors who don't need the cash and are willing to hold the investment.

And it is not just in private businesses..

- Ergis is a publicly traded company, but in a market with light and sporadic liquidity. Will the lack of liquidity affect your valuation of Polish companies?
  a. Yes
  b. No
- If yes, where, in your valuation, would you reflect it? If not, why not?

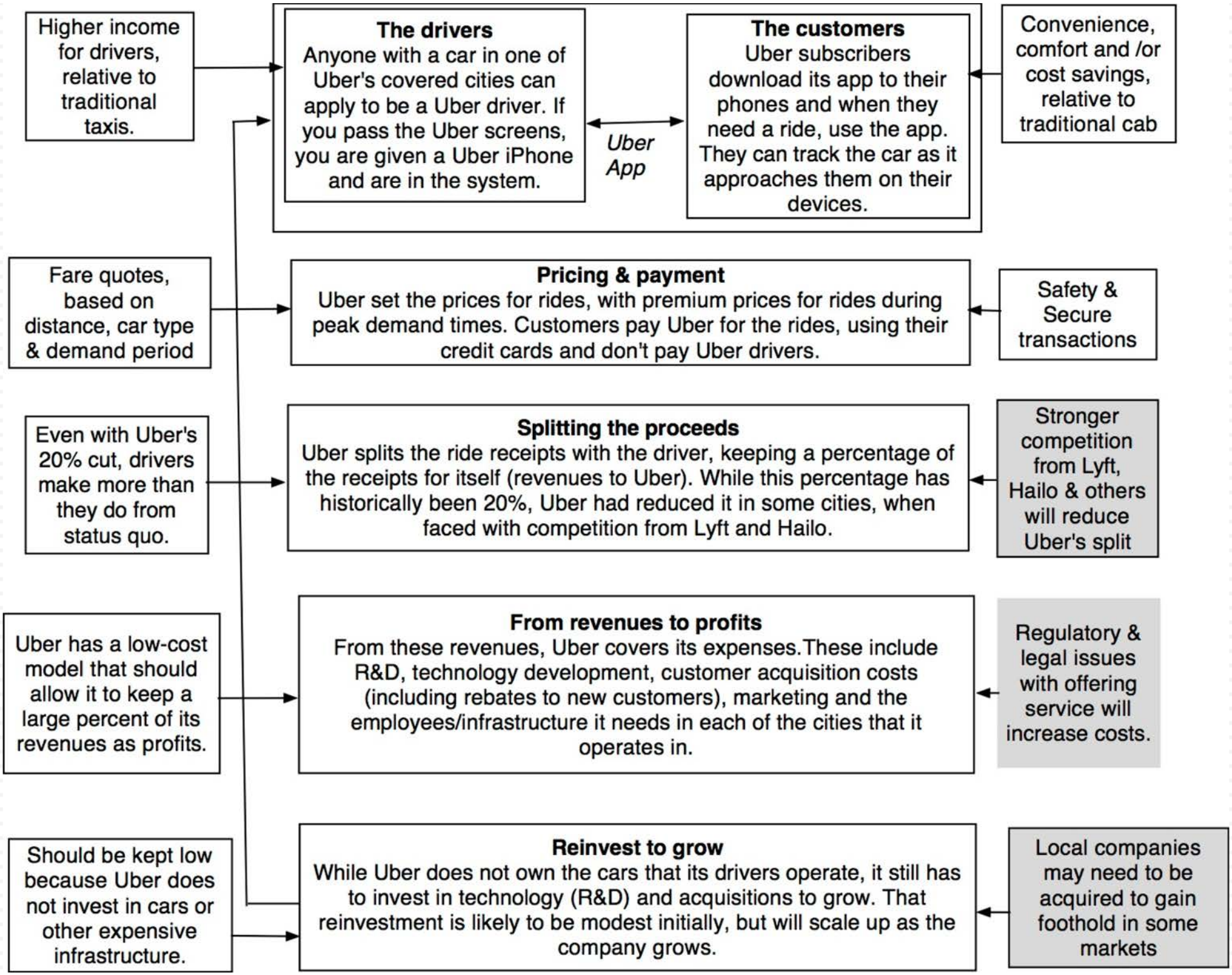
NARRATIVE AND NUMBERS: VALUATION AS A BRIDGE

Valuation as a bridge



Step 1: Survey the landscape

- Every valuation starts with a narrative, a story that you see unfolding for your company in the future.
- In developing this narrative, you will be making assessments of
  - Your company (its products, its management and its history.
  - The market or markets that you see it growing in.
  - The competition it faces and will face.
  - The macro environment in which it operates.


Higher income for drivers, relative to traditional taxis.
The drivers
Anyone with a car in one of Uber's covered cities can apply to be a Uber driver. If you pass the Uber screens, you are given a Uber iPhone and are in the system.
Uber App
The customers
Uber subscribers download its app to their phones and when they need a ride, use the app. They can track the car as it approaches them on their devices.
Convenience, comfort and /or cost savings, relative to traditional cab
Fare quotes, based on distance, car type & demand period
Pricing & payment
Uber set the prices for rides, with premium prices for rides during peak demand times. Customers pay Uber for the rides, using their credit cards and don't pay Uber drivers.
Safety & Secure transactions
Even with Uber's 20% cut, drivers make more than they do from status quo.
Splitting the proceeds
Uber splits the ride receipts with the driver, keeping a percentage of the receipts for itself (revenues to Uber). While this percentage has historically been 20%, Uber had reduced it in some cities, when faced with competition from Lyft and Hailo.
Stronger competition from Lyft, Hailo & others will reduce Uber's split
Uber has a low-cost model that should allow it to keep a large percent of its revenues as profits.
From revenues to profits
From these revenues, Uber covers its expenses.These include R&D, technology development, customer acquisition costs (including rebates to new customers), marketing and the employees/infrastructure it needs in each of the cities that it operates in.
Regulatory & legal issues with offering service will increase costs.
Should be kept low because Uber does not invest in cars or other expensive infrastructure.
Reinvest to grow
While Uber does not own the cars that its drivers operate, it still has to invest in technology (R&D) and acquisitions to grow. That reinvestment is likely to be modest initially, but will scale up as the company grows.
Local companies may need to be acquired to gain foothold in some markets

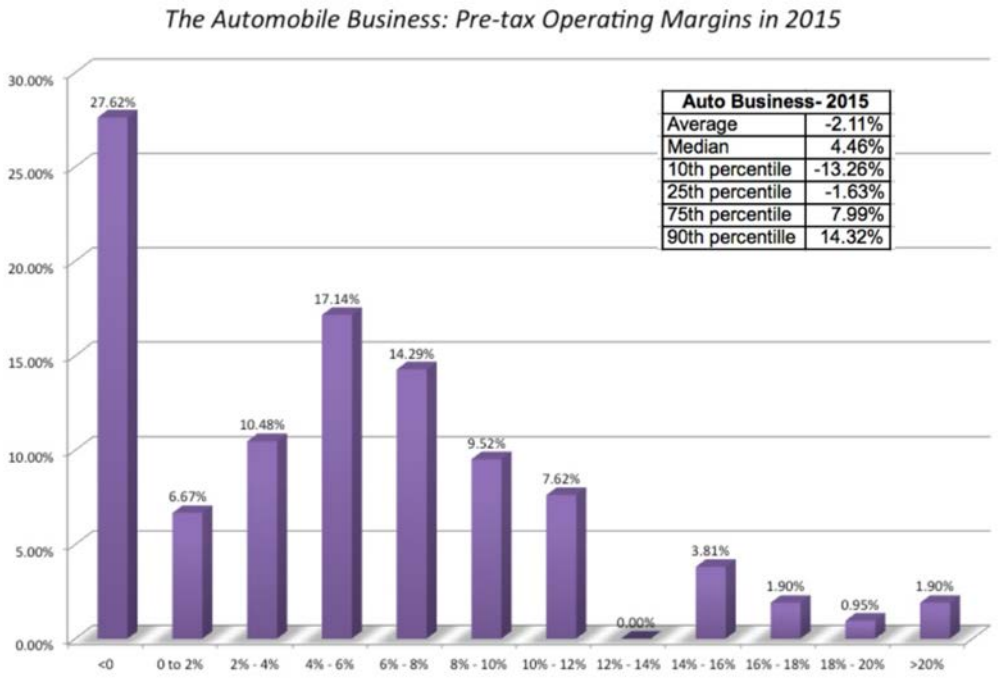
The Auto Business

Low Growth

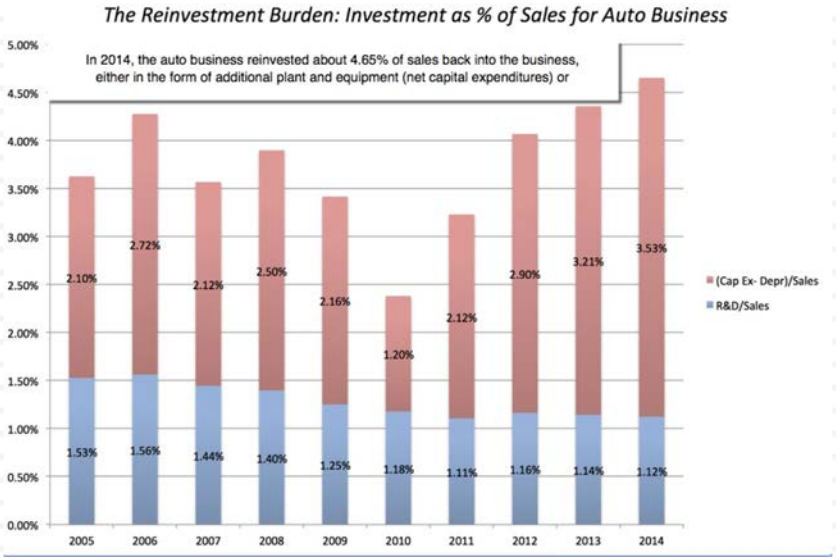
Year	Revenues ($)	% Growth Rate
2005	1,274,716.60	
2006	1,421,804.20	11.54%
2007	1,854,576.40	30.44%
2008	1,818,533.00	-1.94%
2009	1,572,890.10	-13.51%
2010	1,816,269.40	15.47%
2011	1,962,630.40	8.06%
2012	2,110,572.20	7.54%
2013	2,158,603.00	2.28%
2014	2,086,124.80	-3.36%
ounded Average =		5.63%

+

Low Margins



High & Increasing Reinvestment



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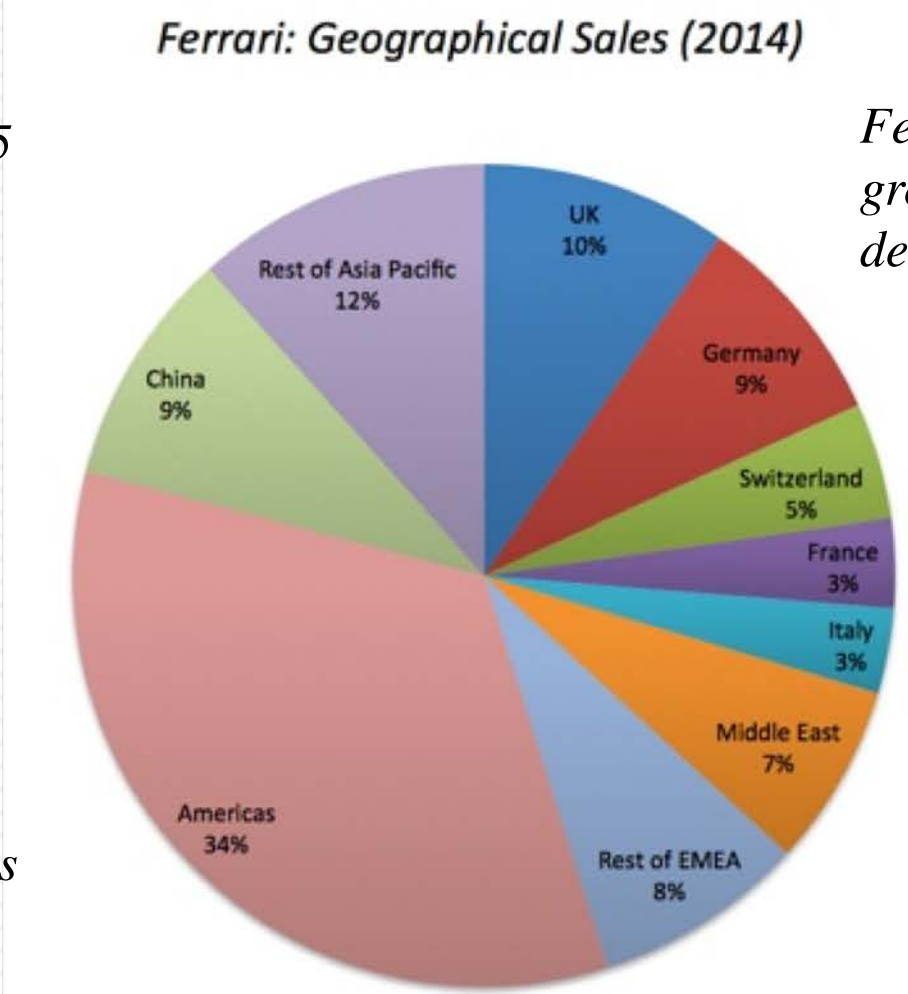
Bad Business

	ROIC	Cost of capital	ROiC - Cost of capital
2004	6.82%	7.93%	-1.11%
2005	10.47%	7.02%	3.45%
2006	4.60%	7.97%	-3.37%
2007	7.62%	8.50%	-0.88%
2008	3.48%	8.03%	-4.55%
2009	-4.97%	8.58%	-13.55%
2010	5.16%	8.03%	-2.87%
2011	7.55%	8.15%	-0.60%
2012	7.80%	8.55%	-0.75%
2013	7.83%	8.47%	-0.64%
2014	6.47%	7.53%	-1.06%

Only once in the last 10 years have auto companies collectively earned more than their cost of capital

What makes Ferrari different?

Ferrari sold only 7,255 cars in all of 2014



Ferrari sales (in units) have grown very little in the last decade & have been stable

Ferrari had a profit margin of 18.2%, in the 95th percentile, partly because of its high prices and partly because it spends little on advertising.

Ferrari has not invested in new plants.

Step 2: Create a narrative for the future

- Every valuation starts with a narrative, a story that you see unfolding for your company in the future.
- In developing this narrative, you will be making assessments of your company (its products, its management), the market or markets that you see it growing in, the competition it faces and will face and the macro environment in which it operates.
  - Rule 1: Keep it simple.
  - Rule 2: Keep it focused.

The Uber Narrative

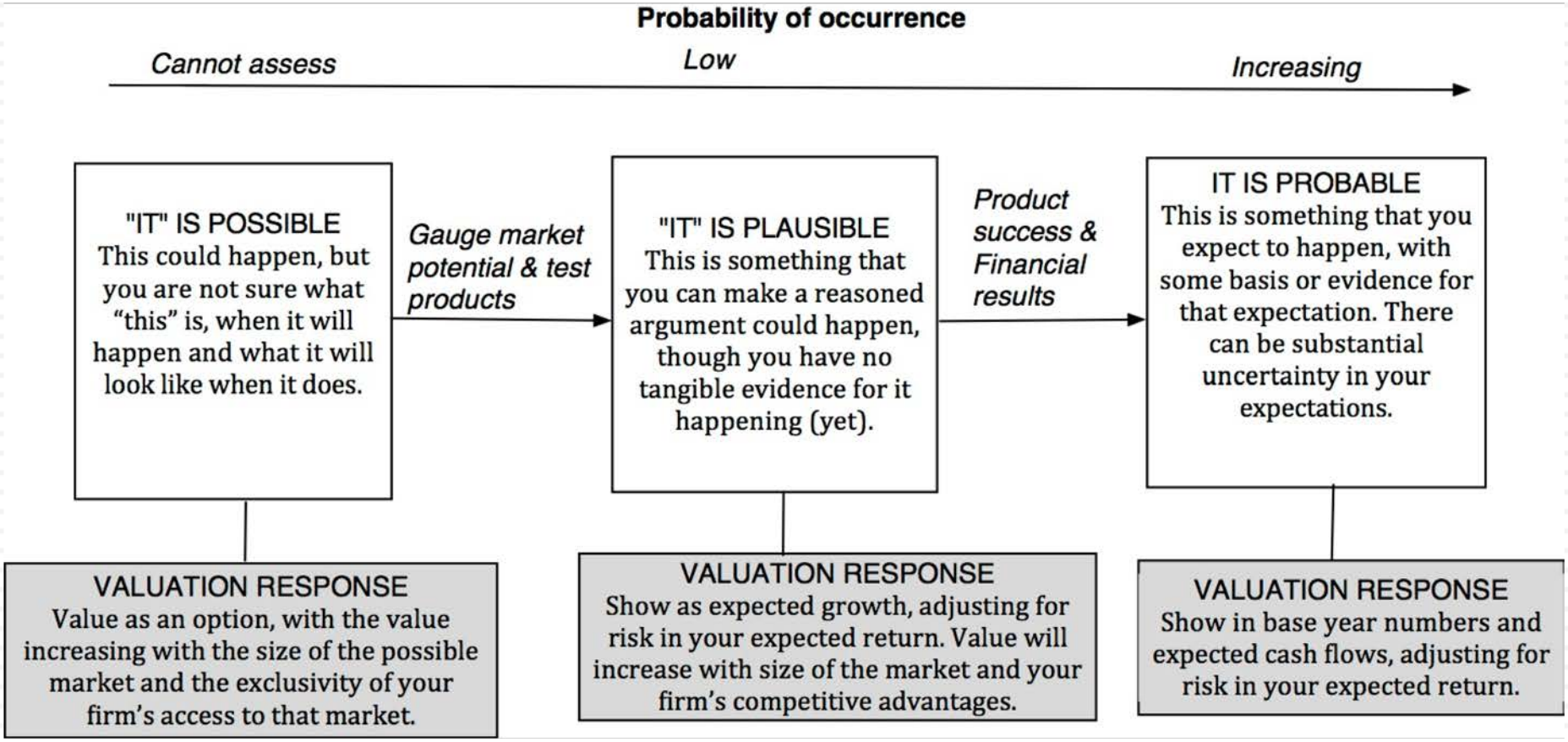
In June 2014, my initial narrative for Uber was that it would be

1. An urban car service business: I saw Uber primarily as a force in urban areas and only in the car service business.
2. Which would expand the business moderately (about 40% over ten years) by bringing in new users.
3. With local networking benefits: If Uber becomes large enough in any city, it will quickly become larger, but that will be of little help when it enters a new city.
4. Maintain its revenue sharing (20%) system due to strong competitive advantages (from being a first mover).
5. And its existing low-capital business model, with drivers as contractors and very little investment in infrastructure.

The Ferrari Narrative

- Ferrari will stay an exclusive auto club, deriving its allure from its scarcity and the fact that only a few own Ferraris.
- By staying exclusive, the company gets three benefits:
  - It can continue to charge nose bleed prices for its cars and sell them with little or no advertising.
  - It does not need to invest in new assembly plants, since it does not plan to ramp up production.
  - It sells only to the super rich, who are unaffected by overall economic conditions or market crises.

Step 3: Check the narrative against history, economic first principles & common sense



The Impossible, The Implausible and the Improbable

The Impossible

Bigger than the economy
Assuming Growth rate for company in perpetuity> Growth rate for economy

Bigger than the total market
Allowing a company's revenues to grow so much that it has more than a 100% market share of whatever business it is in.

Profit margin > 100%
Assuming earnings growth will exceeds revenue growth for a long enough period, and pushing margins above 100%

Depreciation without cap ex
Assuming that depreciation will exceed cap ex in perpetuity.

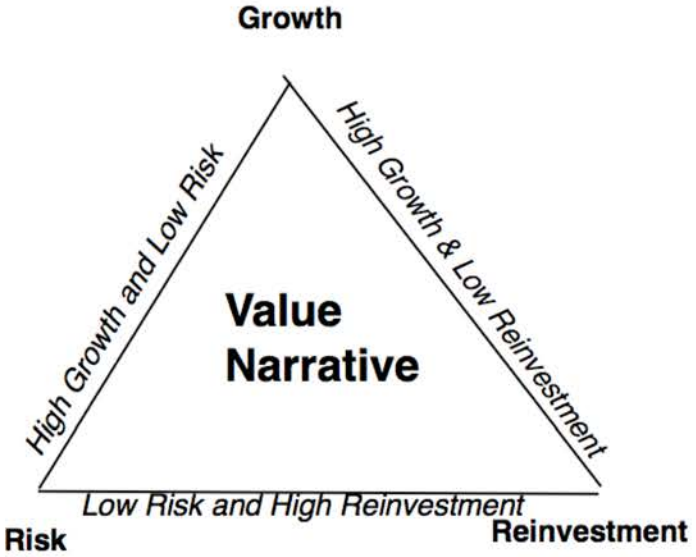
The Implausible

Growth without reinvestment
Assuming growth forever without reinvestment.

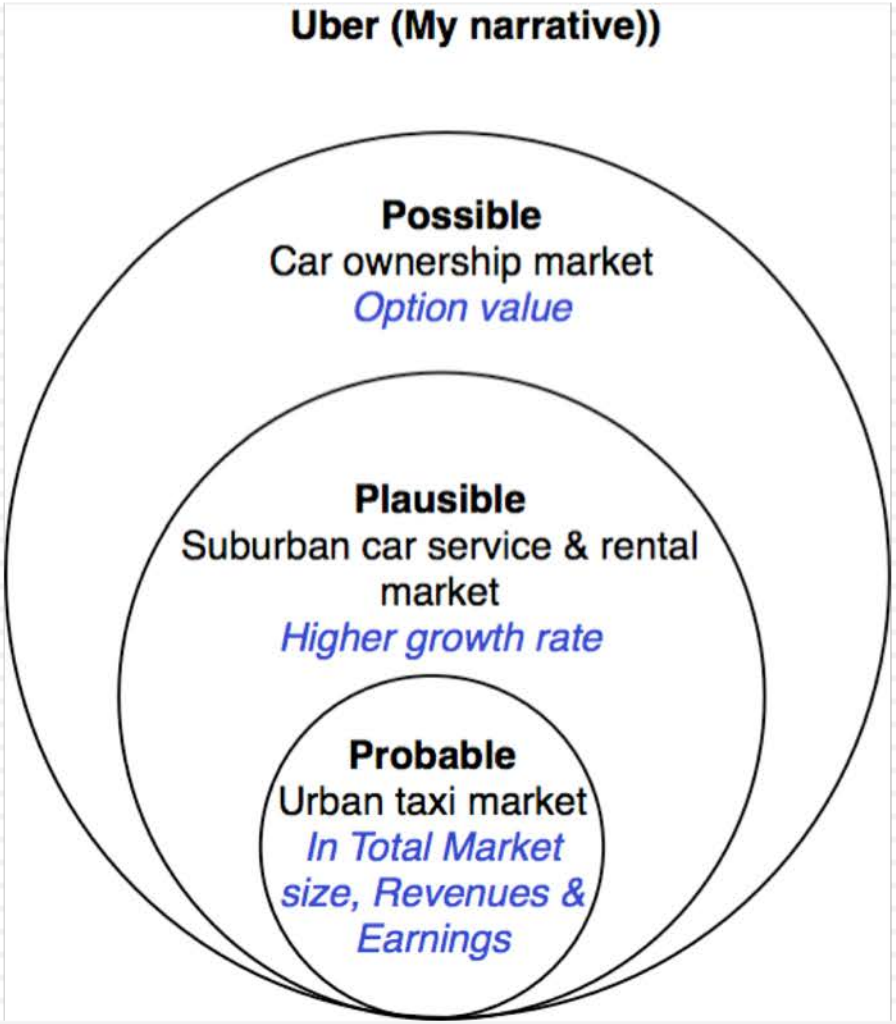
Profits without competition
Assuming that your company will grow and earn higher profits, with no competition.

Returns without risk
Assuming that you can generate high returns in a business with no risk.

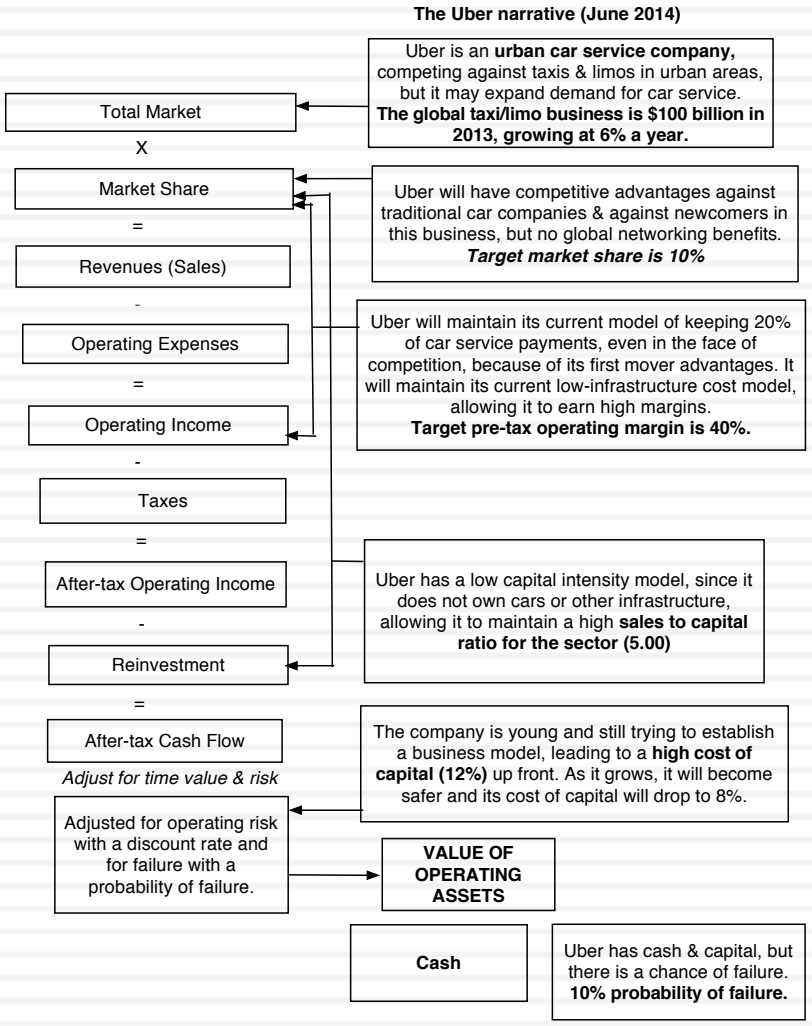
The Improbable



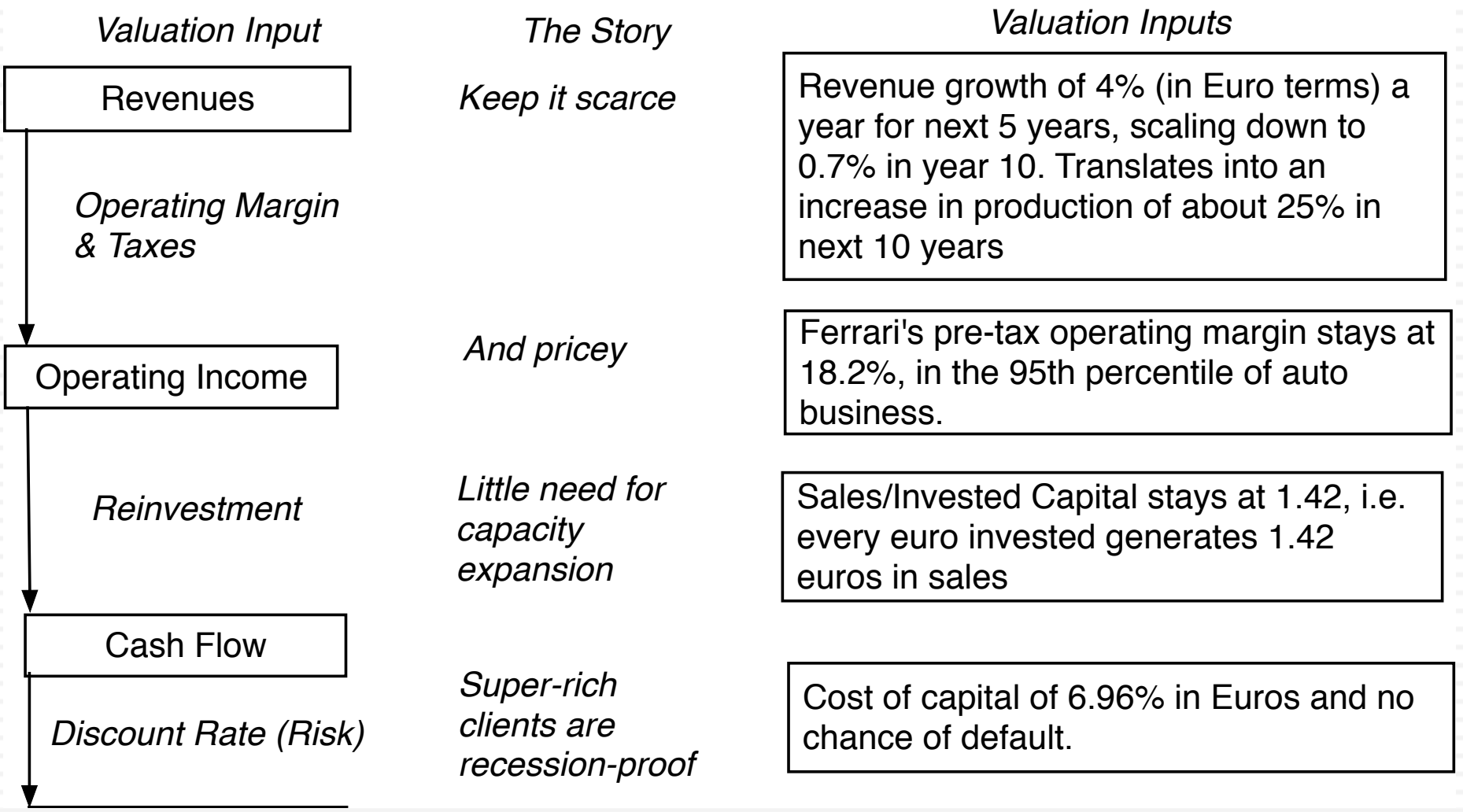
Uber: Possible, Plausible and Probable



Step 4: Connect your narrative to key drivers of value



Ferrari: From story to numbers



Step 5: Value the company (Uber)

Uber: Intrinsic valuation - June 8, 2014 (in US $)

Stable Growth (after year 10)
Expected growth rate = 2.50%
Cost of capital = 8%
Return on capital= 25%
Reinvestment Rate= 2.5%/25% = 10%

Terminal Value$_{10}$= 793/(.08-025) = $14,418

Term yr
EBIT (1-t) $881
- Reinv 88
FCFF $793

Global taxi market is $100 billlion currently, expected to grow 6% a year for next ten years.

Uber will keep 20% of the gross cab receipts as its revenues

Uber's market share of this market will increase to 10% over the next 10 years.

Uber's operating expenses will amount to 60% of its revenues. (Operating margin=40%)

Uber will pay a tax rate of 30% on its income, increasing to 40% over the next 10 years

Uber will generate $5 in incremental revenues for every dollar of incremental capital.

	1	2	3	4	5	6	7	8	9	10
Overall market	$106,000	$112,360	$119,102	$126,248	$133,823	$141,852	$150,363	$159,385	$168,948	$179,085
Share of market (gross)	3.63%	5.22%	6.41%	7.31%	7.98%	8.49%	8.87%	9.15%	9.36%	10.00%
Revenues as percent of gross	20.00%	20.00%	20.00%	20.00%	20.00%	20.00%	20.00%	20.00%	20.00%	20.00%
Annual Revenue	$769	$1,173	$1,528	$1,846	$2,137	$2,408	$2,666	$2,916	$3,163	$3,582
Operating margin	7.00%	10.67%	14.33%	18.00%	21.67%	25.33%	29.00%	32.67%	36.33%	40.00%
Operating Income	$54	$125	$219	$332	$463	$610	$773	$953	$1,149	$1,433
Effective tax rate	31%	32%	33%	34%	35%	36%	37%	38%	39%	40%
- Taxes	$17	$40	$72	$113	$162	$220	$286	$362	$448	$573
After-tax operating income	$37	$85	$147	$219	$301	$390	$487	$591	$701	$860
Sales/Capital Ratio	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
- Reinvestment	$94	$81	$71	$64	$58	$54	$52	$50	$49	$84
Free Cash Flow to the Firm	-$57	$4	$76	$156	$243	$336	$435	$541	$652	$776

Based on the investment of $1.2 billion made by investors, the imputed value for Uber's operating assets, in June 2014 ,was $17 billion.

Discount back the cash flows (including terminal value) at the cumulated cost of capital.

Value of operating assets = $6,595

Adust for probability of failure (10%)
Expected value = $6,595 (.9) = $5,895

Cost of capital for first 5 years = Top decile of US companies = 12%

Cost of capital declines from 12% to 8% from years 6 to 10.

Ferrari: The "Exclusive Club" Value

Stay Super Exclusive: Revenue growth is low

	Base year	1	2	3	4	5	6	7	8	9	10	Terminal year
Revenue growth rate		4.00%	4.00%	4.00%	4.00%	4.00%	3.34%	2.68%	2.02%	1.36%	0.70%	0.70%
Revenues	€ 2,763	€ 2,874	€ 2,988	€ 3,108	€ 3,232	€ 3,362	€ 3,474	€ 3,567	€ 3,639	€ 3,689	€ 3,714	€ 3,740
EBIT (Operating) margin	18.20%	18.20%	18.20%	18.20%	18.20%	18.20%	18.20%	18.20%	18.20%	18.20%	18.20%	18.20%
EBIT (Operating income)	€ 503	€ 523	€ 544	€ 566	€ 588	€ 612	€ 632	€ 649	€ 662	€ 671	€ 676	€ 681
Tax rate	33.54%	33.54%	33.54%	33.54%	33.54%	33.54%	33.54%	33.54%	33.54%	33.54%	33.54%	33.54%
EBIT(1-t)	€ 334	€ 348	€ 361	€ 376	€ 391	€ 407	€ 420	€ 431	€ 440	€ 446	€ 449	€ 452
- Reinvestment		€ 78	€ 81	€ 84	€ 87	€ 91	€ 79	€ 66	€ 51	€ 35	€ 18	€ 22
FCFF		€ 270	€ 281	€ 292	€ 303	€ 316	€ 341	€ 366	€ 389	€ 411	€ 431	€ 431
Cost of capital		6.96%	6.96%	6.96%	6.96%	6.96%	6.96%	6.97%	6.98%	6.99%	7.00%	7.00%
PV(FCFF)		€ 252	€ 245	€ 238	€ 232	€ 225	€ 228	€ 228	€ 227	€ 224	€ 220	

Terminal value	€ 6,835
PV(Terminal value)	€ 3,485
PV (CF over next 10 years)	€ 2,321
Value of operating assets =	€ 5,806
- Debt	€ 623
- Minority interests	€ 13
+ Cash	€ 1,141
Value of equity	€ 6,311

High Prices + No selling cost = Preserve current operating margin

Minimal Reinvestment due to low growth

The super rich are not sensitive to economic downturns

Step 5: Keep the feedback loop

1. Not just car service company.: Uber is a car company, not just a car service company, and there may be a day when consumers will subscribe to a Uber service, rather than own their own cars. It could also expand into logistics, i.e., moving and transportation businesses.
2. Not just urban: Uber can create new demands for car service in parts of the country where taxis are not used (suburbia, small towns).
3. Global networking benefits: By linking with technology and credit card companies, Uber can have global networking benefits.

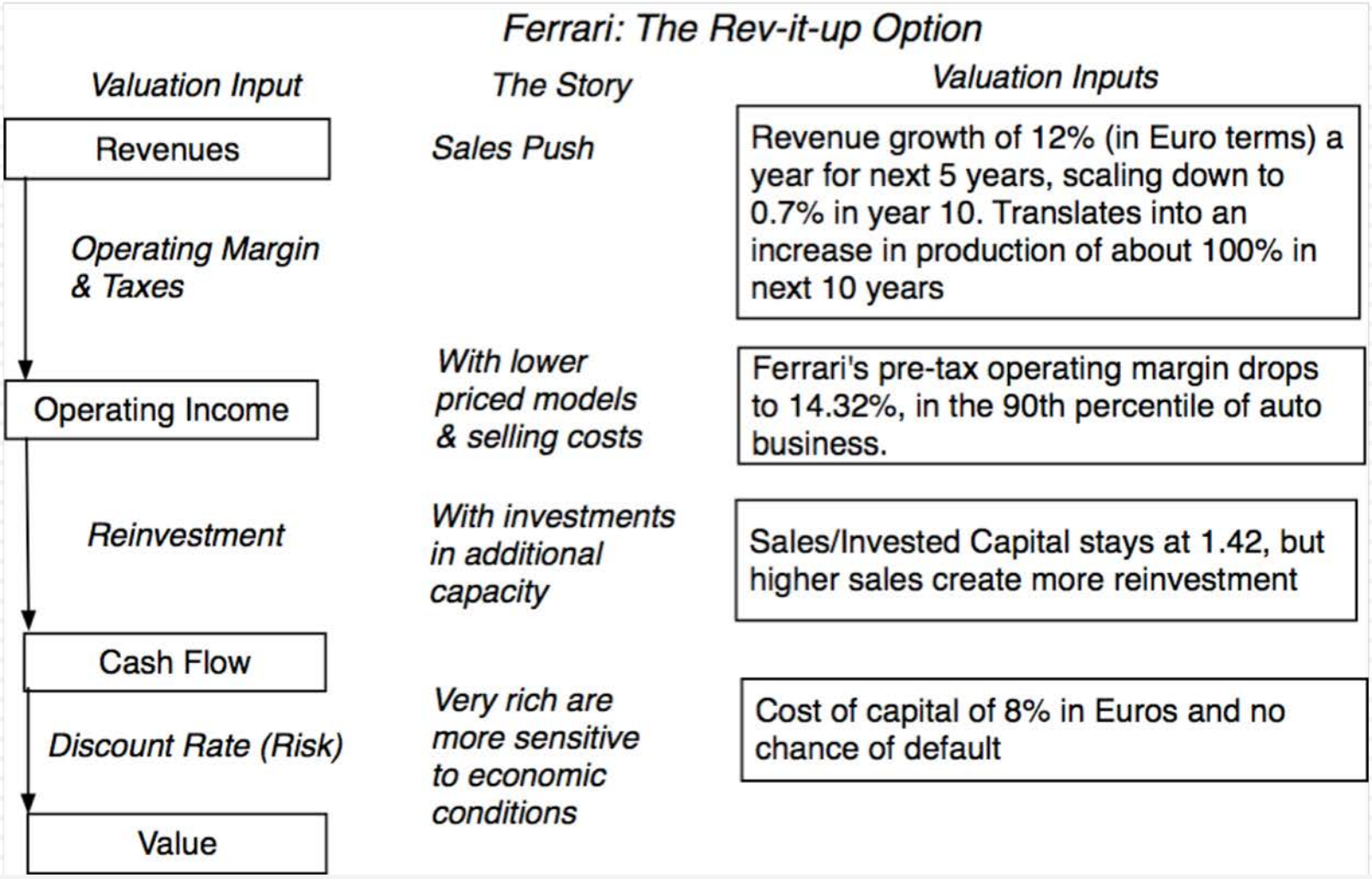
Valuing Bill Gurley's Uber narrative

	Uber (Gurley)	*Uber (Gurley Mod)*	*Uber (Damodaran)*
Narrative	Uber will expand the car service market substantially, bringing in mass transit users & non-users from the suburbs into the market, and use its networking advantage to gain a dominant market share, while maintaining its revenue slice at 20%.	Uber will expand the car service market substantially, bringing in mass transit users & non-users from the suburbs into the market, and use its networking advantage to gain a dominant market share, while cutting prices and margins (to 10%).	Uber will expand the car service market moderately, primarily in urban environments, and use its competitive advantages to get a significant but not dominant market share and maintain its revenue slice at 20%.
Total Market	$300 billion, growing at 3% a year	$300 billion, growing at 3% a year	$100 billion, growing at 6% a year
Market Share	40%	40%	10%
Uber's revenue slice	20%	10%	20%
Value for Uber	$53.4 billion + Option value of entering car ownership market ($10 billion+)	$28.7 billion + Option value of entering car ownership market ($6 billion+)	$5.9 billion + Option value of entering car ownership market ($2-3 billion)

Different narratives, Different Numbers

Total Market	*Growth Effect*	*Network Effect*	*Competitive Advantages*	*Value of Uber*
A4. Mobility Services	B4. Double market size	C5. Strong global network effects	D4. Strong & Sustainable	$90,457
A3. Logistics	B4. Double market size	C5. Strong global network effects	D4. Strong & Sustainable	$65,158
A4. Mobility Services	B3. Increase market by 50%	C3. Strong local network effects	D3. Semi-strong	$52,346
A2. All car service	B4. Double market size	C5. Strong global network effects	D4. Strong & Sustainable	$47,764
A1. Urban car service	B4. Double market size	C5. Strong global network effects	D4. Strong & Sustainable	$31,952
A3. Logistics	B3. Increase market by 50%	C3. Strong local network effects	D3. Semi-strong	$14,321
A1. Urban car service	B3. Increase market by 50%	C3. Strong local network effects	D3. Semi-strong	$7,127
A2. All car service	B3. Increase market by 50%	C3. Strong local network effects	D3. Semi-strong	$4,764
A4. Mobility Services	B1. None	C1. No network effects	D1. None	$1,888
A3. Logistics	B1. None	C1. No network effects	D1. None	$1,417
A2. All car service	B1. None	C1. No network effects	D1. None	$1,094
A1. Urban car service	B1. None	C1. No network effects	D1. None	$799

The Ferrari Counter Narrative



Ferrari: The "Rev-it-up" Alternative

Get less exclusive: Double number of cars sold over next decade

	Base year	1	2	3	4	5	6	7	8	9	10	Terminal year
Revenue growth rate		12.00%	12.00%	12.00%	12.00%	12.00%	9.74%	7.48%	5.22%	2.96%	0.70%	0.70%
Revenues	€ 2,763	€ 3,095	€ 3,466	€ 3,882	€ 4,348	€ 4,869	€ 5,344	€ 5,743	€ 6,043	€ 6,222	€ 6,266	€ 6,309
EBIT (Operating) margin	18.20%	17.81%	17.42%	17.04%	16.65%	16.26%	15.87%	15.48%	15.10%	14.71%	14.32%	14.32%
EBIT (Operating income)	€ 503	€ 551	€ 604	€ 661	€ 724	€ 792	€ 848	€ 889	€ 912	€ 915	€ 897	€ 904
Tax rate	33.54%	33.54%	33.54%	33.54%	33.54%	33.54%	33.54%	33.54%	33.54%	33.54%	33.54%	33.54%
EBIT(1-t)	€ 334	€ 366	€ 401	€ 439	€ 481	€ 526	€ 564	€ 591	€ 606	€ 608	€ 596	€ 600
- Reinvestment		€ 233	€ 261	€ 293	€ 328	€ 367	€ 334	€ 281	€ 211	€ 126	€ 31	€ 35
FCFF		€ 133	€ 140	€ 147	€ 153	€ 159	€ 230	€ 310	€ 395	€ 482	€ 566	€ 565
Cost of capital		8.00%	8.00%	8.00%	8.00%	8.00%	7.90%	7.80%	7.70%	7.60%	7.50%	7.50%
PV(FCFF)		€ 123	€ 120	€ 117	€ 113	€ 108	€ 145	€ 181	€ 215	€ 244	€ 266	

Terminal value	€ 8,315
PV(Terminal value)	€ 3,906
PV (CF over next 10 years)	€ 1,631
Value of operating assets =	€ 5,537
- Debt	€ 623
- Minority interests	€ 13
+ Cash	€ 1,141
Value of equity	€ 6,042

Lower Prices + Some selling cost = Lower operating margin

Reinvestment reflects higher sales

The very rich are more sensitive to economic conditions

And the world is full of feedback.. My Ferrari afterthought!

Step 6: Be ready to modify narrative as events unfold

Narrative Break/End	Narrative Shift	Narrative Change (Expansion or Contraction)
Events, external (legal, political or economic) or internal (management, competitive, default), that can cause the narrative to break or end.	Improvement or deterioration in initial business model, changing market size, market share and/or profitability.	Unexpected entry/success in a new market or unexpected exit/failure in an existing market.
Your valuation estimates (cash flows, risk, growth & value) are no longer operative	Your valuation estimates will have to be modified to reflect the new data about the company.	Valuation estimates have to be redone with new overall market potential and characteristics.
Estimate a probability that it will occur & consequences	Monte Carlo simulations or scenario analysis	Real Options

Uber: The September 2015 Update

Input	*June 2014*	*September 2015*	*Rationale*
Total Market	$100 billion; Urban car service	$230 billion; Logistics	Market is broader, bigger & more global than I thought it would be. Uber's entry into delivery & moving businesses is now plausible, perhaps even probable.
Growth in market	Increase market size by 34%; CAGR of 6%.	Double market size; CAGR of 10.39%.	New customers being drawn to car sharing, with more diverse offerings.
Market Share	10% (Local Networking)	25% (Weak Global Networking)	Higher cost of entry will reduce competitors, but remaining competitors have access to capital & in Asia, the hometown advantage.
Slice of gross receipts	20% (Left at status quo)	15%	Increased competition will reduce car service company slice.
Operating margin	40% (Low cost model)	25% (Partial employee model)	Drivers will become partial employees, higher insurance and regulatory costs.
Cost of capital	12% (Ninth decile of US companies)	10% (75th percentile of US companies)	Business model in place and substantial revenues.
Probability of failure	10%	0%	Enough cash on hand to find off threats to survival.
Value of equity	**$5.9 billion**	**$23.4 billion**	**Value increased more than four fold.**

Potential Market	Market size (in millions)
A1. Urban car service	$100,000
A2. All car service	$175,000
A3. Logistics	$230,000
A4. Mobility Services	$310,000

Increases overall market to $618 billion in year 10

Growth Effect	CAGR (next 10 years)
B1. None	3.00%
B2. Increase market by 25%	5.32%
B3. Increase market size by 50%	7.26%
B4: Double market size	10.39%

Network Effects	Market Share
C1. No network effects	5%
C2. Weak local network effects	10%
C3. Strong local network effects	15%
C4. Weak global network effects	25%
C5. Strong global network effects	40%

	Base	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	Assumptions
Overall market	$230,000	$253,897	$280,277	$309,398	$341,544	$377,031	$416,204	$459,448	$507,184	$559,881	$618,052	A3 & B4
Share of market (gross)	4.71%	6.74%	8.77%	10.80%	12.83%	14.86%	16.89%	18.91%	20.94%	22.97%	25.00%	C4
Gross Billings	$10,840	$17,117	$24,582	$33,412	$43,813	$56,014	$70,277	$86,900	$106,218	$128,612	$154,513	
Revenues as percent of gross	20.00%	19.50%	19.00%	18.50%	18.00%	17.50%	17.00%	16.50%	16.00%	15.50%	15.00%	D3
Annual Revenue	$2,168	$3,338	$4,670	$6,181	$7,886	$9,802	$11,947	$14,338	$16,995	$19,935	$23,177	
Operating margin	-23.06%	-18.26%	-13.45%	-8.64%	-3.84%	0.97%	5.77%	10.58%	15.39%	20.19%	25.00%	E2
Operating Income	-$500	-$609	-$628	-$534	-$303	$95	$690	$1,517	$2,615	$4,026	$5,794	
Effective tax rate	30.00%	31.00%	32.00%	33.00%	34.00%	35.00%	36.00%	37.00%	38.00%	39.00%	40.00%	
- Taxes	-$150	-$189	-$201	-$176	-$103	$33	$248	$561	$994	$1,570	$2,318	
After-tax operating income	-$350	-$420	-$427	-$358	-$200	$62	$442	$956	$1,621	$2,456	$3,477	
Sales/Capital Ratio		5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	F
- Reinvestment		$234	$267	$302	$341	$383	$429	$478	$531	$588	$648	
Free Cash Flow to the Firm		-$654	-$694	-$660	-$541	-$322	$13	$478	$1,090	$1,868	$2,828	
Terminal value											$56,258	
Present value of FCFF		-$595	-$573	-$496	-$369	-$200	$7	$248	$520	$822	$1,152	
Present value of terminal value											$22,914	
Cost of capital	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	9.60%	9.20%	8.80%	8.40%	8.00%	G1

PV of cash flows during next 10 years =	$515	
PV of terminal value =	$22,914	
Value of operating assets	$23,429	
Probability of failure	0.00%	G2
Adjusted value of operating assets	$23,429	
Less Debt	$0	
Value of Equity	$23,429	

Capital Intensity
F: Status Quo: Sales/Capital = 5

Expense Profile	Operating Margin
E1: Independent contractor	40%
E2: Partial employee	25%
E3: Full employee	15%

Competitive Advantages	Slice of Gross Receipts
D1. None	5%
D2. Weak	10%
D3. Semi-strong	15%
D4. Strong & Sustainable	20%

Risk Estimates
G1. Cost of capital at 75th percentile of US companies = 10%
G2. Probability of failure in next 10 years= 0%

Uber Valuation: September 2015

Ergis

The Story

Ergis is a company that is in a bad business, struggling to grow while earning enough to cover its cost of capital. In the near term, the company will continue to tread water, with sluggish growth and not much change in margins. Over time, the company will gradually increase its return on capital to become a neutral business, earning its cost of capital in steady state.

The Assumptions

	Base year	Years 1-5	Years 6-10		After year 10	Link to story
Revenues (a)	$ 750	3.48% →	2.39%		2.39%	Growth slows to recent average (2013-17)
Operating margin (b)	4.47%	4.47% →	4.54%		4.54%	Margins stay stable
Tax rate	30.26%	30.26% →	25.00%		25.00%	Tax rate converges to EU average
Reinvestment (c)		Sales to capital ratio	2.06	RIR =	34.69%	Reinvestment at historical rates
Return on capital	6.31%	Marginal ROIC =	9.72%		6.89%	ROIC climnbs from below to matdh WACC
Cost of capital (d)		6.19% →	6.89%		6.89%	Cost of capital increases slightly over time

The Cash Flows

	Revenues	Operating Margin	EBIT	EBIT (1-t)	Reinvestment	FCFF
1	776 zł	4.48%	34.76 zł	24.24 zł	12.66 zł	11.58 zł
2	803 zł	4.49%	36.02 zł	25.12 zł	13.10 zł	12.02 zł
3	831 zł	4.49%	37.33 zł	26.03 zł	13.56 zł	12.47 zł
4	860 zł	4.50%	38.68 zł	26.98 zł	14.03 zł	12.95 zł
5	889 zł	4.51%	40.09 zł	27.96 zł	14.52 zł	13.44 zł
6	918 zł	4.51%	41.46 zł	29.35 zł	14.08 zł	15.26 zł
7	946 zł	4.52%	42.78 zł	30.73 zł	13.57 zł	17.16 zł
8	973 zł	4.53%	44.05 zł	32.11 zł	12.98 zł	19.13 zł
9	999 zł	4.53%	45.27 zł	33.47 zł	12.32 zł	21.15 zł
10	1,022 zł	4.54%	46.42 zł	34.81 zł	11.58 zł	23.23 zł
Terminal year	1,047 zł	4.54%	47.53 zł	35.64 zł	12.36 zł	23.28 zł

The Value

Terminal value	517.34 zł		
PV(Terminal value)	278.25 zł		
PV (CF over next 10 years)	110.37 zł		
Value of operating assets =	388.62 zł		
Adjustment for distress	0.00 zł	Probability of failure =	0.00%
- Debt & Mnority Interests	183.39 zł		
+ Cash & Other Non-operating assets	22.39 zł		
Value of equity	227.62 zł		
- Value of equity options	0.00 zł		
Number of shares	38.40 zł		
Value per share	5.93 zł	Stock was trading at =	3.95 zł

RELATIVE VALUATION (PRICING)

Aswath Damodaran

Relative valuation is pervasive…

- Most asset valuations are relative.
- Most equity valuations on Wall Street are relative valuations.
  - Almost 85% of equity research reports are based upon a multiple and comparables.
  - More than 50% of all acquisition valuations are based upon multiples
  - Rules of thumb based on multiples are not only common but are often the basis for final valuation judgments.
- While there are more discounted cashflow valuations in consulting and corporate finance, they are often relative valuations masquerading as discounted cash flow valuations.
  - The objective in many discounted cashflow valuations is to back into a number that has been obtained by using a multiple.
  - The terminal value in a significant number of discounted cashflow valuations is estimated using a multiple.

The Reasons for the allure…

- "If you think I'm crazy, you should see the guy who lives across the hall"

  Jerry Seinfeld talking about Kramer in a Seinfeld episode

- " A little inaccuracy sometimes saves tons of explanation"

  H.H. Munro

- " If you are going to screw up, make sure that you have lots of company"

  Ex-portfolio manager

Pricing versus Valuation

Drivers of intrinsic value
- Cashflows from existing assets
- Growth in cash flows
- Quality of Growth

Drivers of price
- Market moods & momentum
- Surface stories about fundamentals

Accounting Estimates

Valuation Estimates

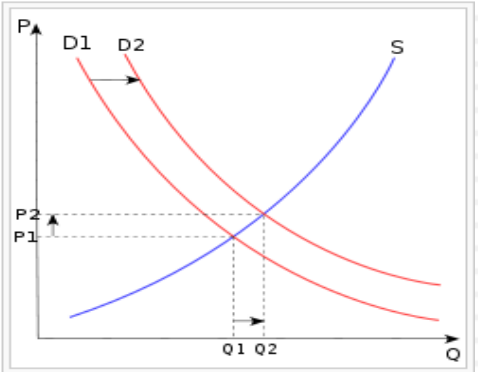
INTRINSIC VALUE

Value

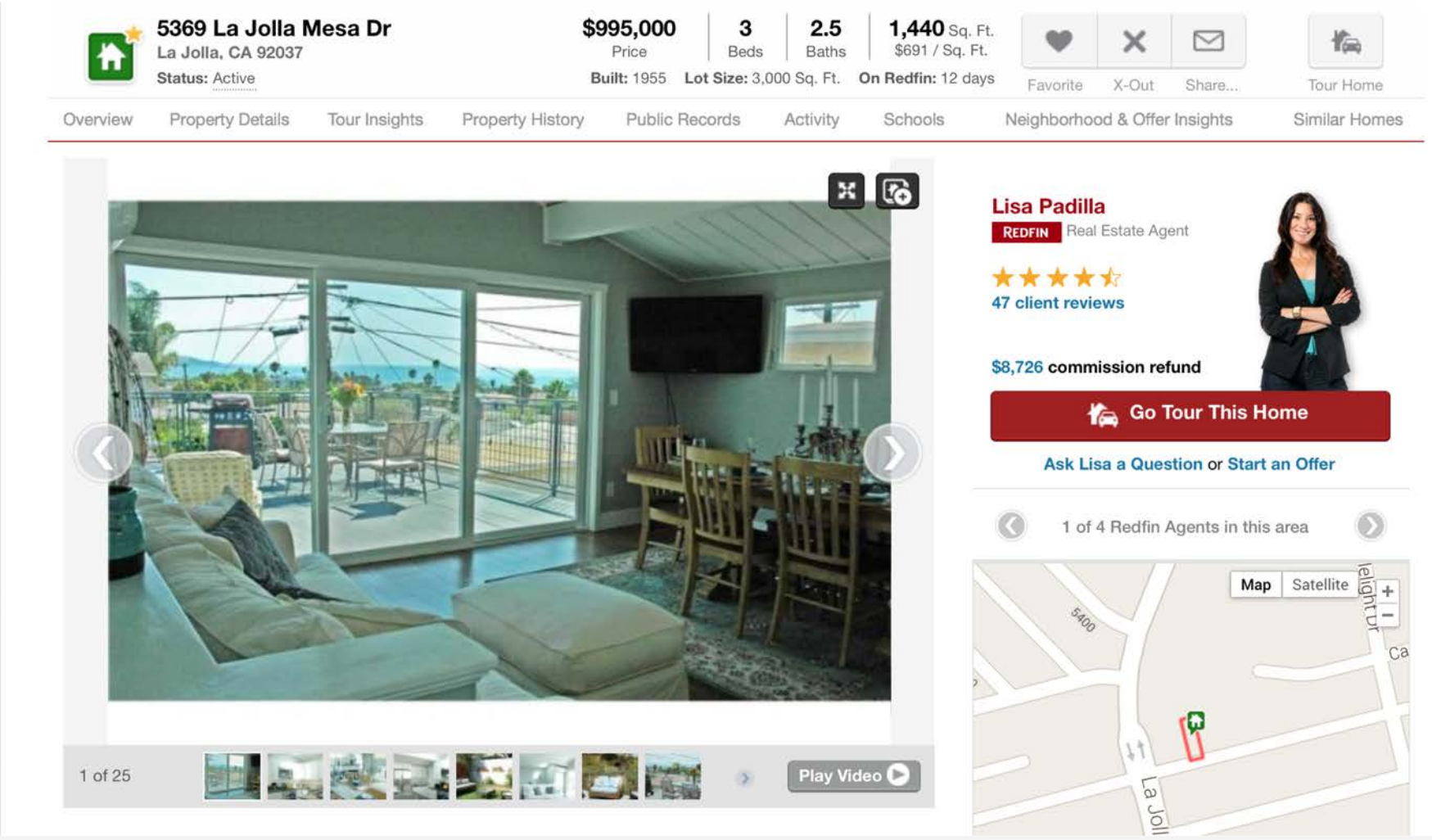
THE GAP
Is there one?
If so, will it close?
If it will close, what will cause it to close?

Price

PRICE



Test 1: Are you pricing or valuing?



Test 2: Are you pricing or valuing?

Europe
Switzerland

Biotechnology
Biotechnology

Reuters	Bloomberg	Exchange	Ticker
BION.S	BION SW	SWX	BION

Price at 12 Aug 2013 (CHF)	124.00
Price Target (CHF)	164.50
52-week range (CHF)	128.40 - 84.90

Strong sector and stock-picking continue

Impressive performance

Over the past two years, BB Biotech shares have roughly tripled, which could tempt investors to take profits. However, this performance has been well backed by a deserved revival of the biotech industry, encouraging fundamental news, M&A, and increased money flow into health care stocks. In addition, BBB returned to index outperformance by modifying its stock-picking approach. Hence, despite excellent performance, the shares still trade at a 23% discount to the net asset value of the portfolio. Hence, the shares are an attractive value vehicle to capture growth opportunities in an attractive sector.

Biotech industry remains attractive

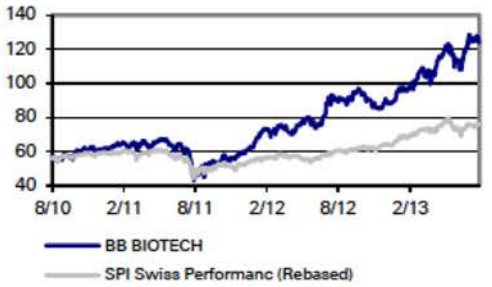
With the re-rating of the pharma sector, investors have also showed increased interest in biotech stocks. Established biotech stocks have delivered encouraging financial results and approvals, while there has also been substantial industry consolidation, which is not surprising in times of "cheap" money and high liquidity. BB Biotech remains an attractive vehicle to capture the future potential of the biotech sector. In addition, investors benefit from a 23% discount to NAV and attractive cash distribution policy of 5% yield p.a. Hence, we reiterate our Buy on BB Biotech shares

Key changes

Target Price 106.50 to 164.50 ↑ 54.5%

Source: Deutsche Bank

Price/price relative



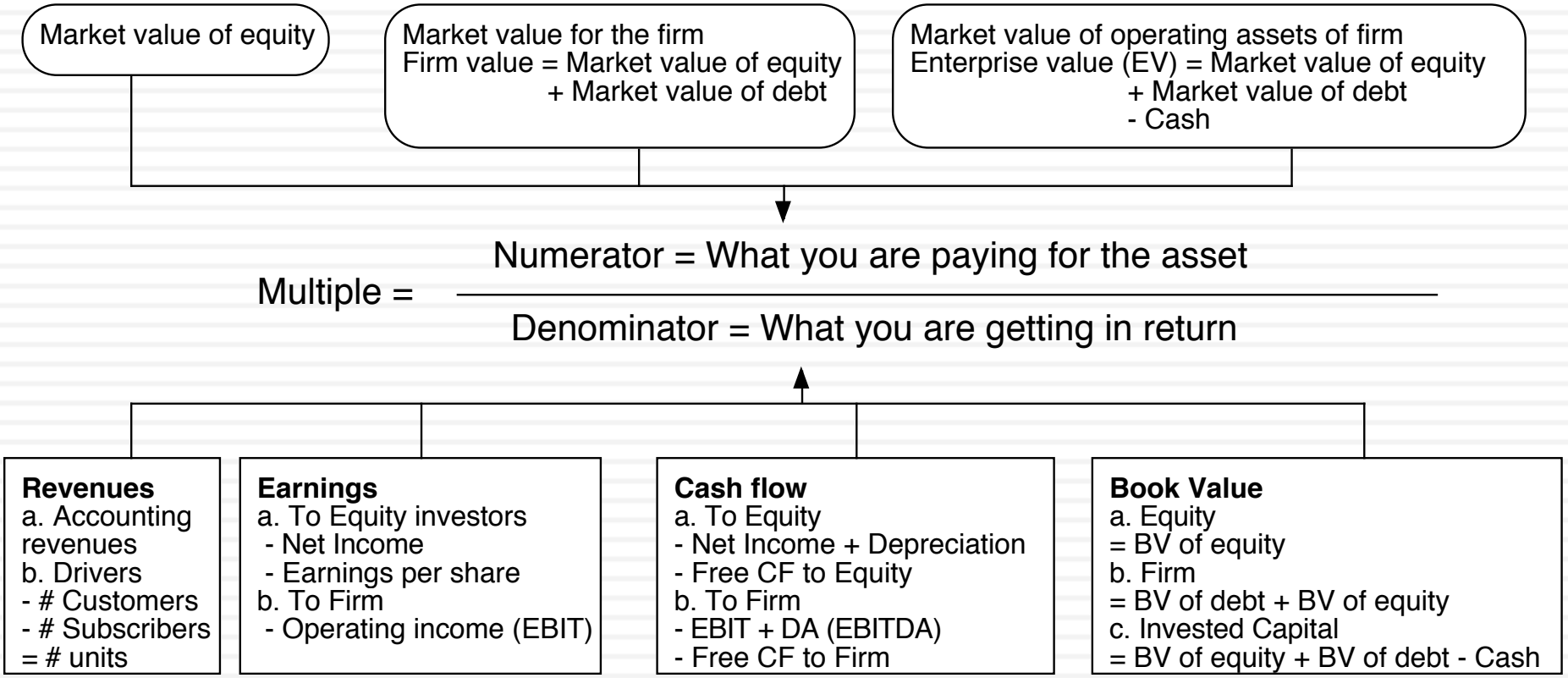
Performance (%)	1m	3m	12m
Absolute	-1.4	5.4	37.4

Test 3: Are you pricing or valuing?

	1	2	3	4	5
EBITDA	$100.00	$120.00	$144.00	$172.80	$207.36
- Depreciation	$20.00	$24.00	$28.80	$34.56	$41.47
EBIT	$80.00	$96.00	$115.20	$138.24	$165.89
- Taxes	$24.00	$28.80	$34.56	$41.47	$49.77
EBIT (1-t)	$56.00	$67.20	$80.64	$96.77	$116.12
+ Depreciation	$20.00	$24.00	$28.80	$34.56	$41.47
- Cap Ex	$50.00	$60.00	$72.00	$86.40	$103.68
- Chg in WC	$10.00	$12.00	$14.40	$17.28	$20.74
FCFF	$16.00	$19.20	$23.04	$27.65	$33.18
Terminal Value					$1,658.88
Cost of capital	8.25%	8.25%	8.25%	8.25%	8.25%
Present Value	$14.78	$16.38	$18.16	$20.14	$1,138.35

Value of operating assets today	$1,207.81
+ Cash	$125.00
- Debt	$200.00
Value of equity	**$1,132.81**

The tool for pricing: A multiple



The Pricing Game: Choices

Measure	Choices	Considerations/ Questions
Value	Enterprise, Equity or Firm Value?	1. Is this a financial service business? 2. Are there big differences in leverage?
Scalar	Revenues, Earnings, Cash Flows or Book Value?	1. How are you measuring value? 2. Is the scaling number positive? 3. How (and how much) do accounting choices affect the scaling measure?
Timing & Normalizing	Current, Trailing, Forward or Really Forward?	1. Where are you in the life cycle? 2. How much cyclicality is there in the number? 3. Can you get forecasted values?
Comparable	What is your peer group? (Global or local? Similar size or all firms? …)	1. How much do companies share in common globally? 2. Does company size affect business economics? 3. How big a sample of firms do you need? 4. How do you plan to control for differences?

The Four Steps to Deconstructing Multiples

- Define the multiple
  - In use, the same multiple can be defined in different ways by different users. When comparing and using multiples, estimated by someone else, it is critical that we understand how the multiples have been estimated
- Describe the multiple
  - Too many people who use a multiple have no idea what its cross sectional distribution is. If you do not know what the cross sectional distribution of a multiple is, it is difficult to look at a number and pass judgment on whether it is too high or low.
- Analyze the multiple
  - It is critical that we understand the fundamentals that drive each multiple, and the nature of the relationship between the multiple and each variable.
- Apply the multiple
  - Defining the comparable universe and controlling for differences is far more difficult in practice than it is in theory.

Definitional Tests

- Is the multiple consistently defined?
  - Proposition 1: Both the value (the numerator) and the standardizing variable (the denominator) should be to the same claimholders in the firm. In other words, the value of equity should be divided by equity earnings or equity book value, and firm value should be divided by firm earnings or book value.
- Is the multiple uniformly estimated?
  - The variables used in defining the multiple should be estimated uniformly across assets in the "comparable firm" list.
  - If earnings-based multiples are used, the accounting rules to measure earnings should be applied consistently across assets. The same rule applies with book-value based multiples.

Example 1: Price Earnings Ratio: Definition

PE = Market Price per Share / Earnings per Share

- There are a number of variants on the basic PE ratio in use. They are based upon how the price and the earnings are defined.

Price: is usually the current price

is sometimes the average price for the year

EPS: EPS in most recent financial year

EPS in trailing 12 months (Trailing PE)

Forecasted EPSnnext year (Forward PE)

Forecasted EPS in future year

Example 2: Enterprise Value /EBITDA Multiple

- The enterprise value to EBITDA multiple is obtained by netting cash out against debt to arrive at enterprise value and dividing by EBITDA.

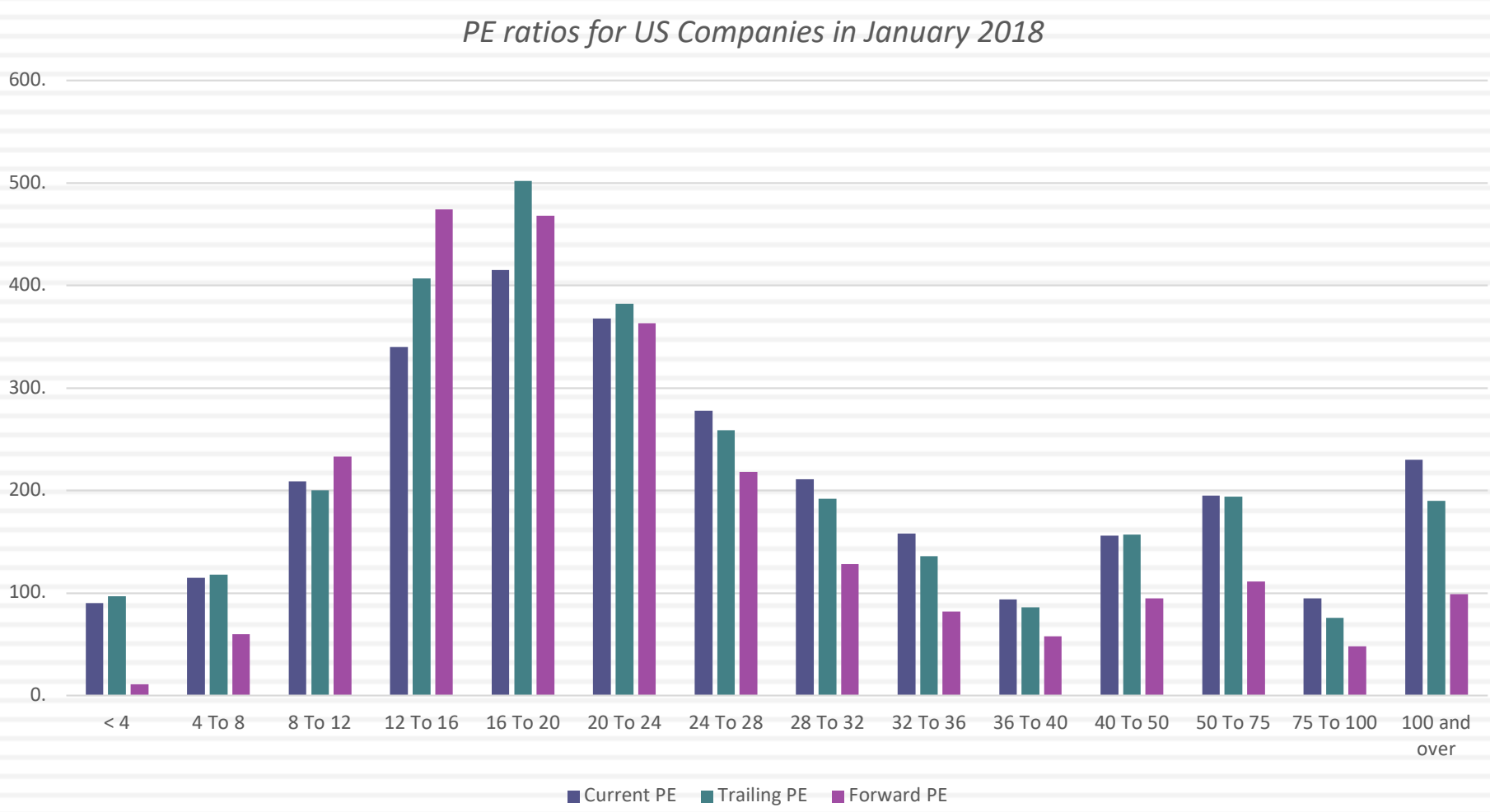
$$\frac{\text{Enterprise Value}}{\text{EBITDA}} = \frac{\text{Market Value of Equity} + \text{Market Value of Debt} - \text{Cash}}{\text{Earnings before Interest, Taxes and Depreciation}}$$

- Why do we net out cash from firm value?
- What happens if a firm has cross holdings which are categorized as:
  - Minority interests?
  - Majority active interests?

Descriptive Tests

- What is the average and standard deviation for this multiple, across the universe (market)?
- What is the median for this multiple?
  - The median for this multiple is often a more reliable comparison point.
- How large are the outliers to the distribution, and how do we deal with the outliers?
  - Throwing out the outliers may seem like an obvious solution, but if the outliers all lie on one side of the distribution (they usually are large positive numbers), this can lead to a biased estimate.
- Are there cases where the multiple cannot be estimated? Will ignoring these cases lead to a biased estimate of the multiple?
- How has this multiple changed over time?

1. Multiples have skewed distributions…



2. Making statistics "dicey"

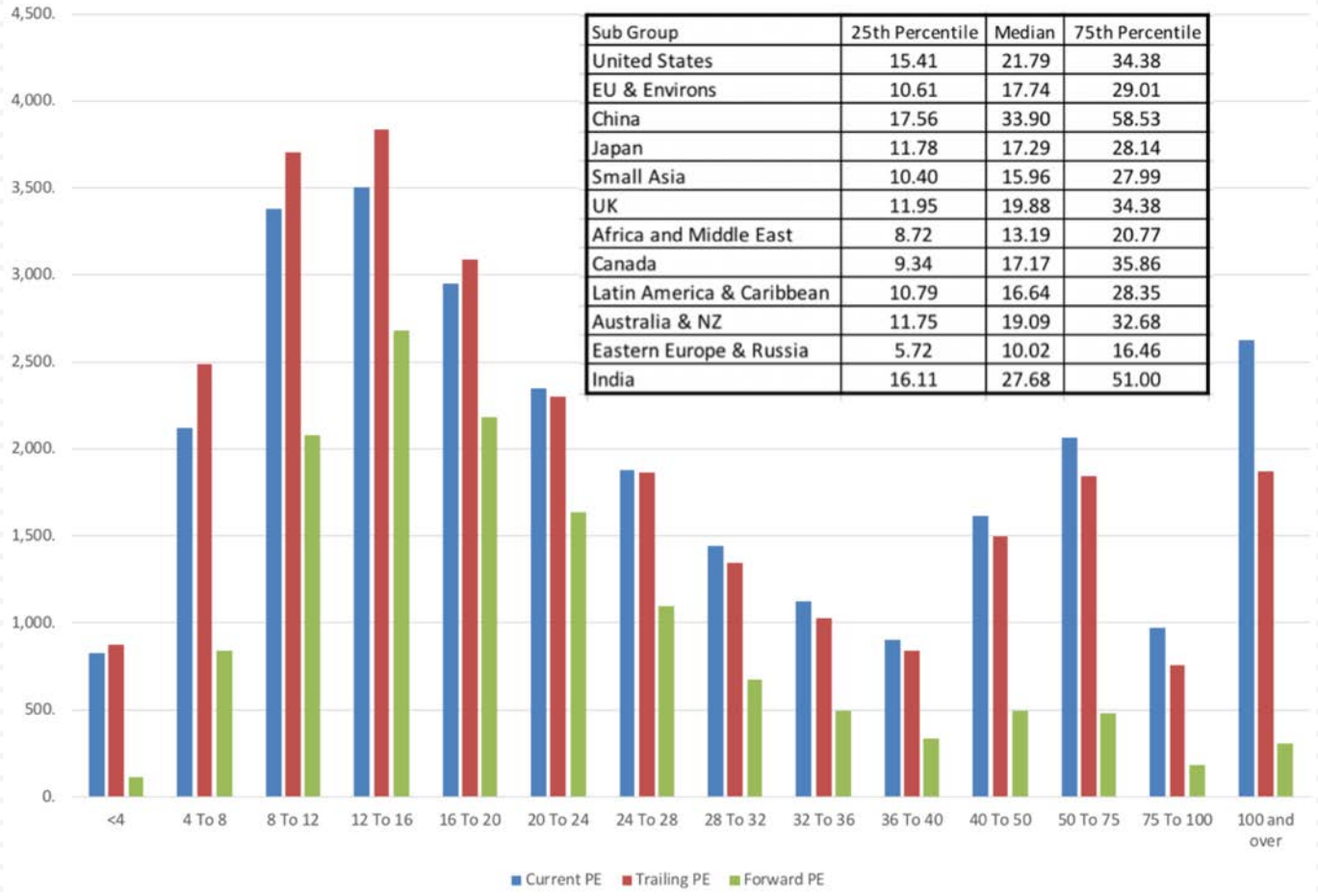
	Current PE	Trailing PE	Forward PE
Number of firms	7,247	7,247	7,247
Number with PE	2,955	2,958	2,448
Average	71.28	65.33	41.75
Median	23.13	21.79	19.76
Minimum	0.05	0.07	0.3
Maximum	21,560	10,333	9,087
Standard deviation	491.39	401.07	251.2
Standard error	9.03	7.33	5.08
Skewness	80.51	73.51	80.08
25th percentile	15.86	15.41	14.86
75th percentile	37.22	34.38	28.19

US firms in January 2018

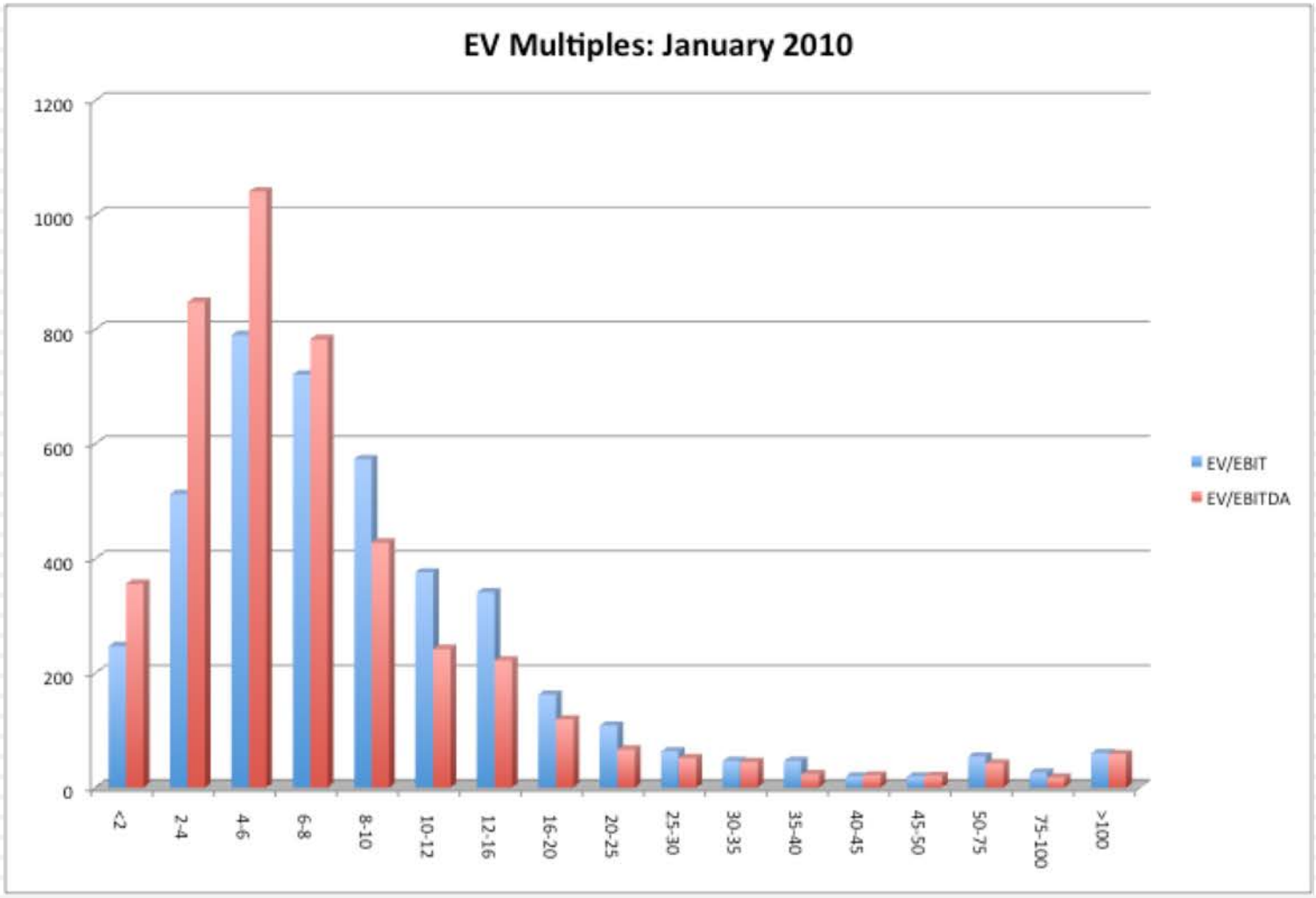
3. Markets have a lot in common : Comparing Global PEs

PE ratios across the globe on January 1, 2018

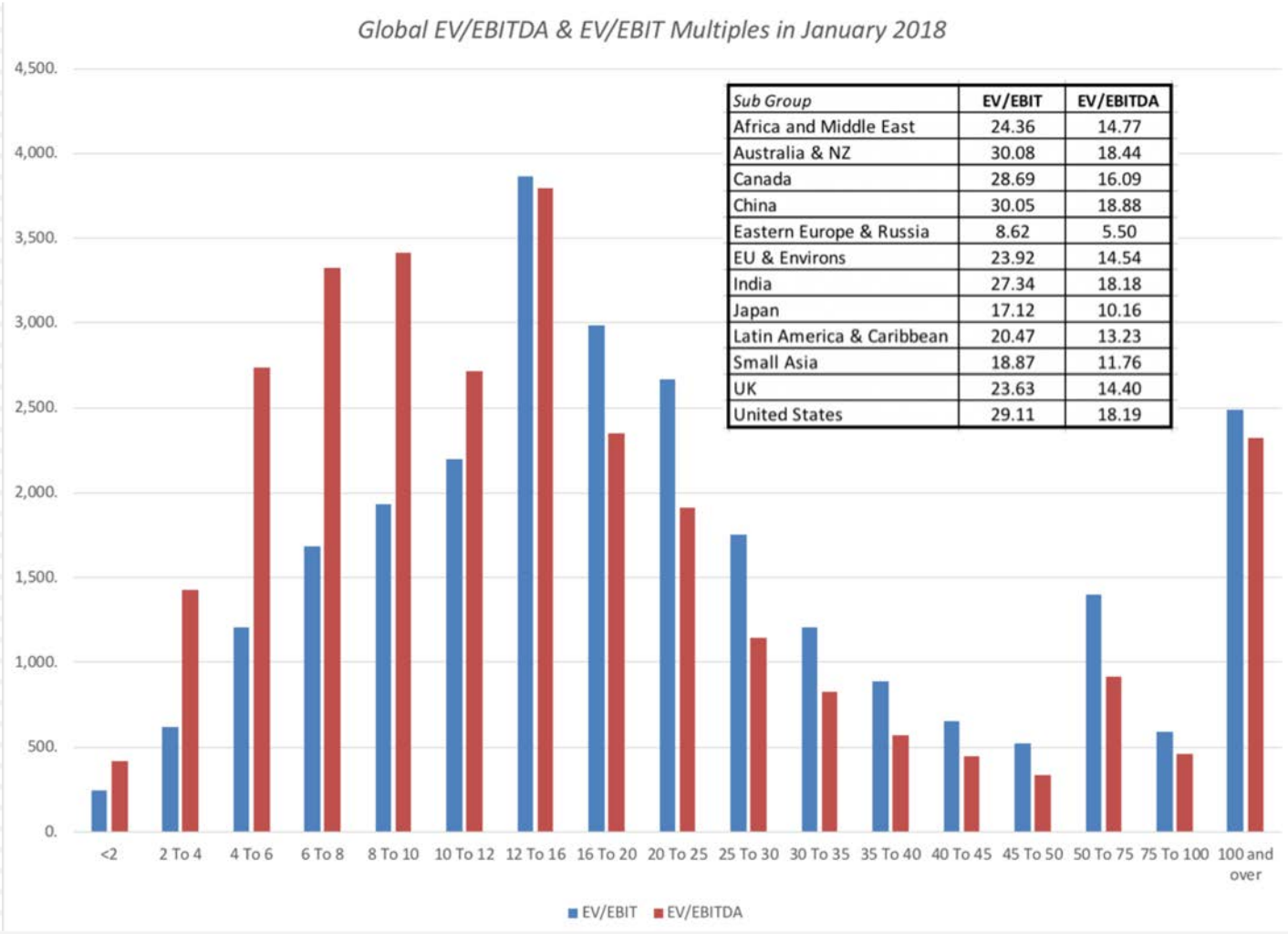
Sub Group	25th Percentile	Median	75th Percentile
United States	15.41	21.79	34.38
EU & Environs	10.61	17.74	29.01
China	17.56	33.90	58.53
Japan	11.78	17.29	28.14
Small Asia	10.40	15.96	27.99
UK	11.95	19.88	34.38
Africa and Middle East	8.72	13.19	20.77
Canada	9.34	17.17	35.86
Latin America & Caribbean	10.79	16.64	28.35
Australia & NZ	11.75	19.09	32.68
Eastern Europe & Russia	5.72	10.02	16.46
India	16.11	27.68	51.00



4. Simplistic rules almost always break down…6 times EBITDA may not be cheap…



But it may be in 2018, unless you are in Russia!



Sub Group	EV/EBIT	EV/EBITDA
Africa and Middle East	24.36	14.77
Australia & NZ	30.08	18.44
Canada	28.69	16.09
China	30.05	18.88
Eastern Europe & Russia	8.62	5.50
EU & Environs	23.92	14.54
India	27.34	18.18
Japan	17.12	10.16
Latin America & Caribbean	20.47	13.23
Small Asia	18.87	11.76
UK	23.63	14.40
United States	29.11	18.19

Analytical Tests

- What are the fundamentals that determine and drive these multiples?
  - Proposition 2: Embedded in every multiple are all of the variables that drive every discounted cash flow valuation - growth, risk and cash flow patterns.
  - In fact, using a simple discounted cash flow model and basic algebra should yield the fundamentals that drive a multiple
- How do changes in these fundamentals change the multiple?
  - The relationship between a fundamental (like growth) and a multiple (such as PE) is seldom linear. For example, if firm A has twice the growth rate of firm B, it will generally not trade at twice its PE ratio
  - Proposition 3: It is impossible to properly compare firms on a multiple, if we do not know the nature of the relationship between fundamentals and the multiple.

A Simple Analytical device

	Start with a basic intrinsic value model	*Divide both sides of the equation by the denominator of the multiple that you are trying to deconstruct,.*	You should end up with an intrinsic version of your multiple, which should relate it to fundamentals.
If Equity Multiple	Start with a dividend or FCFE model, preferably simple. Price= EPS * Payout / (r -g)	Divide your dividend or FCFE model by denominator of equity multiple. Prtce/Book = ROE * Payout / (r -g)	Intrinsic version of equity multiple, with drivers of value Price/Book = f(ROE, r, g, Payout)
If EV Multiple	Start with a operating asset value model, preferably simple. EV= EBIT (1-t) (1- RIR)/ (WACC -g)	Divide your operating asset model by denominator of EV multiple. EV/Sales = After-tax Operating Margin (1- RIR)/ (WACC -g)	Intrinsic version of EV multiple, with drivers of value EV/Sales = f(After-tax Operating Margin, RIR, WACC, g)

PE Ratio: Understanding the Fundamentals

- To understand the fundamentals, start with a basic equity discounted cash flow model.
- With the dividend discount model,

$$P_0 = \frac{DPS_1}{r - g_n}$$

- Dividing both sides by the current earnings per share,

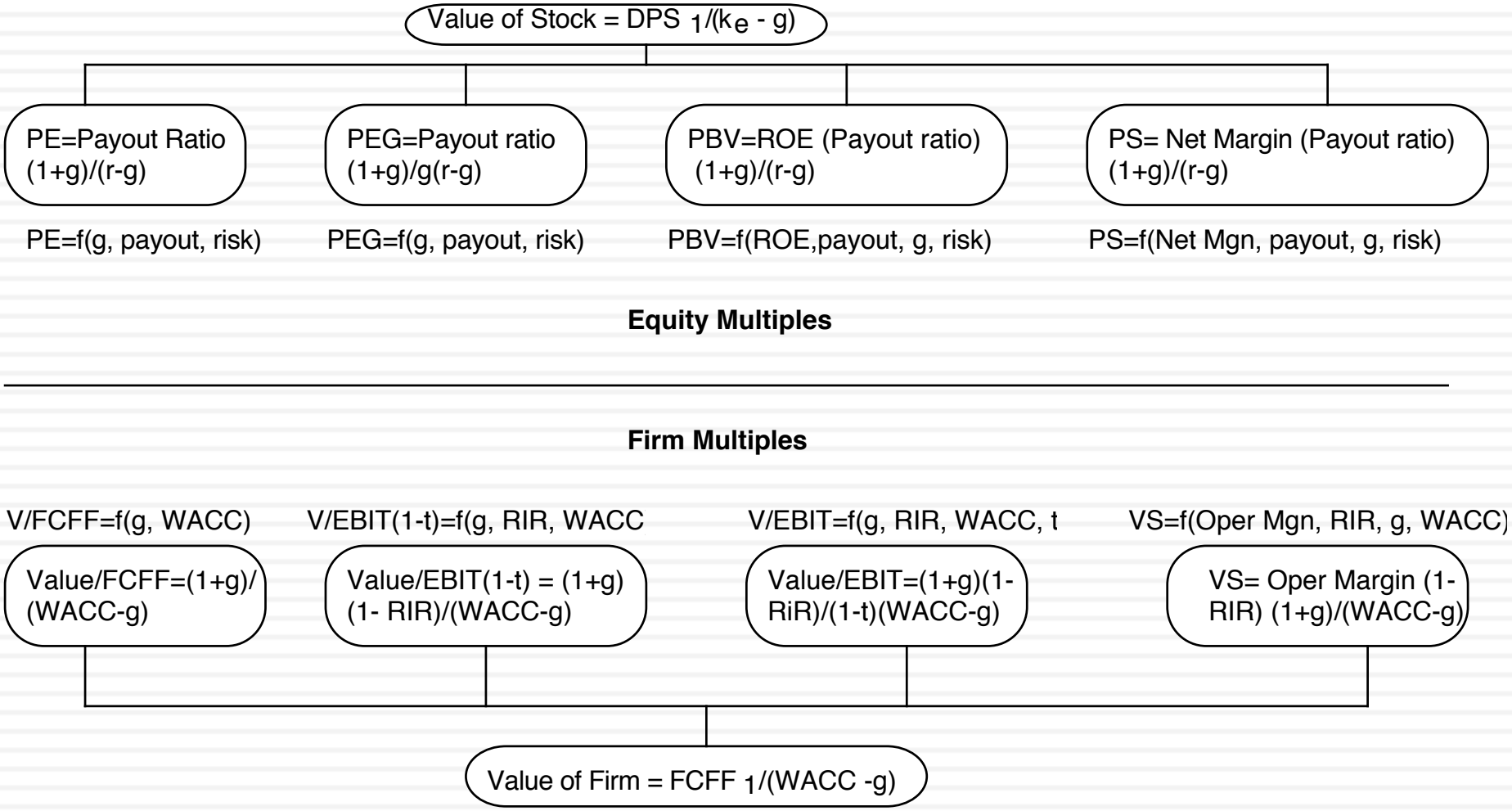
$$\frac{P_0}{EPS_0} = PE = \frac{\text{Payout Ratio} * (1 + g_n)}{r - g_n}$$

- If this had been a FCFE Model,

$$P_0 = \frac{FCFE_1}{r - g_n}$$

$$\frac{P_0}{EPS_0} = PE = \frac{(FCFE/Earnings) * (1 + g_n)}{r - g_n}$$

The Determinants of Multiples…



Application Tests

- Given the firm that you are valuing, what is a "comparable" firm?
  - While traditional analysis is built on the premise that firms in the same sector are comparable firms, valuation theory would suggest that a comparable firm is one which is similar to the one being analyzed in terms of fundamentals.
  - Proposition 4: There is no reason why a firm cannot be compared with another firm in a very different business, if the two firms have the same risk, growth and cash flow characteristics.
- Given the comparable firms, how do you adjust for differences across firms on the fundamentals?
  - Proposition 5: It is impossible to find an exactly identical firm to the one you are valuing.

An Example: Comparing PE Ratios across a Sector: PE

Company Name	PE	Growth
PT Indosat ADR	7.8	0.06
Telebras ADR	8.9	0.075
Telecom Corporation of New Zealand ADR	11.2	0.11
Telecom Argentina Stet - France Telecom SA ADR B	12.5	0.08
Hellenic Telecommunication Organization SA ADR	12.8	0.12
Telecomunicaciones de Chile ADR	16.6	0.08
Swisscom AG ADR	18.3	0.11
Asia Satellite Telecom Holdings ADR	19.6	0.16
Portugal Telecom SA ADR	20.8	0.13
Telefonos de Mexico ADR L	21.1	0.14
Matav RT ADR	21.5	0.22
Telstra ADR	21.7	0.12
Gilat Communications	22.7	0.31
Deutsche Telekom AG ADR	24.6	0.11
British Telecommunications PLC ADR	25.7	0.07
Tele Danmark AS ADR	27	0.09
Telekomunikasi Indonesia ADR	28.4	0.32
Cable & Wireless PLC ADR	29.8	0.14
APT Satellite Holdings ADR	31	0.33
Telefonica SA ADR	32.5	0.18
Royal KPN NV ADR	35.7	0.13
Telecom Italia SPA ADR	42.2	0.14
Nippon Telegraph & Telephone ADR	44.3	0.2
France Telecom SA ADR	45.2	0.19
Korea Telecom ADR	71.3	0.44

PE, Growth and Risk

- Dependent variable is: PE
- R squared = 66.2% R squared (adjusted) = 63.1%

Variable	*Coefficient*	*SE*	*t-ratio*	*Probability*
Constant	13.1151	3.471	3.78	0.0010
Growth rate	121.223	19.27	6.29	≤ 0.0001
Emerging Market	-13.853	3.606	-3.84	0.0009

Emerging Market is a dummy: 1 if emerging market

0 if not

- Is Indosat cheap?

PE = 13.13 + 121.22 (.06) -13.85 (1) = 6.55

At 7.8 times earnings, Indosat is over valued.

Ergis: Priced against East European Packaging/Chemical Companies

Country	# Firms	PE	PBV	EV/EBITDA	EV/Sales	EV/Invested Capital
Croatia	1	NA	NA	NA	0.44	1.67
Czech Republic	1	10.44	1.29	6.08	0.47	1.34
Poland	17	15.17	1.15	6.35	0.79	1.14
Romania	2	1.28	0.34	8.18	0.62	1.40
Russia	7	9.41	1.43	5.91	1.57	1.09
Serbia	1	8.49	1.08	4.76	1.33	1.12
East Europe	43	13.55	1.70	9.91	1.07	1.37
Ergis		7.05	0.70	5.52	0.41	0.83
vs Polish		-53.55%	-39.37%	-13.11%	-47.76%	-27.35%
vs East Europe		-47.98%	-58.97%	-44.33%	-61.38%	-39.44%

Controlling for Differences?

- There are clear differences in fundamentals across building supplies companies, especially when it comes to margins and ROE, which may explain variation in pricing multiples. For instance,
  - Ergis has an operating margin of 4.43%, much lower than the margins for other Polish companies (6.84%) and other SE Asian food companies (9.22%)
  - Ergis also has a return on capital of 6.22%, much lower than the ROIC for other Polish companies (8.57%) and other SE Asian food companies (9.31%)
- Regressing EV/Sales against Operating Margin, for instance:
  - EV/Sales = 0.81 + 2.74 Op Mgn R^2 = 11.5%
- Plugging in Ergis's margin (4.43%) into the regression, we get:

  EV/Sales = 0.81 + 2.74 (.0443) = 0.93

  At 0.41 times sales, Ergis looks significantly under priced (by about 60%) against other East European packaging/chemical firms.

Comparisons to the entire market: Why not?

- In contrast to the 'comparable firm' approach, the information in the entire cross-section of firms can be used to predict PE ratios.
- The simplest way of summarizing this information is with a multiple regression, with the PE ratio as the dependent variable, and proxies for risk, growth and payout forming the independent variables.

PE Ratio: Standard Regression for US stocks - January 2018

Model Summary[a,c,d]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.611[b]	.373	.372	2322.83634

a. Broad Group = United States

b. Predictors: (Constant), Expected growth rate in EPS- Next 5 years, Payout ratio, Beta

c. Dependent Variable: Trailing PE

d. Weighted Least Squares Regression - Weighted by Market Cap (in US $)

The regression is run with growth and payout entered as decimals, i.e., 25% is entered as 0.25)

Coefficients[a,b,c]

Model		Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Standardized Coefficients Beta	t	Sig.
1	(Constant)	5.905	1.567		3.767	.000
	Beta	1.637	1.546	.023	1.059	.290
	Payout ratio	17.434	.826	.448	21.115	.000
	Expected growth rate in EPS- Next 5 years	113.715	5.324	.439	21.359	.000

a. Broad Group = United States

b. Dependent Variable: Trailing PE

c. Weighted Least Squares Regression - Weighted by Market Cap (in US $)

PE ratio regressions across markets – January 2018

Region	Regression – January 2017	R^2
US	PE = 5.91 + 1.64 Beta + 17.43 Payout + 113.72 g_{EPS}	37,2%
Europe	PE = 17.68 – 2.08 Beta + 12.55 Payout + 21.98 g_{EPS}	23.6%
Japan	PE = 14.62 – 1.83 Beta + 23.37 Payout + 14.06 g_{EPS}	16.8%
Emerging Markets	PE = 16.36 – 1.44 Beta + 5.33 Payout + 50.15 g_{EPS}	24.5%
Australia, NZ, Canada	PE = 17.05 – 3.89 Beta + 14.05 Payout + 22.70 g_{EPS}	13.6%
Global	PE = 17.46 – 2.74 Beta + 13.32 Payout + 44.37 g_{EPS}	23.2%

g_{EPS}=Expected Growth: Expected growth in EPS or Net Income: Next 5 years
Beta: Regression or Bottom up Beta
Payout ratio: Dividends/ Net income from most recent year. Set to zero, if net income < 0

Choosing Between the Multiples

- As presented in this section, there are dozens of multiples that can be potentially used to value an individual firm.
- In addition, relative valuation can be relative to a sector (or comparable firms) or to the entire market (using the regressions, for instance)
- Since there can be only one final estimate of value, there are three choices at this stage:
  - Use a simple average of the valuations obtained using a number of different multiples
  - Use a weighted average of the valuations obtained using a nmber of different multiples
  - Choose one of the multiples and base your valuation on that multiple

Picking one Multiple

- This is usually the best way to approach this issue. While a range of values can be obtained from a number of multiples, the "best estimate" value is obtained using one multiple.
- The multiple that is used can be chosen in one of two ways:
  - Use the multiple that best fits your objective. Thus, if you want the company to be undervalued, you pick the multiple that yields the highest value.
  - Use the multiple that has the highest R-squared in the sector when regressed against fundamentals. Thus, if you have tried PE, PBV, PS, etc. and run regressions of these multiples against fundamentals, use the multiple that works best at explaining differences across firms in that sector.
  - Use the multiple that seems to make the most sense for that sector, given how value is measured and created.

Conventional usage…

Sector	Multiple Used	Rationale
Cyclical Manufacturing	PE, Relative PE	Often with normalized earnings
Growth firms	PEG ratio	Big differences in growth rates
Young growth firms w/ losses	Revenue Multiples	What choice do you have?
Infrastructure	EV/EBITDA	Early losses, big DA
REIT	P/CFE (where CFE = Net income + Depreciation)	Big depreciation charges on real estate
Financial Services	Price/ Book equity	Marked to market?
Retailing	Revenue multiples	Margins equalize sooner or later

A closing thought…