Some Initial Thoughts

- "One hundred thousand lemmings cannot be wrong"

Graffiti
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

- **Discounted cashflow valuation**, relates the value of an asset to the present value of expected future cashflows on that asset.

- **Relative valuation**, estimates the value of an asset by looking at the pricing of 'comparable' assets relative to a common variable like earnings, cashflows, 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 an asset is the present value of the expected cash flows on that asset, over its expected life:

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

- Proposition 1: If “it” does not affect the cash flows or alter risk (thus changing discount rates), “it” cannot affect value.

- Proposition 2: For an asset to have value, the expected cash flows have to be positive some time over the life of the asset.

- Proposition 3: 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

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existing Investments</td>
<td>Debt</td>
</tr>
<tr>
<td>Generate cashflows today</td>
<td>Fixed Claim on cash flows</td>
</tr>
<tr>
<td></td>
<td>Little or No role in management</td>
</tr>
<tr>
<td></td>
<td>Fixed Maturity</td>
</tr>
<tr>
<td></td>
<td>Tax Deductible</td>
</tr>
<tr>
<td>Includes long lived (fixed) and short-lived (working capital) assets</td>
<td>Equity</td>
</tr>
<tr>
<td></td>
<td>Residual Claim on cash flows</td>
</tr>
<tr>
<td></td>
<td>Significant Role in management</td>
</tr>
<tr>
<td></td>
<td>Perpetual Lives</td>
</tr>
</tbody>
</table>

**Expected Value that will be created by future investments**

**Growth Assets**

**Assets in Place**

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

Figure 5.5: Equity Valuation

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets in Place</td>
<td>Debt</td>
</tr>
<tr>
<td>Growth Assets</td>
<td>Equity</td>
</tr>
</tbody>
</table>

Cash flows considered are cash flows from assets, after debt payments and after making reinvestments needed for future growth.

Discount rate reflects only the cost of raising equity financing.

Present value is value of just the equity claims on the firm.
**Figure 5.6: Firm Valuation**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets in Place</td>
<td>Debt</td>
</tr>
<tr>
<td>Growth Assets</td>
<td>Equity</td>
</tr>
</tbody>
</table>

Cash flows considered are cashflows from assets, prior to any debt payments but after firm has reinvested to create growth assets.

Discount rate reflects the cost of raising both debt and equity financing, in proportion to their use.

Present value is value of the entire firm, and reflects the value of all claims on the firm.
The Drivers of Value...

Current Cashflows
These are the cash flows from existing investment(s), net of any reinvestment needed to sustain future growth. They can be computed before debt cashflows (to the firm) or after debt cashflows (to equity investors).

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

Efficiency Growth
Growth generated by using existing assets better

Expected Growth during high growth period

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

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

Terminal Value of firm (equity)
Stable growth firm, with no or very limited excess returns
Cashflow to Firm
EBIT (1-t)
- (Cap Ex - Depr)
- Change in WC
= FCFF

Expected Growth
Reinvestment Rate
* Return on Capital

Firm is in stable growth: Grows at constant rate forever

Terminal Value = FCFF_{n+1}/(r-g_n)

Expected Growth
Reinvestment Rate
* Return on Capital

Discount at WACC = Cost of Equity (Equity/(Debt + Equity)) + Cost of Debt (Debt/(Debt + Equity))

Cost of Equity

Cost of Debt
(Riskfree Rate + Default Spread) (1-t)

Weights
Based on Market Value

Riskfree Rate:
- No default risk
- No reinvestment risk
- In same currency and in same terms (real or nominal as cash flows)

Risk Premium
- Premium for average risk investment

Beta
- Measures market risk

Type of Business
Operating Leverage
Financial Leverage
Base Equity Premium
Country Risk Premium

Value of Operating Assets + Cash & Non-op Assets = Value of Firm
- Value of Debt = Value of Equity
Current Cashflow to Firm

EBIT(1-t) = \(0.7336(1-0.28) = 0.6058\)
- Nt CpX = 6443
- Chg WC = 37
= FCFF = 6400 - 423
Reinvestment Rate = 6480/6058 = 106.98%
Return on capital = 16.71%

Expected Growth in EBIT (1-t)

\(0.60 \times 0.16 = 0.096\) or 9.6%

Return on capital = 16%

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

\(\frac{7300}{0.0808 - 0.04} = 179,099\)

Cost of Capital (WACC)

\(11.7\% (0.90) + 3.68\% (0.10) = 10.90\%\)

Cost of Equity

11.70%

Cost of Debt

\((4.78\% + 0.85\%)(1 - 0.35) = 3.66\%\)

Weights

E = 90%; D = 10%

Riskfree Rate:

Riskfree rate = 4.78%

Beta

1.73

Risk Premium

4%

Unlevered Beta for Sectors: 1.59

D/E = 11.06%

On May 1, 2007, Amgen was trading at $55/share
Tata Motors: April 2010

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%

Expected Growth from new inv.
.70*.1716=0.1201

Reinvestment Rate 70%

Return on Capital

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 Value5= 23493/(.1039-.05) = Rs 435,686

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

Op. Assets Rs210,813
- Cash: 11418
- Other NO 140576
- Debt 109198
=Equity 253,628
Value/Share Rs 614

Cost of Equity 14.00%

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

Weights
E = 74.7% D = 25.3%

Riskfree Rate: Rs Riskfree Rate= 5%

Beta 1.20

Mature market premium 4.5%

Lambda 0.80

Country Default Spread 3%

Country Equity Risk Premium 4.50%

Hei Equity Mkt Vol 1.50

On April 1, 2010
Tata Motors price = Rs 781
IA. ESTIMATING DISCOUNT RATES
Risk in the DCF Model

*Expectation of cash flows across all scenarios, good and bad. Incorporates all risks that affect the asset/business.*

\[
\text{Expected Cash Flows} = \frac{\text{Risk Adjusted Discount Rate}}{}
\]

*Discount rate should reflect the risk perceived by the marginal investor in the company*

\[
\text{Risk Adjusted Cost of equity} = \text{Risk free rate in the currency of analysis} + \text{Relative risk of company/equity in question} \times \text{Equity Risk Premium required for average risk equity}
\]

Aswath Damodaran
Not all risk is created equal...

- **Estimation versus Economic uncertainty**
  - Estimation uncertainty reflects the possibility that you could have the “wrong model” or estimated inputs incorrectly within this model.
  - Economic uncertainty comes the fact that markets and economies can change over time and that even the best models will fail to capture these unexpected changes.

- **Micro uncertainty versus Macro uncertainty**
  - Micro uncertainty refers to uncertainty about the potential market for a firm’s products, the competition it will face and the quality of its management team.
  - Macro uncertainty reflects the reality that your firm’s fortunes can be affected by changes in the macro economic environment.

- **Discrete versus continuous uncertainty**
  - Discrete risk: Risks that lie dormant for periods but show up at points in time. (Examples: A drug working its way through the FDA pipeline may fail at some stage of the approval process or a company in Venezuela may be nationalized)
  - Continuous risk: Risks changes in interest rates or economic growth occur continuously and affect value as they happen.
Risk and Cost of Equity: The role of the marginal investor

- While the notion that the cost of equity should be higher for riskier investments and lower for safer investments is intuitive, what risk should be built into the cost of equity is the question.

- While risk is usually defined in terms of the variance of actual returns around an expected return, risk and return models in finance assume that the risk that should be rewarded (and thus built into the discount rate) in valuation should be the risk perceived by the marginal investor in the investment.

- Most risk and return models in finance also assume that the marginal investor is well diversified, and that the only risk that he or she perceives in an investment is risk that cannot be diversified away (i.e., market or non-diversifiable risk). In effect, it is primarily economic, macro, continuous risk that should be incorporated into the cost of equity.
## The Cost of Equity: Competing “Market Risk” Models

<table>
<thead>
<tr>
<th>Model</th>
<th>Expected Return</th>
<th>Inputs Needed</th>
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</thead>
<tbody>
<tr>
<td>CAPM</td>
<td>$E(R) = R_f + \beta (R_m - R_f)$</td>
<td>Riskfree Rate</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Beta relative to market portfolio</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Market Risk Premium</td>
</tr>
<tr>
<td>APM</td>
<td>$E(R) = R_f + \sum \beta_j (R_j - R_f)$</td>
<td>Riskfree Rate; # of Factors; Beta relative to each factor</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Factor risk premiums</td>
</tr>
<tr>
<td>Multi factor</td>
<td>$E(R) = R_f + \sum \beta_j (R_j - R_f)$</td>
<td>Riskfree Rate; Macro factors</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Betas relative to macro factors</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Macro economic risk premiums</td>
</tr>
<tr>
<td>Proxy</td>
<td>$E(R) = a + \sum b_j Y_j$</td>
<td>Proxies</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Regression coefficients</td>
</tr>
</tbody>
</table>
The CAPM: Cost of Equity

- Consider the standard approach to estimating cost of equity:
  
  \[
  \text{Cost of Equity} = \text{Riskfree Rate} + \text{Equity Beta} \times (\text{Equity Risk Premium})
  \]

- In practice,
  - Government security rates are used as risk free rates
  - Historical risk premiums are used for the risk premium
  - Betas are estimated by regressing stock returns against market returns
I. A Riskfree Rate

- On a riskfree asset, the actual return is equal to the expected return. Therefore, there is no variance around the expected return.

- For an investment to be riskfree, then, it has to have:
  - No default risk
  - No reinvestment risk

1. **Time horizon matters:** Thus, the riskfree rates in valuation will depend upon when the cash flow is expected to occur and will vary across time.

2. **Not all government securities are riskfree:** Some governments face default risk and the rates on bonds issued by them will not be riskfree.
Test 1: A riskfree rate in US dollars!

- In valuation, we estimate cash flows forever (or at least for very long time periods). The right risk free rate to use in valuing a company in US dollars would be:
  
  a. A three-month Treasury bill rate (0.1%)
  b. A ten-year Treasury bond rate (2%)
  c. A thirty-year Treasury bond rate (3%)
  d. A TIPS (inflation-indexed treasury) rate (1%)
  e. None of the above
Test 2: A Riskfree Rate in Euros

Figure 4: Government Bond Rates in Euros
Test 3: A Riskfree Rate in Indian Rupees

- The Indian government had 10-year Rupee bonds outstanding, with a yield to maturity of about 8.5% on January 1, 2012.

- In January 2012, the Indian government had a local currency sovereign rating of Baa3. The typical default spread (over a default free rate) for Baa3 rated country bonds in early 2012 was 2%. The riskfree rate in Indian Rupees is
  a. The yield to maturity on the 10-year bond (8.5%)
  b. The yield to maturity on the 10-year bond + Default spread (10.5%)
  c. The yield to maturity on the 10-year bond – Default spread (6.5%)
  d. None of the above
Sovereign Default Spread: Three paths to the same destination...

- **Sovereign dollar or euro denominated bonds**: Find sovereign bonds denominated in US dollars, issued by emerging markets. The difference between the interest rate on the bond and the US treasury bond rate should be the default spread. For instance, in January 2012, the US dollar denominated 10-year bond issued by the Brazilian government (with a Baa2 rating) had an interest rate of 3.5%, resulting in a default spread of 1.6% over the US treasury rate of 1.9% at the same point in time. (On the same day, the ten-year Brazilian BR denominated bond had an interest rate of 12%)

- **CDS spreads**: Obtain the default spreads for sovereigns in the CDS market. In January 2012, the CDS spread for Brazil in that market was 1.43%.

- **Average spread**: For countries which don’t issue dollar denominated bonds or have a CDS spread, you have to use the average spread for other countries in the same rating class.
### Local Currency Government Bond Rates – January 2013

<table>
<thead>
<tr>
<th>Country</th>
<th>Jan-13</th>
<th>Jan-12</th>
<th>Country</th>
<th>Jan-13</th>
<th>Jan-12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kenya</td>
<td>13.50%</td>
<td>NA</td>
<td>Poland</td>
<td>3.62%</td>
<td>5.96%</td>
</tr>
<tr>
<td>Nigeria</td>
<td>12.01%</td>
<td>15.27%</td>
<td>China</td>
<td>3.60%</td>
<td>3.44%</td>
</tr>
<tr>
<td>Pakistan</td>
<td>11.50%</td>
<td>13.01%</td>
<td>New Zealand</td>
<td>3.54%</td>
<td>3.81%</td>
</tr>
<tr>
<td>Greece</td>
<td>11.47%</td>
<td>37.09%</td>
<td>Thailand</td>
<td>3.54%</td>
<td>3.29%</td>
</tr>
<tr>
<td>Venezuela</td>
<td>10.05%</td>
<td>12.24%</td>
<td>Malaysia</td>
<td>3.50%</td>
<td>3.69%</td>
</tr>
<tr>
<td>Vietnam</td>
<td>9.84%</td>
<td>NA</td>
<td>Bulgaria</td>
<td>3.43%</td>
<td>5.22%</td>
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<tr>
<td>Brazil</td>
<td>9.18%</td>
<td>11.39%</td>
<td>Latvia</td>
<td>3.39%</td>
<td>6.50%</td>
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<tr>
<td>India</td>
<td>8.00%</td>
<td>8.36%</td>
<td>Australia</td>
<td>3.28%</td>
<td>3.93%</td>
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<tr>
<td>Portugal</td>
<td>6.98%</td>
<td>13.46%</td>
<td>South Korea</td>
<td>3.15%</td>
<td>3.80%</td>
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<tr>
<td>Romania</td>
<td>6.88%</td>
<td>NA</td>
<td>Qatar</td>
<td>2.68%</td>
<td>NA</td>
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<tr>
<td>Russia</td>
<td>6.85%</td>
<td>6.00%</td>
<td>Norway</td>
<td>2.12%</td>
<td>2.29%</td>
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<tr>
<td>Iceland</td>
<td>6.80%</td>
<td>NA</td>
<td>Belgium</td>
<td>2.05%</td>
<td>4.37%</td>
</tr>
<tr>
<td>Peru</td>
<td>6.76%</td>
<td>6.76%</td>
<td>France</td>
<td>1.99%</td>
<td>3.32%</td>
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<tr>
<td>Turkey</td>
<td>6.55%</td>
<td>NA</td>
<td>Czech Republic</td>
<td>1.87%</td>
<td>3.61%</td>
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<tr>
<td>South Africa</td>
<td>6.39%</td>
<td>8.20%</td>
<td>United Kingdom</td>
<td>1.82%</td>
<td>2.05%</td>
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<tr>
<td>Hungary</td>
<td>6.23%</td>
<td>10.73%</td>
<td>Canada</td>
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<tr>
<td>Colombia</td>
<td>5.55%</td>
<td>7.56%</td>
<td>United States</td>
<td>1.76%</td>
<td>1.99%</td>
</tr>
<tr>
<td>Chile</td>
<td>5.51%</td>
<td>5.58%</td>
<td>Austria</td>
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<td>Mexico</td>
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<td>6.51%</td>
<td>Sweden</td>
<td>1.54%</td>
<td>1.71%</td>
</tr>
<tr>
<td>Spain</td>
<td>5.26%</td>
<td>5.43%</td>
<td>Finland</td>
<td>1.51%</td>
<td>2.40%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>5.17%</td>
<td>6.08%</td>
<td>Netherlands</td>
<td>1.50%</td>
<td>2.31%</td>
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<tr>
<td>Slovenia</td>
<td>5.03%</td>
<td>NA</td>
<td>Denmark</td>
<td>1.38%</td>
<td>1.72%</td>
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<tr>
<td>Croatia</td>
<td>4.95%</td>
<td>7.41%</td>
<td>Germany</td>
<td>1.31%</td>
<td>1.92%</td>
</tr>
<tr>
<td>Ireland</td>
<td>4.53%</td>
<td>8.21%</td>
<td>Singapore</td>
<td>1.30%</td>
<td>1.60%</td>
</tr>
<tr>
<td>Italy</td>
<td>4.50%</td>
<td>6.92%</td>
<td>Euro Area</td>
<td>1.26%</td>
<td>NA</td>
</tr>
<tr>
<td>Philippines</td>
<td>4.40%</td>
<td>NA</td>
<td>Taiwan</td>
<td>1.17%</td>
<td>NA</td>
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<tr>
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<td>4.31%</td>
<td>Japan</td>
<td>0.79%</td>
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<tr>
<td>Lithuania</td>
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<td>Hong Kong</td>
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<tr>
<td>Israel</td>
<td>3.91%</td>
<td>4.54%</td>
<td>Switzerland</td>
<td>0.46%</td>
<td>0.71%</td>
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</tbody>
</table>
Approach 1: Default spread from Government Bonds – January 2013

<table>
<thead>
<tr>
<th>Bond</th>
<th>Date</th>
<th>Coupon</th>
<th>Rating S*</th>
<th>Rating M*</th>
<th>Rating F*</th>
<th>Bid Price</th>
<th>Bid yield</th>
<th>Day’s chge yield</th>
<th>Mth’s chge yield</th>
<th>Spread vs US</th>
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<tbody>
<tr>
<td>High Yield US$</td>
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<tr>
<td>HSBC Europe</td>
<td>05/13</td>
<td>7.75</td>
<td>BB</td>
<td>Ba3</td>
<td>BB-</td>
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<td>Kazkommerts Int</td>
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<td>B+</td>
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<td>Bertin</td>
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<td>High Yield Euro</td>
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<tr>
<td>Kazkommerts Int</td>
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<td>B+</td>
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US $ denominated bonds NY close; all other London close. *S* - Standard & Poor’s, M - Moody’s, F - Fitch. Source: ThomsonReuters
## Approach 2: CDS Spreads

![Sovereign CDS Monitor]

<table>
<thead>
<tr>
<th>Name (10Y CDS)</th>
<th>Spd (Ask)</th>
<th>Change</th>
<th>#SD</th>
<th>Low</th>
<th>Avg</th>
<th>Now</th>
<th>High</th>
<th>Avg</th>
<th>+/-</th>
<th>1Y Chg</th>
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Approach 3: Typical Default Spreads: January 2013

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<th>Rating</th>
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<td>Aa1/AA+</td>
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<td>Aa2/AA</td>
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<td>Aa3/AA-</td>
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<tr>
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<tr>
<td>A2/A</td>
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</tr>
<tr>
<td>A3A-</td>
<td>1.15%</td>
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<tr>
<td>Baa1/BBB+</td>
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<tr>
<td>Baa2/BBB</td>
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<tr>
<td>Ba1/BB+</td>
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<tr>
<td>B1/B+</td>
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</tr>
<tr>
<td>B2/B</td>
<td>5.00%</td>
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<tr>
<td>B3/B-</td>
<td>6.00%</td>
</tr>
<tr>
<td>Caa1/CCC+</td>
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<td>Caa2/CCC</td>
<td>8.50%</td>
</tr>
<tr>
<td>Caa3/CCC-</td>
<td>10.00%</td>
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Getting to a risk free rate in a currency: Example

- The Brazilian government bond rate in nominal reais in January 2013 was 9.18%. To get to a riskfree rate in nominal reais, we can use one of three approaches.
  - Approach 1: Government Bond spread
    - The 2020 Brazil bond, denominated in US dollars, has a spread of 0.74% over the US treasury bond rate.
    - Riskfree rate in $R = 9.18% - 0.74% = 8.44%
  - Approach 2: The CDS Spread
    - The CDS spread for Brazil on January 1, 2013 was 1.42%.
    - Riskfree rate in $R = 9.18% - 1.42% = 7.76%
  - Approach 3: The Rating based spread
    - Brazil has a Baa2 local currency rating from Moody’s. The default spread for that rating is 1.75%
    - Riskfree rate in $R = 9.18% - 1.75% = 7.43%
Test 4: A Real Riskfree Rate

- In some cases, you may want a riskfree rate in real terms (in real terms) rather than nominal terms.
- To get a real riskfree rate, you would like a security with no default risk and a guaranteed real return. Treasury indexed securities offer this combination.
- In January 2012, the yield on a 10-year indexed treasury bond was 1.00%. Which of the following statements would you subscribe to?
  a. This (1.00%) is the real riskfree rate to use, if you are valuing US companies in real terms.
  b. This (1.00%) is the real riskfree rate to use, anywhere in the world

Explain.
No default free entity: Choices with riskfree rates....

- Estimate a range for the riskfree rate in local terms:
  - Approach 1: Subtract default spread from local government bond rate:
    Government bond rate in local currency terms - Default spread for Government in local currency
  - Approach 2: Use forward rates and the riskless rate in an index currency (say Euros or dollars) to estimate the riskless rate in the local currency.

- Do the analysis in real terms (rather than nominal terms) using a real riskfree rate, which can be obtained in one of two ways –
  - from an inflation-indexed government bond, if one exists
  - set equal, approximately, to the long term real growth rate of the economy in which the valuation is being done.

- Do the analysis in a currency where you can get a riskfree rate, say US dollars or Euros.
Why do risk free rates vary across currencies? January 2013 Risk free rates
In January 2013, the 10-year treasury bond rate in the United States was 1.76%, a historic low. Assume that you were valuing a company in US dollars then, but were wary about the riskfree rate being too low. Which of the following should you do?

a. Replace the current 10-year bond rate with a more reasonable normalized riskfree rate (the average 10-year bond rate over the last 30 years has been about 4%)

b. Use the current 10-year bond rate as your riskfree rate but make sure that your other assumptions (about growth and inflation) are consistent with the riskfree rate

c. Something else...
II. Equity Risk Premiums
The ubiquitous historical risk premium

- The historical premium is the premium that stocks have historically earned over riskless securities.

- While the users of historical risk premiums act as if it is a fact (rather than an estimate), it is sensitive to
  - How far back you go in history...
  - Whether you use T.bill rates or T.Bond rates
  - Whether you use geometric or arithmetic averages.

- For instance, looking at the US:

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<th>Year Range</th>
<th>Arithmetic Average</th>
<th>Geometric Average</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Stocks - T. Bills</td>
<td>Stocks - T. Bonds</td>
</tr>
<tr>
<td></td>
<td>Stocks - T. Bills</td>
<td>Stocks - T. Bills</td>
</tr>
<tr>
<td>1928-2012</td>
<td>7.65%</td>
<td>5.88%</td>
</tr>
<tr>
<td>1928-2012</td>
<td>2.20%</td>
<td>2.33%</td>
</tr>
<tr>
<td>1962-2012</td>
<td>5.93%</td>
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<td>1962-2012</td>
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<tr>
<td>2002-2012</td>
<td>5.38%</td>
<td>1.71%</td>
</tr>
</tbody>
</table>
The perils of trusting the past......

- **Noisy estimates**: Even with long time periods of history, the risk premium that you derive will have substantial standard error. For instance, if you go back to 1928 (about 80 years of history) and you assume a standard deviation of 20% in annual stock returns, you arrive at a standard error of greater than 2%:

  \[
  \text{Standard Error in Premium} = \frac{20}{\sqrt{80}} = 2.26% 
  \]

- **Survivorship Bias**: Using historical data from the U.S. equity markets over the twentieth century does create a sampling bias. After all, the US economy and equity markets were among the most successful of the global economies that you could have invested in early in the century.

- These problems get exacerbated in emerging markets, where there is far less historical data and survivor bias is worse.
Risk Premium for a Mature Market? Broadening the sample

**Historical ERP - By Country 1900-2010**

- Geometric Mean
- Arithmetic Mean

Countries included:
- Australia
- Belgium
- Canada
- Denmark
- Finland
- France
- Germany
- Ireland
- Italy
- Japan
- Netherlands
- New Zealand
- Norway
- South Africa
- Spain
- Sweden
- Switzerland
- U.K.
- U.S.
- Average without U.S.
- Average with U.S.
The simplest way of estimating an additional country risk premium: The country default spread

- **Default spread for country**: In this approach, the country equity risk premium is set equal to the default spread for the country, estimated in one of three ways:
  - The default spread on a dollar denominated bond issued by the country. Brazil’s 10 year $ denominated bond at the start of 2013 was trading at an interest rate of 2.60%, a default spread of 0.84% over the US treasury bond rate of 1.76%.
  - The ten year CDS spread for Brazil of 1.42%
  - Brazil’s sovereign local currency rating is Baa2. The default spread for a Baa2 rated sovereign is about 1.75%.

- **This default spread is added on to the mature market premium to arrive at the total equity risk premium for Brazil, assuming a mature market premium of 5.80%**.
  - Country Risk Premium for Brazil = 1.75%
  - Total ERP for Brazil = 5.80% + 1.75% = 7.55%
An equity volatility based approach to estimating the country total ERP

This approach draws on the standard deviation of two equity markets, the emerging market in question and a base market (usually the US). The total equity risk premium for the emerging market is then written as:

\[
\text{Total equity risk premium} = \text{Risk Premium}_\text{US} \times \frac{\sigma_{\text{Country Equity}}}{\sigma_{\text{US Equity}}}
\]

The country equity risk premium is based upon the volatility of the market in question relative to U.S market.

- Assume that the equity risk premium for the US is 5.80%.
- Assume that the standard deviation in the Bovespa (Brazilian equity) is 21% and that the standard deviation for the S&P 500 (US equity) is 18%.

- Total Equity Risk Premium for Brazil = 5.80% (21%/18%) = 6.77%
- Country equity risk premium for Brazil = 6.77% - 5.80% = 0.97%
A melded approach to estimating the additional country risk premium

- Country ratings measure default risk. While default risk premiums and equity risk premiums are highly correlated, one would expect equity spreads to be higher than debt spreads.

- Another is to multiply the bond default spread by the relative volatility of stock and bond prices in that market. Using this approach for Brazil in January 2013, you would get:
  - Country Equity risk premium = Default spread on country bond* $\sigma_{\text{Country}}$
  - $\text{Equity} / \sigma_{\text{Country Bond}}$
  - Standard Deviation in Bovespa (Equity) = 21%
  - Standard Deviation in Brazil government bond = 14%
  - Default spread on C-Bond = 1.75%
  - Brazil Country Risk Premium = 1.75% (21%/14%) = 2.63%
  - Brazil Total ERP = Mature Market Premium + CRP = 5.80% + 2.63% = 8.43%
<table>
<thead>
<tr>
<th>Country</th>
<th>Black #: Total ERP</th>
<th>Red #: Country risk premium</th>
<th>AVG: GDP weighted average</th>
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<td>Belarus</td>
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<tr>
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<td>14.80%</td>
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<td>Poland</td>
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<td>E. Europe &amp; Russia</td>
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<td>China</td>
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<td>Fiji Islands</td>
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<td>11.80%</td>
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<td>Hong Kong</td>
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<td>8.80%</td>
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<td>8.80%</td>
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<td>Japan</td>
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<td>6.85%</td>
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<tr>
<td>Korea</td>
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<td>6.85%</td>
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<tr>
<td>Macao</td>
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<td>6.85%</td>
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<td>Malaysia</td>
<td>1.73%</td>
<td>7.53%</td>
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<td>11.80%</td>
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<tr>
<td>Pakistan</td>
<td>10.50%</td>
<td>16.30%</td>
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<tr>
<td>Papua New Guinea</td>
<td>6.00%</td>
<td>11.80%</td>
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<tr>
<td>Philippines</td>
<td>3.60%</td>
<td>9.40%</td>
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<tr>
<td>Singapore</td>
<td>0.00%</td>
<td>5.80%</td>
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<tr>
<td>Sri Lanka</td>
<td>6.00%</td>
<td>11.80%</td>
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<tr>
<td>Taiwan</td>
<td>1.05%</td>
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<tr>
<td>Thailand</td>
<td>2.25%</td>
<td>8.05%</td>
<td></td>
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<tr>
<td>Vietnam</td>
<td>7.50%</td>
<td>13.30%</td>
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<tr>
<td>Asia</td>
<td>1.55%</td>
<td>7.35%</td>
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</tr>
<tr>
<td>Australia</td>
<td>0.00%</td>
<td>5.80%</td>
<td></td>
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<tr>
<td>New Zealand</td>
<td>0.00%</td>
<td>5.80%</td>
<td></td>
</tr>
<tr>
<td>Australia &amp; NZ</td>
<td>0.00%</td>
<td>5.80%</td>
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</tbody>
</table>

Country Risk Premium
January 2013

Aswath Damodaran
40
From Country Equity Risk Premiums to Corporate Equity Risk premiums

- **Approach 1**: Assume that every company in the country is equally exposed to country risk. In this case,
  - \( E(\text{Return}) = \text{Riskfree Rate} + \text{CRP} + \beta \times (\text{Mature ERP}) \)
  - Implicitly, this is what you are assuming when you use the local Government’s dollar borrowing rate as your riskfree rate.

- **Approach 2**: Assume that a company’s exposure to country risk is similar to its exposure to other market risk.
  - \( E(\text{Return}) = \text{Riskfree Rate} + \beta \times (\text{Mature ERP} + \text{CRP}) \)

- **Approach 3**: Treat country risk as a separate risk factor and allow firms to have different exposures to country risk (perhaps based upon the proportion of their revenues come from non-domestic sales).
  - \( E(\text{Return}) = \text{Riskfree Rate} + \beta \times (\text{Mature ERP}) + \lambda \times (\text{CRP}) \)

\[ \text{Mature ERP} = \text{Mature market Equity Risk Premium} \]
\[ \text{CRP} = \text{Additional country risk premium} \]
Approaches 1 & 2: Estimating country risk premium exposure

- **Location based CRP**: The standard approach in valuation is to attach a country risk premium to a company based upon its country of incorporation. Thus, if you are an Indian company, you are assumed to be exposed to the Indian country risk premium. A developed market company is assumed to be unexposed to emerging market risk.

- **Operation-based CRP**: There is a more reasonable modified version. The country risk premium for a company can be computed as a weighted average of the country risk premiums of the countries that it does business in, with the weights based upon revenues or operating income. If a company is exposed to risk in dozens of countries, you can take a weighted average of the risk premiums by region.
Operation based CRP: Single versus Multiple Emerging Markets

- Single emerging market: Embraer, in 2004, reported that it derived 3% of its revenues in Brazil and the balance from mature markets. The mature market ERP in 2004 was 5% and Brazil’s CRP was 7.89%.

<table>
<thead>
<tr>
<th></th>
<th>Revenues</th>
<th>Total ERP</th>
<th>CRP</th>
</tr>
</thead>
<tbody>
<tr>
<td>US and other mature markets</td>
<td>97%</td>
<td>5.00%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Brazil</td>
<td>3%</td>
<td>12.89%</td>
<td>8%</td>
</tr>
<tr>
<td>Embraer</td>
<td></td>
<td>5.24%</td>
<td>0.24%</td>
</tr>
</tbody>
</table>

- Multiple emerging markets: Ambev, the Brazilian-based beverage company, reported revenues from the following countries during 2011.

<table>
<thead>
<tr>
<th></th>
<th>Revenues</th>
<th>%</th>
<th>Total ERP</th>
<th>CRP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>19</td>
<td>9.31%</td>
<td>15.00%</td>
<td>9.00%</td>
</tr>
<tr>
<td>Bolivia</td>
<td>4</td>
<td>1.96%</td>
<td>10.88%</td>
<td>4.88%</td>
</tr>
<tr>
<td>Brazil</td>
<td>130</td>
<td>63.73%</td>
<td>8.63%</td>
<td>2.63%</td>
</tr>
<tr>
<td>Canada</td>
<td>23</td>
<td>11.27%</td>
<td>6.00%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Chile</td>
<td>7</td>
<td>3.43%</td>
<td>7.05%</td>
<td>1.05%</td>
</tr>
<tr>
<td>Ecuador</td>
<td>6</td>
<td>2.94%</td>
<td>12.75%</td>
<td>6.75%</td>
</tr>
<tr>
<td>Paraguay</td>
<td>3</td>
<td>1.47%</td>
<td>12.00%</td>
<td>6.00%</td>
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<tr>
<td>Peru</td>
<td>12</td>
<td>5.88%</td>
<td>9.00%</td>
<td>3.00%</td>
</tr>
<tr>
<td>Ambev</td>
<td>204</td>
<td>9.11%</td>
<td>3.11%</td>
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Extending to a multinational: Regional breakdown Coca Cola’s revenue breakdown and ERP in 2012

<table>
<thead>
<tr>
<th>Region</th>
<th>Revenues</th>
<th>Total ERP</th>
<th>CRP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Western Europe</td>
<td>19%</td>
<td>6.67%</td>
<td>0.67%</td>
</tr>
<tr>
<td>Eastern Europe &amp; Russia</td>
<td>5%</td>
<td>8.60%</td>
<td>2.60%</td>
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<tr>
<td>Asia</td>
<td>15%</td>
<td>7.63%</td>
<td>1.63%</td>
</tr>
<tr>
<td>Latin America</td>
<td>15%</td>
<td>9.42%</td>
<td>3.42%</td>
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<tr>
<td>Australia</td>
<td>4%</td>
<td>6.00%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Africa</td>
<td>4%</td>
<td>9.82%</td>
<td>3.82%</td>
</tr>
<tr>
<td>North America</td>
<td>40%</td>
<td>6.00%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Coca Cola</td>
<td>100%</td>
<td>7.14%</td>
<td>1.14%</td>
</tr>
</tbody>
</table>

Things to watch out for
1. Aggregation across regions. For instance, the Pacific region often includes Australia & NZ with Asia
2. Obscure aggregations including Eurasia and Oceania
Two problems with these approaches..

- **Focus just on revenues:** To the extent that revenues are the only variable that you consider, when weighting risk exposure across markets, you may be missing other exposures to country risk. For instance, an emerging market company that gets the bulk of its revenues outside the country (in a developed market) may still have all of its production facilities in the emerging market.

- **Exposure not adjusted or based upon beta:** To the extent that the country risk premium is multiplied by a beta, we are assuming that beta in addition to measuring exposure to all other macro economic risk also measures exposure to country risk.
Approach 3: Estimate a lambda for country risk

- **Source of revenues**: Other things remaining equal, a company should be more exposed to risk in a country if it generates more of its revenues from that country.

- **Manufacturing facilities**: Other things remaining equal, a firm that has all of its production facilities in a “risky country” should be more exposed to country risk than one which has production facilities spread over multiple countries. The problem will be accented for companies that cannot move their production facilities (mining and petroleum companies, for instance).

- **Use of risk management products**: Companies can use both options/futures markets and insurance to hedge some or a significant portion of country risk.
Estimating Lambdas: The Revenue Approach

- The easiest and most accessible data is on revenues. Most companies break their revenues down by region.
  \[ \lambda = \frac{\% \text{ of revenues domestically}_{\text{firm}}}{\% \text{ of revenues domestically}_{\text{average firm}}} \]

- Consider two firms – Tata Motors and Tata Consulting Services, both Indian companies. 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:
  - \[ \lambda_{\text{Tata Motors}} = \frac{91\%}{80\%} = 1.14 \]
  - \[ \lambda_{\text{TCS}} = \frac{7.62\%}{80\%} = 0.09 \]

- Note that if the proportion of revenues of the average company gets in the market is assumed to be 100%, this approach collapses into the first one.

- There are two implications
  - A company’s risk exposure is determined by where it does business and not by where it is located
  - Firms might be able to actively manage their country risk exposure
Estimating Company Exposure to Country Risk

- The factor “λ” measures the relative exposure of a firm to country risk. One simplistic solution would be to do the following:
  \[ \lambda = \frac{\% \text{ of revenues domestically}_{\text{firm}}}{\% \text{ of revenues domestically}_{\text{average firm}}} \]

- Consider two firms – Tata Motors and Tata Consulting Services, both Indian companies. 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:
  - \( \lambda_{\text{Tata Motors}} = \frac{91\%}{80\%} = 1.14 \)
  - \( \lambda_{\text{TCS}} = \frac{7.62\%}{80\%} = 0.09 \)

- There are two implications
  - A company’s risk exposure is determined by where it does business and not by where it is incorporated.
  - Firms might be able to actively manage their country risk exposures.
Why revenue exposure can be deceptive...

- Operations can still be exposed to country risk: Even though a company may very little of its revenues from a market, there is the very real possibility that its operations are still centered in that market, thus exposing it to country risk.
  - While Tata Consulting Services gets the bulk of its revenues from the United States and Western Europe, the bulk of its operations (back office, consulting and outsourcing) are in India.

- Acquisitions and strategic decisions to enter new markets can alter country risk exposure: A firm can change its revenue exposure dramatically with a big acquisition of a company in another market as well as by targeting new markets for growth.
  - Tata Motors acquired Jaguar/Land Rover in 2008-09. While the 2008-09 numbers don’t reflect this acquisition yet, Tata Motors will get a much larger portion of its revenues from developed markets in the future.
  - TCS is actively expanding targeting Latin America for growth. While the percent of revenues from Latin American right now is very small, it may grow over time.
Estimating lambdas: Tata Motors versus TCS

<table>
<thead>
<tr>
<th></th>
<th>Tata Motors</th>
<th>TCS</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of production/operations in India</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>% of revenues in India</td>
<td>91.37% (in 2009) Estimated 70% (in 2010)</td>
<td>7.62%</td>
</tr>
<tr>
<td>Lambda</td>
<td>0.80</td>
<td>0.20</td>
</tr>
<tr>
<td>Flexibility in moving operations</td>
<td>Low. Significant physical assets.</td>
<td>High. Human capital is mobile.</td>
</tr>
</tbody>
</table>
An Alternative: Watch what I pay, not what I say!

- On January 1, 2013, the S&P 500 was at 1426.19, essentially unchanged for the year. And it was a year of macro shocks – political upheaval in the Middle East and sovereign debt problems in Europe. The treasury bond rate dropped below 2% and buybacks/dividends surged.

In 2012, the actual cash returned to stockholders was 72.25. Using the average total yield for the last decade yields 69.46.

Analyzers expect earnings to grow 7.67% in 2013, 7.28% in 2014, scaling down to 1.76% in 2017, resulting in a compounded annual growth rate of 5.27% over the next 5 years. We will assume that dividends & buybacks will grow 5.27% a year for the next 5 years.

After year 5, we will assume that earnings on the index will grow at 1.76%, the same rate as the entire economy (= riskfree rate).

\[
1426.19 = \frac{73.12}{(1 + r)} + \frac{76.97}{(1 + r)^2} + \frac{81.03}{(1 + r)^3} + \frac{85.30}{(1 + r)^4} + \frac{89.80}{(1 + r)^5} + \frac{89.80(1.0176)}{(r - .0176)(1 + r)^5}
\]

Expected Return on Stocks (1/1/13) = 7.54%
T.Bond rate on 1/1/13 = 1.76%
Equity Risk Premium = 7.54% - 1.76% = 5.78%

Data Sources:
Dividends and Buybacks last year: S&P
Expected growth rate: S&P, Media reports, Factset, Thomson-Reuters
Implied Premiums in the US

Implied Premium for US Equity Market
The Anatomy of a Crisis: Implied ERP from September 12, 2008 to January 1, 2009

![Graph showing Implied Equity Risk Premium from September 12, 2008 to December 31, 2008. The graph compares the S&P 500 index and the implied equity risk premium over time. The average implied ERP from 1960-2007 is approximately 4.20%.](image)
Implied Premium versus Risk Free Rate

Expected Return on Stocks = T.Bond Rate + Equity Risk Premium

At the end of 2008, the ERP was almost three times the risk free rate. The highest ratio ever prior to this was in 1960, when the ERP was 1.2 times the risk free rate.
Equity Risk Premiums and Bond Default Spreads
Equity Risk Premiums and Cap Rates (Real Estate)
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%
Why implied premiums matter?

- In many investment banks, it is common practice (especially in corporate finance departments) to use historical risk premiums (and arithmetic averages at that) as risk premiums to compute cost of equity. If all analysts in the department used the geometric average premium for 1928-2012 of 4.2% to value stocks in January 2013, given the implied premium of 5.78%, what were they likely to find?
  
a. The values they obtain will be too low (most stocks will look overvalued)
  
b. The values they obtain will be too high (most stocks will look under valued)
  
c. There should be no systematic bias as long as they use the same premium to value all stocks.
Which equity risk premium should you use?

If you assume this

- Premiums revert back to historical norms and your time period yields these norms

- Market is correct in the aggregate or that your valuation should be market neutral

- Marker makes mistakes even in the aggregate but is correct over time

Premium to use

- Historical risk premium

- Current implied equity risk premium

- Average implied equity risk premium over time.

<table>
<thead>
<tr>
<th>Predictor</th>
<th>Correlation with implied premium next year</th>
<th>Correlation with actual risk premium – next 10 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current implied premium</td>
<td>0.712</td>
<td>0.424</td>
</tr>
<tr>
<td>Average implied premium: Last 5 years</td>
<td>0.646</td>
<td>0.360</td>
</tr>
<tr>
<td>Historical Premium</td>
<td>-0.394</td>
<td>-0.486</td>
</tr>
<tr>
<td>Default Spread based premium</td>
<td>0.059</td>
<td>0.174</td>
</tr>
</tbody>
</table>
Relative Risk Measure
How risky is this asset, relative to the average risk investment?

APM/ Multi-factor Models
Regression beta of stock returns at firm versus stock returns on market index

The CAPM Beta
Regression beta of stock returns at firm versus stock returns on market index

Sector-average Beta
Average regression beta across all companies in the business(es) that the firm operates in.

Price Variance Model
Standard deviation, relative to the average across all stocks

Debt cost based
Estimate cost of equity based upon cost of debt and relative volatility

Implied Beta/ Cost of equity
Estimate a cost of equity for firm or sector based upon current price today and expected cash flows in future

Proxy measures
Use a proxy for risk (market cap, sector).

Accounting Earnings Volatility
How volatile is your company's earnings, relative to the average company's earnings?

Accounting Earnings Beta
Regression beta of changes in earnings at firm versus changes in earnings for market index

Balance Sheet Ratios
Risk based upon balance sheet ratios (debt ratio, working capital, cash, fixed assets) that measure risk

Composite Risk Measures
Use a mix of quantitative (price, ratios) & qualitative analysis (management quality) to estimate relative risk

Price based, Model Agnostic Quadrant

MPT Quadrant

Accounting Risk Quadrant

Intrinsic Risk Quadrant

Aswath Damodaran
The standard procedure for estimating betas is to regress stock returns \( (R_j) \) against market returns \( (R_m) \) -

\[
R_j = a + b \cdot R_m
\]

where \( a \) is the intercept and \( b \) is the slope of the regression.

The slope of the regression corresponds to the beta of the stock, and measures the riskiness of the stock.

This beta has three problems:

- It has high standard error
- It reflects the firm’s business mix over the period of the regression, not the current mix
- It reflects the firm’s average financial leverage over the period rather than the current leverage.
Beta estimates are noisy...

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>AMGN</td>
<td>US Equity</td>
<td></td>
</tr>
<tr>
<td>Relative Index</td>
<td>SPX</td>
<td></td>
</tr>
<tr>
<td>Period</td>
<td>Weekly</td>
<td></td>
</tr>
<tr>
<td>Range</td>
<td>5/13/05 to 5/4/07</td>
<td></td>
</tr>
<tr>
<td>Market</td>
<td>Trade</td>
<td></td>
</tr>
<tr>
<td>ADJ BETA</td>
<td>0.83</td>
<td></td>
</tr>
<tr>
<td>RAW BETA</td>
<td>0.75</td>
<td></td>
</tr>
<tr>
<td>Alpha (Intercept)</td>
<td>-0.13</td>
<td></td>
</tr>
<tr>
<td>R2 (Correlation)</td>
<td>0.10</td>
<td></td>
</tr>
<tr>
<td>Std Dev of Error</td>
<td>3.07</td>
<td></td>
</tr>
<tr>
<td>Std Error of Beta</td>
<td>0.22</td>
<td></td>
</tr>
<tr>
<td>Number of Points</td>
<td>103</td>
<td></td>
</tr>
</tbody>
</table>

ADJ BETA = (0.57) * RAW BETA + (0.33) * 1.0
Beta Estimation: The Index Effect

```
ADJ BETA = (0.67) * RAW BETA + (0.33) * 1.0
```

```
ADJ BETA = 1.18
RAW BETA = 1.27
Alpha(Intercept) = 0.42
R2 (Correlation) = 0.94
Std Dev of Error = 1.87
Std Error of Beta = 0.03
Number of Points = 103
```

```
Y = 1.27 X + 0.42
```

Screen Printed
In emerging markets... two betas for Tata Motors
Stock-priced based solutions to the Regression Beta Problem

- Modify the regression beta by
  - changing the index used to estimate the beta
  - adjusting the regression beta estimate, by bringing in information about the fundamentals of the company

- Estimate the beta for the firm using
  - the standard deviation in stock prices instead of a regression against an index
  - Relative risk = Standard deviation in stock prices for investment/Average standard deviation across all stocks

- Estimate the beta for the firm from the bottom up without employing the regression technique. This will require
  - understanding the business mix of the firm
  - estimating the financial leverage of the firm

- Imputed or implied beta (cost of equity) for the sector.
Determinants of Betas

- **Nature of product or service offered by company:** Other things remaining equal, the more discretionary the product or service, the higher the beta.

  - **Implications**
    1. Cyclical companies should have higher betas than non-cyclical companies.
    2. Luxury goods firms should have higher betas than basic goods.
    3. High priced goods/service firms should have higher betas than low prices goods/services firms.
    4. Growth firms should have higher betas.

- **Operating Leverage (Fixed Costs as percent of total costs):** Other things remaining equal, the greater the proportion of the costs that are fixed, the higher the beta of the company.

  - **Implications**
    1. Firms with high infrastructure needs and rigid cost structures should have higher betas than firms with flexible cost structures.
    2. Smaller firms should have higher betas than larger firms.
    3. Young firms should have higher betas.

- **Financial Leverage:** Other things remaining equal, the greater the proportion of capital that a firm raises from debt, the higher its equity beta will be.

  - **Implications**
    Highly levered firms should have higher betas than firms with less debt.
Bottom-up Betas

Step 1: Find the business or businesses that your firm operates in.

Step 2: Find publicly traded firms in each of these businesses and obtain their regression betas. Compute the simple average across these regression betas to arrive at an average beta for these publicly traded firms. Unlever this average beta using the average debt to equity ratio across the publicly traded firms in the sample. Unlevered beta for business = Average beta across publicly traded firms/ (1 + (1 - t) (Average D/E ratio across firms))

Step 3: Estimate how much value your firm derives from each of the different businesses it is in.

Step 4: Compute a weighted average of the unlevered betas of the different businesses (from step 2) using the weights from step 3. Bottom-up Unlevered beta for your firm = Weighted average of the unlevered betas of the individual business

Step 5: Compute a levered beta (equity beta) for your firm, using the market debt to equity ratio for your firm. Levered bottom-up beta = Unlevered beta (1 + (1-t) (Debt/Equity))

Possible Refinements

If you can, adjust this beta for differences between your firm and the comparable firms on operating leverage and product characteristics.

While revenues or operating income are often used as weights, it is better to try to estimate the value of each business.

If you expect the business mix of your firm to change over time, you can change the weights on a year-to-year basis.

If you expect your debt to equity ratio to change over time, the levered beta will change over time.
Two 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 \( (1+ (1-.3399)(.3387)) = 1.20 \)

- **A Question to ponder: Tata Motors recently made two big investments.**
  - Tata Nano: Promoted as the cheapest car in the world, Tata Motors hopes that volume (especially in Asia) will make up for tight margins.
  - Jaguar/Land Rover: Tata acquired both firms, catering to luxury markets.
  - What effect will these investments have on Tata Motor’s beta?
Bottom-up Beta: Firm in Multiple Businesses
SAP in 2004

- **Approach 1: Based on business mix**
  - SAP is in three business: software, consulting and training. We will aggregate the consulting and training businesses
  
<table>
<thead>
<tr>
<th>Business</th>
<th>Revenues</th>
<th>EV/Sales Value</th>
<th>Weights</th>
<th>Beta</th>
</tr>
</thead>
<tbody>
<tr>
<td>Software</td>
<td>$ 5.3</td>
<td>3.25</td>
<td>17.23</td>
<td>80%</td>
</tr>
<tr>
<td>Consulting</td>
<td>$ 2.2</td>
<td>2.00</td>
<td>4.40</td>
<td>20%</td>
</tr>
<tr>
<td>SAP</td>
<td>$ 7.5</td>
<td>21.63</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- **Approach 2: Customer Base**
From Cost of Equity to Cost of Capital

Cost of Capital = Cost of Equity \( \frac{\text{Equity}}{\text{Debt + Equity}} \) + Cost of Borrowing \( (1\text{-}t) \frac{\text{Debt}}{\text{Debt + Equity}} \)

Cost of borrowing should be based upon
(1) synthetic or actual bond rating
(2) default spread
Cost of Borrowing = Riskfree rate + Default spread

Marginal tax rate, reflecting tax benefits of debt

Weights should be market value weights

Cost of equity based upon bottom-up beta
What is debt?

- General Rule: Debt generally has the following characteristics:
  - Commitment to make fixed payments in the future
  - The fixed payments are tax deductible
  - Failure to make the payments can lead to either default or loss of control of the firm to the party to whom payments are due.

- As a consequence, debt should include
  - Any interest-bearing liability, whether short term or long term.
  - Any lease obligation, whether operating or capital.
Estimating the Cost of Debt

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

- Amgen had a bond rating. In 2007, its actual rating was A+.
- For firms without a rating, you estimate a synthetic rating. In its simplest form, the rating can be estimated from the interest coverage ratio
  \[
  \text{Interest Coverage Ratio} = \frac{\text{EBIT}}{\text{Interest Expenses}}
  \]
- For Tata Motor’s interest coverage ratio, we used the interest expenses and EBIT from 2008-09.
  \[
  \text{Interest Coverage Ratio} = \frac{17527}{6737} = 2.60
  \]
Interest Coverage Ratios, Ratings and Default Spreads: Small market cap companies (January ‘10)

<table>
<thead>
<tr>
<th>If interest coverage ratio is greater than</th>
<th>≤ to</th>
<th>Rating is</th>
<th>Spread is</th>
</tr>
</thead>
<tbody>
<tr>
<td>-100000</td>
<td>0.499999</td>
<td>D</td>
<td>15.00%</td>
</tr>
<tr>
<td>0.5</td>
<td>0.799999</td>
<td>C</td>
<td>12.00%</td>
</tr>
<tr>
<td>0.8</td>
<td>1.249999</td>
<td>CC</td>
<td>10.00%</td>
</tr>
<tr>
<td>1.25</td>
<td>1.499999</td>
<td>CCC</td>
<td>8.50%</td>
</tr>
<tr>
<td>1.5</td>
<td>1.999999</td>
<td>B-</td>
<td>5.50%</td>
</tr>
<tr>
<td>2</td>
<td>2.499999</td>
<td>B</td>
<td>5.25%</td>
</tr>
<tr>
<td>2.5</td>
<td>2.999999</td>
<td>B+</td>
<td>4.25%</td>
</tr>
<tr>
<td>3</td>
<td>3.499999</td>
<td>BB</td>
<td>4.00%</td>
</tr>
<tr>
<td>3.5</td>
<td>3.999999</td>
<td>BB+</td>
<td>3.50%</td>
</tr>
<tr>
<td>4</td>
<td>4.499999</td>
<td>BBB</td>
<td>2.00%</td>
</tr>
<tr>
<td>4.5</td>
<td>5.999999</td>
<td>A-</td>
<td>1.50%</td>
</tr>
<tr>
<td>6</td>
<td>7.499999</td>
<td>A</td>
<td>1.25%</td>
</tr>
<tr>
<td>7.5</td>
<td>9.499999</td>
<td>A+</td>
<td>1.00%</td>
</tr>
<tr>
<td>9.5</td>
<td>12.499999</td>
<td>AA</td>
<td>0.75%</td>
</tr>
<tr>
<td>12.5</td>
<td>100000</td>
<td>AAA</td>
<td>0.50%</td>
</tr>
</tbody>
</table>
Estimating the cost of debt for a firm

- The actual rating for Amgen was A. Using the 2007 default spread of 0.85%, we estimate a cost of debt of
  
  \[ \text{Cost of debt} = \text{Riskfree rate} + \text{Default spread} \]  
  
  \[ = 4.78\% + 0.85\% \]  
  
  \[ = 5.63\% \]

- The synthetic rating for Tata Motors is B+. Using the 2010 default spread of 4.25%, we estimate a cost of debt of 12.25% (using a RS riskfree rate of 5% and adding in the country default spread of 3%):
  
  \[ \text{Cost of debt} = \text{Riskfree rate} + \text{Country default spread} + \text{Company default spread} \]  
  
  \[ = 5.00\% + 4.25\% + 3\% = 12.25\% \]
## Default Spreads: The effect of the crisis of 2008.. And the aftermath

<table>
<thead>
<tr>
<th>Rating</th>
<th>1-Jan-08</th>
<th>12-Sep-08</th>
<th>12-Nov-08</th>
<th>1-Jan-09</th>
<th>1-Jan-10</th>
<th>1-Jan-11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aaa/AAA</td>
<td>0.99%</td>
<td>1.40%</td>
<td>2.15%</td>
<td>2.00%</td>
<td>0.50%</td>
<td>0.55%</td>
</tr>
<tr>
<td>Aa1/AA+</td>
<td>1.15%</td>
<td>1.45%</td>
<td>2.30%</td>
<td>2.25%</td>
<td>0.55%</td>
<td>0.60%</td>
</tr>
<tr>
<td>Aa2/AA</td>
<td>1.25%</td>
<td>1.50%</td>
<td>2.55%</td>
<td>2.50%</td>
<td>0.65%</td>
<td>0.65%</td>
</tr>
<tr>
<td>Aa3/AA-</td>
<td>1.30%</td>
<td>1.65%</td>
<td>2.80%</td>
<td>2.75%</td>
<td>0.70%</td>
<td>0.75%</td>
</tr>
<tr>
<td>A1/A+</td>
<td>1.35%</td>
<td>1.85%</td>
<td>3.25%</td>
<td>3.25%</td>
<td>0.85%</td>
<td>0.85%</td>
</tr>
<tr>
<td>A2/A</td>
<td>1.42%</td>
<td>1.95%</td>
<td>3.50%</td>
<td>3.50%</td>
<td>0.90%</td>
<td>0.90%</td>
</tr>
<tr>
<td>A3/A-</td>
<td>1.48%</td>
<td>2.15%</td>
<td>3.75%</td>
<td>3.75%</td>
<td>1.05%</td>
<td>1.00%</td>
</tr>
<tr>
<td>Baa1/BBB+</td>
<td>1.73%</td>
<td>2.65%</td>
<td>4.50%</td>
<td>5.25%</td>
<td>1.65%</td>
<td>1.40%</td>
</tr>
<tr>
<td>Baa2/BBB</td>
<td>2.02%</td>
<td>2.90%</td>
<td>5.00%</td>
<td>5.75%</td>
<td>1.80%</td>
<td>1.60%</td>
</tr>
<tr>
<td>Baa3/BBB-</td>
<td>2.60%</td>
<td>3.20%</td>
<td>5.75%</td>
<td>7.25%</td>
<td>2.25%</td>
<td>2.05%</td>
</tr>
<tr>
<td>Ba1/BB+</td>
<td>3.20%</td>
<td>4.45%</td>
<td>7.00%</td>
<td>9.50%</td>
<td>3.50%</td>
<td>2.90%</td>
</tr>
<tr>
<td>Ba2/BB</td>
<td>3.65%</td>
<td>5.15%</td>
<td>8.00%</td>
<td>10.50%</td>
<td>3.85%</td>
<td>3.25%</td>
</tr>
<tr>
<td>Ba3/BB-</td>
<td>4.00%</td>
<td>5.30%</td>
<td>9.00%</td>
<td>11.00%</td>
<td>4.00%</td>
<td>3.50%</td>
</tr>
<tr>
<td>B1/B+</td>
<td>4.55%</td>
<td>5.85%</td>
<td>9.50%</td>
<td>11.50%</td>
<td>4.25%</td>
<td>3.75%</td>
</tr>
<tr>
<td>B2/B</td>
<td>5.65%</td>
<td>6.10%</td>
<td>10.50%</td>
<td>12.50%</td>
<td>5.25%</td>
<td>5.00%</td>
</tr>
<tr>
<td>B3/B-</td>
<td>6.45%</td>
<td>9.40%</td>
<td>13.50%</td>
<td>15.50%</td>
<td>5.50%</td>
<td>6.00%</td>
</tr>
<tr>
<td>Caa/CCC+</td>
<td>7.15%</td>
<td>9.80%</td>
<td>14.00%</td>
<td>16.50%</td>
<td>7.75%</td>
<td>7.75%</td>
</tr>
<tr>
<td>ERP</td>
<td>4.37%</td>
<td>4.52%</td>
<td>6.30%</td>
<td>6.43%</td>
<td>4.36%</td>
<td>5.20%</td>
</tr>
</tbody>
</table>
# Updated Default Spreads - January 2013

<table>
<thead>
<tr>
<th>Rating</th>
<th>1 year</th>
<th>5 year</th>
<th>10 year</th>
<th>30 year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aaa/AAA</td>
<td>0.04%</td>
<td>0.16%</td>
<td>0.41%</td>
<td>0.65%</td>
</tr>
<tr>
<td>Aa1/AA+</td>
<td>0.07%</td>
<td>0.35%</td>
<td>0.57%</td>
<td>0.84%</td>
</tr>
<tr>
<td>Aa2/AA</td>
<td>0.09%</td>
<td>0.53%</td>
<td>0.73%</td>
<td>1.03%</td>
</tr>
<tr>
<td>Aa3/AA-</td>
<td>0.12%</td>
<td>0.58%</td>
<td>0.78%</td>
<td>1.09%</td>
</tr>
<tr>
<td>A1/A+</td>
<td>0.15%</td>
<td>0.62%</td>
<td>0.82%</td>
<td>1.15%</td>
</tr>
<tr>
<td>A2/A</td>
<td>0.36%</td>
<td>0.77%</td>
<td>0.95%</td>
<td>1.23%</td>
</tr>
<tr>
<td>A3/A-</td>
<td>0.41%</td>
<td>1.04%</td>
<td>1.31%</td>
<td>1.74%</td>
</tr>
<tr>
<td>Baa1/BBB+</td>
<td>0.63%</td>
<td>1.28%</td>
<td>1.55%</td>
<td>1.99%</td>
</tr>
<tr>
<td>Baa2/BBB</td>
<td>0.81%</td>
<td>1.53%</td>
<td>1.84%</td>
<td>2.33%</td>
</tr>
<tr>
<td>Baa3/BBB-</td>
<td>1.29%</td>
<td>1.98%</td>
<td>2.28%</td>
<td>2.74%</td>
</tr>
<tr>
<td>Ba1/BB+</td>
<td>2.07%</td>
<td>2.78%</td>
<td>3.12%</td>
<td>3.56%</td>
</tr>
<tr>
<td>Ba2/BB</td>
<td>2.85%</td>
<td>3.58%</td>
<td>3.97%</td>
<td>4.39%</td>
</tr>
<tr>
<td>Ba3/BB-</td>
<td>3.63%</td>
<td>4.38%</td>
<td>4.81%</td>
<td>5.21%</td>
</tr>
<tr>
<td>B1/B+</td>
<td>4.41%</td>
<td>5.18%</td>
<td>5.65%</td>
<td>6.03%</td>
</tr>
<tr>
<td>B2/B</td>
<td>5.19%</td>
<td>5.98%</td>
<td>6.49%</td>
<td>6.85%</td>
</tr>
<tr>
<td>B3/B-</td>
<td>5.97%</td>
<td>6.78%</td>
<td>7.34%</td>
<td>7.68%</td>
</tr>
<tr>
<td>Caa/CCC+</td>
<td>6.75%</td>
<td>7.57%</td>
<td>8.18%</td>
<td>8.50%</td>
</tr>
</tbody>
</table>
Weights for the Cost of Capital Computation

- The weights used to compute the cost of capital should be the market value weights for debt and equity.
- There is an element of circularity that is introduced into every valuation by doing this, since the values that we attach to the firm and equity at the end of the analysis are different from the values we gave them at the beginning.
- For private companies, neither the market value of equity nor the market value of debt is observable. Rather than use book value weights, you should try:
  - Industry average debt ratios for publicly traded firms in the business
  - Target debt ratio (if management has such a target)
  - Estimated value of equity and debt from valuation (through an iterative process)
## Company costs of capital

<table>
<thead>
<tr>
<th></th>
<th>Amgen</th>
<th>Tata Motors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Riskfree rate</td>
<td>4.78%</td>
<td>5%</td>
</tr>
<tr>
<td>Beta</td>
<td>1.73</td>
<td>1.2</td>
</tr>
<tr>
<td>Mature ERP</td>
<td>4%</td>
<td>4.50%</td>
</tr>
<tr>
<td>Lambda</td>
<td>0.00</td>
<td>0.80</td>
</tr>
<tr>
<td>CRP</td>
<td>0.00%</td>
<td>4.50%</td>
</tr>
<tr>
<td>Cost of equity</td>
<td>11.70%</td>
<td>14.00%</td>
</tr>
<tr>
<td>Rating</td>
<td>A</td>
<td>B+</td>
</tr>
<tr>
<td>Default spread</td>
<td>0.85%</td>
<td>4.25%</td>
</tr>
<tr>
<td>Default spread (country)</td>
<td>0.00%</td>
<td>3.00%</td>
</tr>
<tr>
<td>Cost of debt</td>
<td>5.63%</td>
<td>12.2500%</td>
</tr>
<tr>
<td>Marginal tax rate</td>
<td>35%</td>
<td>33.99%</td>
</tr>
<tr>
<td>After-tax cost of debt</td>
<td>3.66%</td>
<td>8.09%</td>
</tr>
<tr>
<td>MV of equity</td>
<td>$74,287</td>
<td>INR 322,388</td>
</tr>
<tr>
<td>MV of debt</td>
<td>$8,272</td>
<td>INR 109,198</td>
</tr>
<tr>
<td>D/ (D+E)</td>
<td>10.00%</td>
<td>25.30%</td>
</tr>
<tr>
<td>Cost of capital</td>
<td>10.90%</td>
<td>12.50%</td>
</tr>
</tbody>
</table>
IB. ESTIMATING CASHFLOWS AND GROWTH
Defining Cashflow

Cash flows can be measured to

All claimholders in the firm

- EBIT (1- tax rate)
  - (Capital Expenditures - Depreciation)
  - Change in non-cash working capital
  = Free Cash Flow to Firm (FCFF)

Just Equity Investors

- Net Income
  - (Capital Expenditures - Depreciation)
  - Change in non-cash Working Capital
  - (Principal Repaid - New Debt Issues)
  - Preferred Dividend

- Dividends
  + Stock Buybacks
From Reported to Actual Earnings

- Update
  - Trailing Earnings
  - Unofficial numbers

- Normalize Earnings
  - Firm's history
  - Comparable Firms

- Measuring Earnings
  - Operating leases
    - Convert into debt
    - Adjust operating income
  - R&D Expenses
    - Convert into asset
    - Adjust operating income
  - Cleanse operating items of
    - Financial Expenses
    - Capital Expenses
    - Non-recurring expenses
Dealing with Operating Lease Expenses

- Operating Lease Expenses are treated as operating expenses in computing operating income. In reality, operating lease expenses should be treated as financing expenses, with the following adjustments to earnings and capital:
- Debt Value of Operating Leases = Present value of Operating Lease Commitments at the pre-tax cost of debt
- When you convert operating leases into debt, you also create an asset to counter it of exactly the same value.
- Adjusted Operating Earnings
  - Adjusted Operating Earnings = Operating Earnings + Operating Lease Expenses - Depreciation on Leased Asset
  As an approximation, this works:
  - Adjusted Operating Earnings = Operating Earnings + Pre-tax cost of Debt * PV of Operating Leases.
Operating Leases at Amgen in 2007

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Commitment</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$96.00</td>
<td>$90.88</td>
</tr>
<tr>
<td>2</td>
<td>$95.00</td>
<td>$85.14</td>
</tr>
<tr>
<td>3</td>
<td>$102.00</td>
<td>$86.54</td>
</tr>
<tr>
<td>4</td>
<td>$98.00</td>
<td>$78.72</td>
</tr>
<tr>
<td>5</td>
<td>$87.00</td>
<td>$66.16</td>
</tr>
<tr>
<td>6-12</td>
<td>$107.43</td>
<td>$462.10 ($752 million prorated)</td>
</tr>
</tbody>
</table>

- 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
Collateral Effects of Treating Operating Leases as Debt for a lease-rich company: The Gap

<table>
<thead>
<tr>
<th>Conventional Accounting</th>
<th>Operating Leases Treated as Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income Statement</strong></td>
<td></td>
</tr>
<tr>
<td>EBIT &amp; Leases = 1,990</td>
<td>EBIT &amp; Leases = 1,990</td>
</tr>
<tr>
<td>- Op Leases = 978</td>
<td>- Deprec: OL = 628</td>
</tr>
<tr>
<td>EBIT = 1,012</td>
<td>EBIT = 1,362</td>
</tr>
</tbody>
</table>

Interest expense will rise to reflect the conversion of operating leases as debt. Net income should not change.

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>Asset</th>
<th>Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Off balance sheet (Not shown as debt or as an asset). Only the conventional debt of $1,970 million shows up on balance sheet</td>
<td>OL Asset 4397</td>
<td>OL Debt 4397</td>
</tr>
<tr>
<td>Total debt = 4397 + 1970 = $6,367 million</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Cost of capital = 8.20%\(\frac{7350}{9320}\) + 4%\(\frac{1970}{9320}\) = 7.31%
Cost of equity for The Gap = 8.20%
After-tax cost of debt = 4%
Market value of equity = 7350

Cost of capital = 8.20%\(\frac{7350}{13717}\) + 4%\(\frac{6367}{13717}\) = 6.25%

Return on capital = 1012 \(\frac{1-.35}{3130+1970}\) = 12.90%

Return on capital = 1362 \(\frac{1-.35}{3130+6367}\) = 9.30%
R&D Expenses: Operating or Capital Expenses

- Accounting standards require us to consider R&D as an operating expense even though it is designed to generate future growth. It is more logical to treat it as capital expenditures.

- To capitalize R&D,
  - Specify an amortizable life for R&D (2 - 10 years)
  - Collect past R&D expenses for as long as the amortizable life
  - Sum up the unamortized R&D over the period. (Thus, if the amortizable life is 5 years, the research asset can be obtained by adding up 1/5th of the R&D expense from five years ago, 2/5th of the R&D expense from four years ago...: )
## Capitalizing R&D Expenses: Amgen

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

<table>
<thead>
<tr>
<th>Year</th>
<th>R&amp;D Expense</th>
<th>Unamortized portion</th>
<th>Amortization this year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>3366.00</td>
<td>1.00</td>
<td>3366.00</td>
</tr>
<tr>
<td>-1</td>
<td>2314.00</td>
<td>0.90</td>
<td>2082.60</td>
</tr>
<tr>
<td>-2</td>
<td>2028.00</td>
<td>0.80</td>
<td>1622.40</td>
</tr>
<tr>
<td>-3</td>
<td>1655.00</td>
<td>0.70</td>
<td>1158.50</td>
</tr>
<tr>
<td>-4</td>
<td>1117.00</td>
<td>0.60</td>
<td>670.20</td>
</tr>
<tr>
<td>-5</td>
<td>865.00</td>
<td>0.50</td>
<td>432.50</td>
</tr>
<tr>
<td>-6</td>
<td>845.00</td>
<td>0.40</td>
<td>338.00</td>
</tr>
<tr>
<td>-7</td>
<td>823.00</td>
<td>0.30</td>
<td>246.90</td>
</tr>
<tr>
<td>-8</td>
<td>663.00</td>
<td>0.20</td>
<td>132.60</td>
</tr>
<tr>
<td>-9</td>
<td>631.00</td>
<td>0.10</td>
<td>63.10</td>
</tr>
<tr>
<td>-10</td>
<td>558.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
</tbody>
</table>

Value of Research Asset = $10,112.80

Adjusted Operating Income = $5,120 + 3,366 - 1,150 = $7,336 million
### The Effect of Capitalizing R&D at Amgen

<table>
<thead>
<tr>
<th>Conventional Accounting</th>
<th>R&amp;D treated as capital expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income Statement</strong></td>
<td></td>
</tr>
<tr>
<td>EBIT &amp; R&amp;D = 8,486</td>
<td>EBIT &amp; R&amp;D = 8,486</td>
</tr>
<tr>
<td>- R&amp;D = 3,366</td>
<td>- Amort: R&amp;D = 1,150</td>
</tr>
<tr>
<td>EBIT = 5,120</td>
<td>EBIT = 7,336 (Increase 2,216 m)</td>
</tr>
<tr>
<td>EBIT (1-t) = 3,686</td>
<td>EBIT (1-t) = 5,282 m</td>
</tr>
<tr>
<td></td>
<td>Ignored tax benefit = (3366-1150)(.28) = 621</td>
</tr>
<tr>
<td></td>
<td>Adjusted EBIT (1-t) = 5,282 +621 = 5,902 million</td>
</tr>
<tr>
<td></td>
<td>Net Income will also increase by 2,216 million</td>
</tr>
<tr>
<td><strong>Balance Sheet</strong></td>
<td></td>
</tr>
<tr>
<td>Off balance sheet asset. Book value of equity at $18,964 million is understated because biggest asset is off the books.</td>
<td>R&amp;D Asset 10,112 Book Equity +10,112</td>
</tr>
<tr>
<td></td>
<td>Book Equity = 18,964+ 10,112= 29,076 mil</td>
</tr>
<tr>
<td><strong>Capital Expenditures</strong></td>
<td></td>
</tr>
<tr>
<td>Conventional net cap ex of $4,227 million</td>
<td>Net Cap ex = 4,227 + 2216 = $6,493 mil</td>
</tr>
<tr>
<td><strong>Cash Flows</strong></td>
<td></td>
</tr>
<tr>
<td>EBIT (1-t) = 3686</td>
<td>EBIT (1-t) = 5902</td>
</tr>
<tr>
<td>- Net Cap Ex &amp; WC = 4279</td>
<td>- Net Cap Ex = 6443</td>
</tr>
<tr>
<td>FCFF = -578</td>
<td>FCFF = - 678 m</td>
</tr>
<tr>
<td>Return on capital = 3686/22753 = 14.00%</td>
<td>Return on capital = 5902/36432 = 16.71%</td>
</tr>
</tbody>
</table>
What tax rate?

- The tax rate that you should use in computing the after-tax operating income should be
  a. The effective tax rate in the financial statements (taxes paid/Taxable income)
  b. The tax rate based upon taxes paid and EBIT (taxes paid/EBIT)
  c. The marginal tax rate for the country in which the company operates
  d. The weighted average marginal tax rate across the countries in which the company operates
  e. None of the above
  f. Any of the above, as long as you compute your after-tax cost of debt using the same tax rate
Tax Rates
Capital expenditures should include

- Research and development expenses, once they have been re-categorized as capital expenses. The adjusted net cap ex will be:
  \[
  \text{Adjusted Net Capital Expenditures} = \text{Net Capital Expenditures} + \text{Current year’s R&D expenses} - \text{Amortization of Research Asset}
  \]

- Acquisitions of other firms, since these are like capital expenditures. The adjusted net cap ex will be:
  \[
  \text{Adjusted Net Cap Ex} = \text{Net Capital Expenditures} + \text{Acquisitions of other firms} - \text{Amortization of such acquisitions}
  \]

Two caveats:
1. Most firms do not do acquisitions every year. Hence, a normalized measure of acquisitions (looking at an average over time) should be used.
2. The best place to find acquisitions is in the statement of cash flows, usually categorized under other investment activities.
Amgen Net Capital Expenditures

- If we define capital expenditures broadly to include R&D and acquisitions:
  - Accounting Capital Expenditures = $1,218 million
  - Accounting Depreciation = $963 million
  - Accounting Net Capital Expenditures = $255 million
  - Net R&D Capital Expenditures = (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.
Working Capital Investments

- In accounting terms, the working capital is the difference between current assets (inventory, cash and accounts receivable) and current liabilities (accounts payables, short term debt and debt due within the next year).

- A cleaner definition of working capital from a cash flow perspective is the difference between non-cash current assets (inventory and accounts receivable) and non-debt current liabilities (accounts payable).

- Any investment in this measure of working capital ties up cash. Therefore, any increases (decreases) in working capital will reduce (increase) cash flows in that period.

- When forecasting future growth, it is important to forecast the effects of such growth on working capital needs, and building these effects into the cash flows.
### FCFF estimates: Last year

<table>
<thead>
<tr>
<th></th>
<th>Amgen</th>
<th>Tata Motors</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBIT (1-t)</td>
<td>$6,058.00</td>
<td>20,116.00Rs</td>
</tr>
<tr>
<td>- Net Cap Ex</td>
<td>$6,443.00</td>
<td>31,590.00Rs</td>
</tr>
<tr>
<td>- Change in non-cash WC</td>
<td>$37.00</td>
<td>2,732.00Rs</td>
</tr>
<tr>
<td>FCFF</td>
<td>-$422.00</td>
<td>14,206.00Rs</td>
</tr>
<tr>
<td>Reinvestment Rate</td>
<td>106.97%</td>
<td>170.62%</td>
</tr>
</tbody>
</table>
From FCFF to FCFE: Debt cash flows....

- In the strictest sense, the only cash flow that an investor will receive from an equity investment in a publicly traded firm is the dividend paid on the stock.

- Actual dividends, however, are set by the managers of the firm and may be much lower than the potential dividends (that could have been paid out)
  - managers are conservative and try to smooth out dividends
  - managers like to hold on to cash to meet unforeseen future contingencies and investment opportunities

- The potential dividends of a firm are the cash flows left over after the firm has made any “investments” it needs to make to create future growth and net debt repayments (debt repayments - new debt issues):
  - Net Income
    - (Capital Expenditures - Depreciation)
    - Changes in non-cash Working Capital
    - (Principal Repayments - New Debt Issues)
  = Free Cash flow to Equity
Growth in Earnings

- Look at the past
  - The historical growth in earnings per share is usually a good starting point for growth estimation

- Look at what others are estimating
  - Analysts estimate growth in earnings per share for many firms. It is useful to know what their estimates are.

- Look at fundamentals
  - Ultimately, all growth in earnings can be traced to two fundamentals - how much the firm is investing in new projects, and what returns these projects are making for the firm.
I. Historical Growth in EPS

- Historical growth rates can be estimated in a number of different ways
  - Arithmetic versus Geometric Averages
  - Simple versus Regression Models
- Historical growth rates can be sensitive to
  - the period used in the estimation
- In using historical growth rates, the following factors have to be considered
  - how to deal with negative earnings
  - the effect of changing size
II. Analyst Growth Rates

- Proposition 1: There is far less private information and far more public information in most analyst forecasts than is generally claimed.
- Proposition 2: The biggest source of private information for analysts remains the company itself which might explain
  - why there are more buy recommendations than sell recommendations (information bias and the need to preserve sources)
  - why there is such a high correlation across analysts forecasts and revisions
  - why All-America analysts become better forecasters than other analysts after they are chosen to be part of the team.
- Proposition 3: There is value to knowing what analysts are forecasting as earnings growth for a firm. There is, however, danger when they agree too much (lemmingitis) and when they agree to little (in which case the information that they have is so noisy as to be useless).
III. Fundamental or Intrinsic Growth

- **Expected Growth**
  - **Net Income**
    - Retention Ratio = 1 - Dividends/Net Income
    - Return on Equity = Net Income/Book Value of Equity
  - **Operating Income**
    - Reinvestment Rate = (Net Cap Ex + Chg in WC)/EBIT(1-t)
    - Return on Capital = EBIT(1-t)/Book Value of Capital

- **Expected Growth** = Net Income * Return on Equity * Operating Income * Reinvestment Rate
Measuring Return on Capital (Equity)

ROC = \frac{EBIT (1 - \text{tax rate})}{\text{Book Value of Equity} + \text{Book value of debt} - \text{Cash}}

Adjust EBIT for:
- a. Extraordinary or one-time expenses or income
- b. Operating leases and R&D
- c. Cyclicality in earnings (Normalize)
- d. Acquisition Debris (Goodwill amortization etc.)

Use a marginal tax rate to be safe. A high ROC created by paying low effective taxes is not sustainable.

Adjust book equity for:
- 1. Capitalized R&D
- 2. Acquisition Debris (Goodwill)

Adjust book value of debt for:
- a. Capitalized operating leases

Use end of prior year numbers or average over the year but be consistent in your application.
Fundamental Growth when return on equity (capital) is changing

- When the return on equity or capital is changing, there will be a second component to growth, positive if the return is increasing and negative if the return is decreasing. If ROC\(_t\) is the return on capital in period \(t\) and ROC\(_{t+1}\) is the return on capital in period \(t+1\), the expected growth rate in operating income will be:

  \[
  \text{Expected Growth Rate} = \text{ROC}_{t+1} \times \text{Reinvestment rate} + \frac{(\text{ROC}_{t+1} - \text{ROC}_t)}{\text{ROC}_t}
  \]

- For example, assume that you have a firm that is generating a return on capital of 8% on its existing assets and expects to increase this return to 10% next year. The efficiency growth for this firm is

  \[
  \text{Efficiency growth} = \frac{(10\% - 8\%)}{8\%} = 25\%
  \]

- Thus, if this firm has a reinvestment rate of 50% and makes a 10% return on capital on its new investments as well, its total growth next year will be 30%

  \[
  \text{Growth rate} = .50 \times 10\% + 25\% = 30\%
  \]

- The key difference is that growth from new investments is sustainable whereas returns from efficiency are short term (or transitory).
IC. THE TAIL THAT WAGS THE DOG... TERMINAL VALUE
Getting Closure in Valuation

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

$$\text{Value} = \sum_{t=1}^{\infty} \frac{\text{CF}_t}{(1+r)^t}$$

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

$$\text{Value} = \sum_{t=1}^{N} \frac{\text{CF}_t}{(1+r)^t} + \frac{\text{Terminal Value}}{(1+r)^N}$$
Ways of Estimating Terminal Value

Terminal Value

- Liquidation Value
  - Most useful when assets are separable and marketable

- Multiple Approach
  - Easiest approach but makes the valuation a relative valuation

- Stable Growth Model
  - Technically soundest, but requires that you make judgments about when the firm will grow at a stable rate which it can sustain forever, and the excess returns (if any) that it will earn during the period.
Stable Growth and Terminal Value

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

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

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

1. Obey the growth cap

- The stable growth rate cannot exceed the growth rate of the economy but it can be set lower.
  - If you assume that the economy is composed of high growth and stable growth firms, the growth rate of the latter will probably be lower than the growth rate of the economy.
  - The stable growth rate can be negative. The terminal value will be lower and you are assuming that your firm will disappear over time.
  - If you use nominal cashflows and discount rates, the growth rate should be nominal in the currency in which the valuation is denominated.

- One simple proxy for the nominal growth rate of the economy is the riskfree rate.
  - Riskfree rate = Expected inflation + Expected Real Interest Rate
  - Nominal growth rate in economy = Expected Inflation + Expected Real Growth
Getting Terminal Value Right

2. Don’t wait too long...

- Assume that you are valuing a young, high growth firm with great potential, just after its initial public offering. How long would you set your high growth period?
  
  a. < 5 years  
  b. 5 years  
  c. 10 years  
  d. >10 years

- While analysts routinely assume very long high growth periods (with substantial excess returns during the periods), the evidence suggests that they are much too optimistic. Most growth firms have difficulty sustaining their growth for long periods, especially while earning excess returns.
And the key determinant of growth periods is the company’s competitive advantage...

- Recapping a key lesson about growth, it is not growth per se that creates value but growth with excess returns. For growth firms to continue to generate value creating growth, they have to be able to keep the competition at bay.

- **Proposition 1**: The stronger and more sustainable the competitive advantages, the longer a growth company can sustain “value creating” growth.

- **Proposition 2**: Growth companies with strong and sustainable competitive advantages are rare.
Getting terminal value right

3. Don’t forget that growth has to be earned

In the section on expected growth, we laid out the fundamental equation for growth:

\[ \text{Growth rate} = \text{Reinvestment Rate} \times \text{Return on invested capital} \]

\[ + \text{Growth rate from improved efficiency} \]

In stable growth, you cannot count on efficiency delivering growth (why?) and you have to reinvest to deliver the growth rate that you have forecast. Consequently, your reinvestment rate in stable growth will be a function of your stable growth rate and what you believe the firm will earn as a return on capital in perpetuity:

- Reinvestment Rate = Stable growth rate / Stable period Return on capital

A key issue in valuation is whether it okay to assume that firms can earn more than their cost of capital in perpetuity. There are some (McKinsey, for instance) who argue that the return on capital = cost of capital in stable growth...
And don’t fall for sleight of hand...

- A typical assumption in many DCF valuations, when it comes to stable growth, is that capital expenditures offset depreciation and there are no working capital needs. Stable growth firms, we are told, just have to make maintenance cap ex (replacing existing assets) to deliver growth. If you make this assumption, what expected growth rate can you use in your terminal value computation?

- What if the stable growth rate = inflation rate? Is it okay to make this assumption then?
Getting Terminal Value Right

4. Be internally consistent..

- Risk and costs of equity and capital: Stable growth firms tend to
  - Have betas closer to one
  - Have debt ratios closer to industry averages (or mature company averages)
  - Country risk premiums (especially in emerging markets should evolve over time)

- The excess returns at stable growth firms should approach (or become) zero. ROC -> Cost of capital and ROE -> Cost of equity

- The reinvestment needs and dividend payout ratios should reflect the lower growth and excess returns:
  - Stable period payout ratio = 1 - g/ ROE
  - Stable period reinvestment rate = g/ ROC
Valuation: Stable Growth Inputs

<table>
<thead>
<tr>
<th></th>
<th>Amgen</th>
<th>Tata Motors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beta High Growth</td>
<td>1.73</td>
<td>1.20</td>
</tr>
<tr>
<td>Stable Growth</td>
<td>1.10</td>
<td>1.00</td>
</tr>
<tr>
<td>Lambda High Growth</td>
<td>0.00</td>
<td>0.80</td>
</tr>
<tr>
<td>Stable Growth</td>
<td>0.00</td>
<td>0.80</td>
</tr>
<tr>
<td>Country Risk Premium High Growth</td>
<td>0.00%</td>
<td>4.50%</td>
</tr>
<tr>
<td>Stable Growth</td>
<td>0.00%</td>
<td>3.00%</td>
</tr>
<tr>
<td>Cost of equity High Growth</td>
<td>11.70%</td>
<td>14.00%</td>
</tr>
<tr>
<td>Stable Growth</td>
<td>9.18%</td>
<td>11.90%</td>
</tr>
<tr>
<td>Debt Ratio High Growth</td>
<td>10.00%</td>
<td>25.30%</td>
</tr>
<tr>
<td>Stable Growth</td>
<td>20.00%</td>
<td>25.30%</td>
</tr>
<tr>
<td>Cost of debt High Growth</td>
<td>5.63%</td>
<td>12.25%</td>
</tr>
<tr>
<td>Stable Growth</td>
<td>5.63%</td>
<td>9.00%</td>
</tr>
<tr>
<td>Cost of capital High Growth</td>
<td>10.90%</td>
<td>12.50%</td>
</tr>
<tr>
<td>Stable Growth</td>
<td>8.08%</td>
<td>10.39%</td>
</tr>
<tr>
<td>Return on capital High Growth</td>
<td>16.00%</td>
<td>17.16%</td>
</tr>
<tr>
<td>Stable Growth</td>
<td>10.00%</td>
<td>10.39%</td>
</tr>
<tr>
<td>Reinvestment Rate High Growth</td>
<td>60.00%</td>
<td>70.00%</td>
</tr>
<tr>
<td>Stable Growth</td>
<td>40.00%</td>
<td>41.67%</td>
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<tr>
<td>Expected growth rate High Growth</td>
<td>9.60%</td>
<td>12.01%</td>
</tr>
<tr>
<td>Stable Growth</td>
<td>4.00%</td>
<td>5.00%</td>
</tr>
</tbody>
</table>
## Terminal Value and Growth

<table>
<thead>
<tr>
<th>Stable growth rate</th>
<th>Amgen</th>
<th>Tata Motors</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>$150,652</td>
<td>435,686Rs</td>
</tr>
<tr>
<td>1%</td>
<td>$154,479</td>
<td>435,686Rs</td>
</tr>
<tr>
<td>2%</td>
<td>$160,194</td>
<td>435,686Rs</td>
</tr>
<tr>
<td>3%</td>
<td>$167,784</td>
<td>435,686Rs</td>
</tr>
<tr>
<td>4%</td>
<td>$179,099</td>
<td>435,686Rs</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ROIC</th>
<th>10%</th>
<th>10.39%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of capital</td>
<td>8.08%</td>
<td>10.39%</td>
</tr>
</tbody>
</table>
Excess returns forever?

- While growth rates seem to fade quickly as firms become larger, well managed firms seem to do much better at sustaining excess returns for longer periods.
II. CORPORATE FINANCE MEETS VALUE: THE SECRET TO VALUE ENHANCEMENT
Price Enhancement versus Value Enhancement

The market gives...

And takes away....

Figure 1: Cumulative abnormal returns earned around the announcement date by firms changing their names to .com names.

NAME THAT STOCK

New Markets, New Names
In the bull market, adding dot-com to a company name made a stock soar. Lately, those zippy new monikers are disappearing.

New Name, Higher Price
But the stocks still get a bounce when dot-com goes away. Chart shows returns in the days before and after the name change.

Sources: Thomson Datastream; P. Raghavendra Raj, Michael J. Cooper, Igor Glebbeek, Purdue Univ.; Alex Khorana, Virginia Univ.; Aaye Patel, Wharton Forest Univ.
The Paths to Value Creation.. Back to the determinants of value..

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

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

- **Efficiency Growth**
  - Growth generated by using existing assets better

- **Expected Growth during high growth period**

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

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

- **Are you investing optimally for future growth?**
- **Are you managing your existing investments/assets?**
- **Are you building on your competitive advantages?**
- **Are you using the right amount and kind of debt for your firm?**
- **Is there scope for more efficient utilization of existing assets?**
Value Creation 1: Increase Cash Flows from Assets in Place

More efficient operations and cost cutting: 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
1.1.: Poor Investments: Should you divest?

- Every firm has at least a few investments in place that are poor investments, earning less than the cost of capital or even losing money.

- In deciding whether to divest, there are three values that we need to consider:
  - Continuing Value: This is the present value of the expected cash flows from continuing the investment through the end of its life.
  - Salvage or Liquidation Value: This is the net cash flow that the firm will receive if it terminated the project today.
  - Divestiture Value: This is the price that will be paid by the highest bidder for this investment.

- If the continuing value is the greatest, there can be no value created by terminating or liquidating this investment, even if it is a bad investment.

- If the liquidation or divestiture value is greater than the continuing value, the firm value will increase by the difference between the two values:
  - If liquidation is optimal: Liquidation Value - Continuing Value
  - If divestiture is optimal: Divestiture Value - Continuing Value
If non-cash working capital is defined to be the difference between non-cash current assets (accounts receivable & inventory) and non-debt current liabilities (accounts payable & supplier credit), there are three ways in which you can reduce working capital (and increase cash flows):

- Reduce inventory at every stage in the process (work in process, finished goods)
- Offer less or tighter credit and/or demand a fair market interest rate when offering credit.
- Use supplier credit or accounts payable, but only if the financing cost (explicit or implicit) is lower than the company’s pre-tax cost of debt.

Reducing working capital is not a free good. The cash flow gain from reducing inventory and tightening credit has to be weighed off against the cost of lost sales and profits.
Value Creation 2: Increase Expected Growth

- Keeping all else constant, increasing the expected growth in earnings will increase the value of a firm.
- The expected growth in earnings of any firm is a function of two variables:
  - The amount that the firm reinvests in assets and projects
  - The quality of these investments

![Diagram]

Reinvest more in projects → Reinvestment Rate
Increase operating margins → Return on Capital
Reinvestment Rate * Return on Capital = Expected Growth Rate
Do acquisitions → Increase capital turnover ratio

Price Leader versus Volume Leader Strategies
Return on Capital = Operating Margin * Capital Turnover Ratio
Value Creating Growth... Evaluating the Alternatives..

<table>
<thead>
<tr>
<th>Category of growth</th>
<th>Shareholder value created for incremental $1 million of growth/target acquisition size¹</th>
<th>Revenue growth/acquisition size necessary to double typical company's share price,² $ billions</th>
</tr>
</thead>
<tbody>
<tr>
<td>New-product market development</td>
<td>1.75–2.00</td>
<td>5–6</td>
</tr>
<tr>
<td>Expanding an existing market</td>
<td>0.30–0.75</td>
<td>13–33</td>
</tr>
<tr>
<td>Maintaining/growing share in a growing market</td>
<td>0.10–0.50</td>
<td>20–100</td>
</tr>
<tr>
<td>Competing for share in a stable market</td>
<td>−0.25–0.40</td>
<td>n/m–25</td>
</tr>
</tbody>
</table>
A postscript on creating growth: The Role of Acquisitions and Divestitures

- An acquisition is just a large-scale project. All of the rules that apply to individual investments apply to acquisitions, as well. For an acquisition to create value, it has to
  - Generate a higher return on capital, after allowing for synergy and control factors, than the cost of capital.
  - Put another way, an acquisition will create value only if the present value of the cash flows on the acquired firm, inclusive of synergy and control benefits, exceeds the cost of the acquisitions.

- A divestiture is the reverse of an acquisition, with a cash inflow now (from divesting the assets) followed by cash outflows (i.e., cash flows foregone on the divested asset) in the future. If the present value of the future cash outflows is less than the cash inflow today, the divestiture will increase value.

- A fair-price acquisition or divestiture is value neutral.
Acquisitions are great for target companies but for acquiring company stockholders...
And the long-term follow up is not positive either..

- Managers often argue that the market is unable to see the long term benefits of mergers that they can see at the time of the deal. If they are right, mergers should create long term benefits to acquiring firms.

- The evidence does not support this hypothesis:
  - McKinsey and Co. has examined acquisition programs at companies on
    - Did the return on capital invested in acquisitions exceed the cost of capital?
    - Did the acquisitions help the parent companies outperform the competition?
    - Half of all programs failed one test, and a quarter failed both.
  - Synergy is elusive. KPMG in a more recent study of global acquisitions concludes that most mergers (>80%) fail - the merged companies do worse than their peer group.
  - A large number of acquisitions that are reversed within fairly short time periods. About 20% of the acquisitions made between 1982 and 1986 were divested by 1988. In studies that have tracked acquisitions for longer time periods (ten years or more) the divestiture rate of acquisitions rises to almost 50%.
A scary thought... The disease is spreading...
Indian firms acquiring US targets – 1999 - 2005

Figure 2. Acquisition Announcement Effect on the Acquiring Firms’ Stocks

Figure 3. Long Term Stock Performance of the Acquiring Firms
Growing through acquisitions seems to be a “loser’s game”

- Firms that grow through acquisitions have generally had far more trouble creating value than firms that grow through internal investments.

- In general, acquiring firms tend to
  - Pay too much for target firms
  - Overestimate the value of “synergy” and “control”
  - Have a difficult time delivering the promised benefits

- Worse still, there seems to be very little learning built into the process. The same mistakes are made over and over again, often by the same firms with the same advisors.

- Conclusion: There is something structurally wrong with the process for acquisitions which is feeding into the mistakes.
Seven reasons why acquisitions fail...

1. Risk Transference: Attributing acquiring company risk characteristics to the target firm. Just because you are a safe firm and operate in a secure market, does not mean that you can transfer these characteristics to a target firm.

2. Debt subsidies: Subsidizing target firm stockholders for the strengths of the acquiring firm is providing them with a benefit they did not earn.

3. Auto-pilot Control: Adding 20% or some arbitrary number to the market price just because other people do it is a recipe for overpayment. Using silly rules such as EPS accretion just makes the problem worse.

4. Elusive Synergy: While there is much talk about synergy in mergers, it is seldom valued realistically or appropriately.

5. It's all relative: The use of transaction multiples (multiples paid by other acquirers in acquisitions) perpetuates over payment.

6. Verdict first, trial afterwards: Deciding you want to do an acquisition first and then looking for justification for the price paid does not make sense.

7. It's not my fault: Holding no one responsible for delivering results is a sure-fire way not to get results...
Let's start with a target firm

- The target firm has the following income statement:
  
  Revenues 100
  Operating Expenses 80
  = Operating Income 20
  Taxes 8
  = After-tax OI 12

- Assume that this firm will generate this operating income forever (with no growth) and that the cost of equity for this firm is 20%. The firm has no debt outstanding. What is the value of this firm?
Test 1: Risk Transference...

- Assume that as an acquiring firm, you are in a much safer business and have a cost of equity of 10%. What is the value of the target firm to you?
Lesson 1: Don’t transfer your risk characteristics to the target firm

- The cost of equity used for an investment should reflect the risk of the investment and not the risk characteristics of the investor who raised the funds.
- Risky businesses cannot become safe just because the buyer of these businesses is in a safe business.
Test 2: Cheap debt?

- Assume as an acquirer that you have access to cheap debt (at 4%) and that you plan to fund half the acquisition with debt. How much would you be willing to pay for the target firm?
Lesson 2: Render unto the target firm that which is the target firm’s but no more..

- As an acquiring firm, it is entirely possible that you can borrow much more than the target firm can on its own and at a much lower rate. If you build these characteristics into the valuation of the target firm, you are essentially transferring wealth from your firm’s stockholder to the target firm’s stockholders.

- When valuing a target firm, use a cost of capital that reflects the debt capacity and the cost of debt that would apply to the firm.
Test 3: Control Premiums

- Assume that you are now told that it is conventional to pay a 20% premium for control in acquisitions (backed up by Mergerstat). How much would you be willing to pay for the target firm?

- Would your answer change if I told you that you can run the target firm better and that if you do, you will be able to generate a 30% pre-tax operating margin (rather than the 20% margin that is currently being earned).

- What if the target firm were perfectly run?
Lesson 3: Beware of rules of thumb...

Valuation is cluttered with rules of thumb. After painstakingly valuing a target firm, using your best estimates, you will be often be told that

- It is common practice to add arbitrary premiums for brand name, quality of management, control etc...
- These premiums will be often be backed up by data, studies and services. What they will not reveal is the enormous sampling bias in the studies and the standard errors in the estimates.
- If you have done your valuation right, those premiums should already be incorporated in your estimated value. Paying a premium will be double counting.
Test 4: Synergy….

- Assume that you are told that the combined firm will be less risky than the two individual firms and that it should have a lower cost of capital (and a higher value). Is this likely?

- Assume now that you are told that there are potential growth and cost savings synergies in the acquisition. Would that increase the value of the target firm?

- Should you pay this as a premium?
The Value of Synergy

Synergy is created when two firms are combined and can be either financial or operating.

Operating Synergy accrues to the combined firm as:

- **Strategic Advantages**
  - Higher returns on new investments
    - Higher ROC
    - Higher Growth Rate
  - More new Investments
  - More sustainable excess returns
    - Longer Growth Period
  - Higher Reinvestment
    - Higher Growth Rate

- **Economies of Scale**
  - Cost Savings in current operations
    - Higher Margin
    - Higher Base-year EBIT

Financial Synergy:

- **Tax Benefits**
  - Lower taxes on earnings due to:
    - Higher depreciation
    - Operating loss carryforwards

- **Added Debt Capacity**
  - Higher debt ratio and lower cost of capital

- **Diversification?**
  - May reduce cost of equity for private or closely held firm
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
## Synergy – Example

### Higher growth and cost savings

<table>
<thead>
<tr>
<th></th>
<th>P&amp;G</th>
<th>Gillette</th>
<th>Piglet: No Synergy</th>
<th>Piglet: Synergy</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free Cashflow to Equity</td>
<td>$5,864.74</td>
<td>$1,547.50</td>
<td>$7,412.24</td>
<td>$7,569.73</td>
<td>Annual operating expenses reduced by $250 million</td>
</tr>
<tr>
<td>Growth rate for first 5 years</td>
<td>12%</td>
<td>10%</td>
<td>11.58%</td>
<td>12.50%</td>
<td>Slightly higher growth rate</td>
</tr>
<tr>
<td>Growth rate after five years</td>
<td>4%</td>
<td>4%</td>
<td>4.00%</td>
<td>4.00%</td>
<td></td>
</tr>
<tr>
<td>Beta</td>
<td>0.90</td>
<td>0.80</td>
<td>0.88</td>
<td>0.88</td>
<td></td>
</tr>
<tr>
<td>Cost of Equity</td>
<td>7.90%</td>
<td>7.50%</td>
<td>7.81%</td>
<td>7.81%</td>
<td>Value of synergy</td>
</tr>
<tr>
<td>Value of Equity</td>
<td>$221,292</td>
<td>$59,878</td>
<td>$281,170</td>
<td>$298,355</td>
<td>$17,185</td>
</tr>
</tbody>
</table>
Lesson 4: Don’t pay for buzz words

- Through time, acquirers have always found ways of justifying paying for premiums over estimated value by using buzz words - synergy in the 1980s, strategic considerations in the 1990s and real options in this decade.

- While all of these can have value, the onus should be on those pushing for the acquisitions to show that they do and not on those pushing against them to show that they do not.
Test 5: Comparables and Exit Multiples

- Now assume that you are told that an analysis of other acquisitions reveals that acquirers have been willing to pay 5 times EBIT. Given that your target firm has EBIT of $20 million, would you be willing to pay $100 million for the acquisition?

- What if I estimate the terminal value using an exit multiple of 5 times EBIT?

- As an additional input, your investment banker tells you that the acquisition is accretive. (Your PE ratio is 20 whereas the PE ratio of the target is only 10... Therefore, you will get a jump in earnings per share after the acquisition...)
Biased samples = Poor results

- Biased samples yield biased results. Basing what you pay on what other acquirers have paid is a recipe for disaster. After all, we know that acquirers, on average, pay too much for acquisitions. By matching their prices, we risk replicating their mistakes.

- Even when we use the pricing metrics of other firms in the sector, we may be basing the prices we pay on firms that are not truly comparable.

- When we use exit multiples, we are assuming that what the market is paying for comparable companies today is what it will continue to pay in the future.
Lesson 5: Don’t be a lemming...

- All too often, acquisitions are justified by using one of the following two arguments:
  - Every one else in your sector is doing acquisitions. You have to do the same to survive.
  - The value of a target firm is based upon what others have paid on acquisitions, which may be much higher than what your estimate of value for the firm is.

- With the right set of comparable firms (selected to back up your story), you can justify almost any price.

- And EPS accretion is a meaningless measure. After all, buying an company with a PE lower than yours will lead mathematically to EPS accretion.
Test 6: The CEO really wants to do this...

- Now assume that you know that the CEO of the acquiring firm really, really wants to do this acquisition and that the investment bankers on both sides have produced fairness opinions that indicate that the firm is worth $100 million. Would you be willing to go along?
Lesson 6: Don’t let egos or investment bankers get the better of common sense...

- If you define your objective in a bidding war as winning the auction at any cost, you will win. But beware the winner’s curse!
- The premiums paid on acquisitions often have nothing to do with synergy, control or strategic considerations (though they may be provided as the reasons). They may just reflect the egos of the CEOs of the acquiring firms.
To illustrate: A bad deal is made, and justified by accountants & bankers

Aswath Damodaran
The CEO steps in... and digs a hole...

- Leo Apotheker was the CEO of HP at the time of the deal, brought in to replace Mark Hurd, the previous CEO who was forced to resign because of a “sex” scandal.

- In the face of almost universal feeling that HP had paid too much for Autonomy, Mr. Apotheker addressing a conference at the time of the deal: “We have a **pretty rigorous process inside H.P.** that we follow for **all our acquisitions**, which is a **D.C.F.-based model**,” he said, in a reference to discounted cash flow, a standard valuation methodology. “And we try to take a **very conservative view**.”

- Apotheker added, “Just to make sure everybody understands, Autonomy will be, on Day 1, **accretive to H.P.** ….. **“Just take it from us.** We did that analysis at **great length, in great detail**, and we feel that we paid a **very fair price** for Autonomy. And it will give a **great return to our shareholders.**
A year later... HP admits a mistake...and explains it...

- Premium for non-existent synergy paid by HP ($4,451 m)
- Primary culprit: Leo Apotheker (HP's old CEO)
- Secondary culprits: HP's deal bankers

- Accounting impropriety effect on synergy ($749 m) and on pre-deal market value ($1,700 m)
- Primary culprit: Autonomy's managers
- Secondary culprit: Deloitte

- HP's remaining write off ($1,900 m) for post-deal deterioration at Autonomy and/or comparison game playing
- Primary culprit: HP's current management
- Secondary culprits: HP's auditors
Test 7: Is it hopeless?

- The odds seem to be clearly weighted against success in acquisitions. If you were to create a strategy to grow, based upon acquisitions, which of the following offers your best chance of success?

<table>
<thead>
<tr>
<th>This</th>
<th>Or this</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Bidder</td>
<td>Bidding War</td>
</tr>
<tr>
<td>Public target</td>
<td>Private target</td>
</tr>
<tr>
<td>Pay with cash</td>
<td>Pay with stock</td>
</tr>
<tr>
<td>Small target</td>
<td>Large target</td>
</tr>
<tr>
<td>Cost synergies</td>
<td>Growth synergies</td>
</tr>
</tbody>
</table>
Better to lose a bidding war than to win one...

Returns in the 40 months before & after bidding war
Source: Malmendier, Moretti & Peters (2011)
You are better off buying small rather than large targets… with cash rather than stock
And focusing on private firms and subsidiaries, rather than public firms...
Growth vs Cost Synergies

Top-line trouble: 70 percent of mergers failed to achieve expected revenue synergies

Mergers achieving stated percentage of expected revenue synergies, percent $N = 77$

<table>
<thead>
<tr>
<th>Percentage</th>
<th>23</th>
<th>13</th>
<th>14</th>
<th>13</th>
<th>17</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;30%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30-50%</td>
<td>5</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>51-60%</td>
<td></td>
<td>6</td>
<td></td>
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</tr>
<tr>
<td>61-70%</td>
<td></td>
<td></td>
<td>8</td>
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<td>71-80%</td>
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<td>9</td>
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<td>81-90%</td>
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<td>13</td>
</tr>
<tr>
<td>91-100%</td>
<td></td>
<td></td>
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</tbody>
</table>

Typical sources of estimation error
- Ignoring or underestimating customer losses (typically 2% to 5%) that result from the integration
- Assuming growth or share targets out of line with overall market growth and competitive dynamics (no “outside view” calibration)


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

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

<table>
<thead>
<tr>
<th>Percentage</th>
<th>3</th>
<th>5</th>
<th>1</th>
<th>4</th>
<th>12</th>
<th>13</th>
<th>25</th>
<th>36</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;30%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30-50%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>51-60%</td>
<td>3</td>
<td></td>
<td>1</td>
<td></td>
<td>4</td>
<td>12</td>
<td>13</td>
<td></td>
</tr>
<tr>
<td>61-70%</td>
<td></td>
<td>5</td>
<td>1</td>
<td>4</td>
<td>13</td>
<td>25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>71-80%</td>
<td></td>
<td></td>
<td>1</td>
<td>4</td>
<td>13</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>81-90%</td>
<td></td>
<td></td>
<td></td>
<td>1</td>
<td>4</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>91-100%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>13</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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)

Synergy: Odds of success

- Studies that have focused on synergies have concluded that you are far more likely to deliver cost synergies than growth synergies.
- Synergies that are concrete and planned for at the time of the merger are more likely to be delivered than fuzzy synergies.
- Synergy is much more likely to show up when someone is held responsible for delivering the synergy.
- You are more likely to get a share of the synergy gains in an acquisition when you are a single bidder than if you are one of multiple bidders.
Lesson 7: For acquisitions to create value, you have to stay disciplined.

- If you have a successful acquisition strategy, stay focused on that strategy. Don’t let size or hubris drive you to “expand” the strategy.
- Realistic plans for delivering synergy and control have to be put in place before the merger is completed. By realistic, we have to mean that the magnitude of the benefits have to be reachable and not pipe dreams and that the time frame should reflect the reality that it takes a while for two organizations to work as one.
- The best thing to do in a bidding war is to drop out.
- Someone (preferably the person pushing hardest for the merger) should be held to account for delivering the benefits.
- The compensation for investment bankers and others involved in the deal should be tied to how well the deal works rather than for getting the deal done.
III. Building Competitive Advantages: Increase length of the growth period

Increase length of growth period

- Build on existing competitive advantages
  - Brand name
  - Legal Protection
- Find new competitive advantages
  - Switching Costs
  - Cost advantages
Value Creation 4: Reduce Cost of Capital

Cost of Equity (E/(D+E) + Pre-tax Cost of Debt (D./(D+E)) = Cost of Capital

- Make product or service less discretionary to customers
  - Changing product characteristics
  - More effective advertising
- Reduce operating leverage
- Change financing mix
  - Match debt to assets, reducing default risk
    - Swaps
    - Derivatives
    - Hybrids
Debt: Summarizing the trade off

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

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

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

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

4. Calculate the effect on Firm Value and Stock Price.
## Amgen’s Optimal Financing Mix

<table>
<thead>
<tr>
<th>Debt Ratio</th>
<th>Beta</th>
<th>Cost of Equity</th>
<th>Bond Rating</th>
<th>Interest rate on debt</th>
<th>Tax Rate</th>
<th>Cost of Debt (after-tax)</th>
<th>WACC</th>
<th>Firm Value (G)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>1.61</td>
<td>11.23%</td>
<td>AAA</td>
<td>5.13%</td>
<td>35.00%</td>
<td>3.33%</td>
<td>11.23%</td>
<td>$77,593</td>
</tr>
<tr>
<td>10%</td>
<td>1.73</td>
<td>11.70%</td>
<td>AAA</td>
<td>5.13%</td>
<td>35.00%</td>
<td>3.33%</td>
<td>10.86%</td>
<td>$82,559</td>
</tr>
<tr>
<td>20%</td>
<td>1.88</td>
<td>12.28%</td>
<td>A+</td>
<td>5.48%</td>
<td>35.00%</td>
<td>3.56%</td>
<td>10.54%</td>
<td>$87,441</td>
</tr>
<tr>
<td>30%</td>
<td>2.06</td>
<td>13.03%</td>
<td>A-</td>
<td>5.78%</td>
<td>35.00%</td>
<td>3.76%</td>
<td>10.25%</td>
<td>$92,273</td>
</tr>
<tr>
<td>40%</td>
<td>2.31</td>
<td>14.03%</td>
<td>CCC</td>
<td>12.78%</td>
<td>35.00%</td>
<td>8.31%</td>
<td>11.74%</td>
<td>$71,646</td>
</tr>
<tr>
<td>50%</td>
<td>2.68</td>
<td>15.49%</td>
<td>CCC</td>
<td>12.78%</td>
<td>33.94%</td>
<td>8.44%</td>
<td>11.97%</td>
<td>$69,237</td>
</tr>
<tr>
<td>60%</td>
<td>3.51</td>
<td>18.82%</td>
<td>C</td>
<td>16.78%</td>
<td>21.54%</td>
<td>13.17%</td>
<td>15.43%</td>
<td>$45,452</td>
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<tr>
<td>70%</td>
<td>4.68</td>
<td>23.51%</td>
<td>C</td>
<td>16.78%</td>
<td>18.46%</td>
<td>13.68%</td>
<td>16.63%</td>
<td>$40,450</td>
</tr>
<tr>
<td>80%</td>
<td>7.02</td>
<td>32.87%</td>
<td>C</td>
<td>16.78%</td>
<td>16.15%</td>
<td>14.07%</td>
<td>17.83%</td>
<td>$36,367</td>
</tr>
<tr>
<td>90%</td>
<td>14.04</td>
<td>60.96%</td>
<td>C</td>
<td>16.78%</td>
<td>14.36%</td>
<td>14.37%</td>
<td>19.03%</td>
<td>$32,972</td>
</tr>
</tbody>
</table>

Amgen’s current debt ratio = 10%
Amgen’s optimal debt ratio = 30%
## Tata Motor’s Optimal Financing Mix

<table>
<thead>
<tr>
<th>Debt Ratio</th>
<th>Beta</th>
<th>Cost of Equity</th>
<th>Bond Rating</th>
<th>Interest rate on debt</th>
<th>Tax Rate</th>
<th>Cost of Debt (after-tax)</th>
<th>WACC</th>
<th>Firm Value (G)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>0.98</td>
<td>12.36%</td>
<td>AAA</td>
<td>8.50%</td>
<td>33.99%</td>
<td>5.61%</td>
<td>12.36%</td>
<td>INR 440,722</td>
</tr>
<tr>
<td>10%</td>
<td>1.05</td>
<td>12.89%</td>
<td>A+</td>
<td>9.00%</td>
<td>33.99%</td>
<td>5.94%</td>
<td>12.20%</td>
<td>INR 450,734</td>
</tr>
<tr>
<td>20%</td>
<td>1.14</td>
<td>13.57%</td>
<td>BB+</td>
<td>11.50%</td>
<td>33.99%</td>
<td>7.59%</td>
<td>12.37%</td>
<td>INR 439,581</td>
</tr>
<tr>
<td>30%</td>
<td>1.26</td>
<td>14.44%</td>
<td>B-</td>
<td>13.50%</td>
<td>33.99%</td>
<td>8.91%</td>
<td>12.78%</td>
<td>INR 415,561</td>
</tr>
<tr>
<td>40%</td>
<td>1.42</td>
<td>15.65%</td>
<td>CC</td>
<td>18.00%</td>
<td>32.81%</td>
<td>12.09%</td>
<td>14.23%</td>
<td>INR 346,933</td>
</tr>
<tr>
<td>50%</td>
<td>1.75</td>
<td>18.15%</td>
<td>C</td>
<td>20.00%</td>
<td>21.23%</td>
<td>15.75%</td>
<td>16.95%</td>
<td>INR 262,949</td>
</tr>
<tr>
<td>60%</td>
<td>2.24</td>
<td>21.79%</td>
<td>D</td>
<td>23.00%</td>
<td>14.47%</td>
<td>19.67%</td>
<td>20.52%</td>
<td>INR 197,512</td>
</tr>
<tr>
<td>70%</td>
<td>3.00</td>
<td>27.52%</td>
<td>D</td>
<td>23.00%</td>
<td>11.66%</td>
<td>20.32%</td>
<td>22.48%</td>
<td>INR 172,970</td>
</tr>
<tr>
<td>80%</td>
<td>4.52</td>
<td>38.91%</td>
<td>D</td>
<td>23.00%</td>
<td>9.76%</td>
<td>20.75%</td>
<td>24.39%</td>
<td>INR 153,836</td>
</tr>
<tr>
<td>90%</td>
<td>9.07</td>
<td>73.00%</td>
<td>D</td>
<td>23.00%</td>
<td>8.40%</td>
<td>21.07%</td>
<td>26.26%</td>
<td>INR 138,352</td>
</tr>
</tbody>
</table>

Tata Motor’s current debt ratio = 25%
Tata Motor’s optimal debt ratio = 10%
III. LOOSE ENDS IN VALUATION: FROM FIRM VALUE TO VALUE OF EQUITY PER SHARE
But what comes next?

<table>
<thead>
<tr>
<th>Value of Operating Assets</th>
<th>Since this is a discounted cashflow valuation, should there be a real option premium?</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ Cash and Marketable Securities</td>
<td>Operating versus Non-operating cash Should cash be discounted for earning a low return?</td>
</tr>
<tr>
<td>+ Value of Cross Holdings</td>
<td>How do you value cross holdings in other companies? What if the cross holdings are in private businesses?</td>
</tr>
<tr>
<td>+ Value of Other Assets</td>
<td>What about other valuable assets? How do you consider underutilized assets?</td>
</tr>
<tr>
<td>Value of Firm</td>
<td>Should you discount this value for opacity or complexity? How about a premium for synergy? What about a premium for intangibles (brand name)?</td>
</tr>
<tr>
<td>- Value of Debt</td>
<td>What should be counted in debt? Should you subtract book or market value of debt? What about other obligations (pension fund and health care)? What about contingent liabilities? What about minority interests?</td>
</tr>
<tr>
<td>= Value of Equity</td>
<td>Should there be a premium/discount for control? Should there be a discount for distress</td>
</tr>
<tr>
<td>- Value of Equity Options</td>
<td>What equity options should be valued here (vested versus non-vested)? How do you value equity options?</td>
</tr>
<tr>
<td>= Value of Common Stock</td>
<td>Should you divide by primary or diluted shares?</td>
</tr>
<tr>
<td>/ Number of shares</td>
<td></td>
</tr>
<tr>
<td>= Value per share</td>
<td>Should there be a discount for illiquidity/marketability? Should there be a discount for minority interests?</td>
</tr>
</tbody>
</table>
1. The Value of Cash
An Exercise in Cash Valuation

<table>
<thead>
<tr>
<th></th>
<th>Company A</th>
<th>Company B</th>
<th>Company C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enterprise Value</td>
<td>$1 billion</td>
<td>$1 billion</td>
<td>$1 billion</td>
</tr>
<tr>
<td>Cash</td>
<td>$100 mil</td>
<td>$100 mil</td>
<td>$100 mil</td>
</tr>
<tr>
<td>Return on Capital</td>
<td>10%</td>
<td>5%</td>
<td>22%</td>
</tr>
<tr>
<td>Cost of Capital</td>
<td>10%</td>
<td>10%</td>
<td>12%</td>
</tr>
<tr>
<td>Trades in</td>
<td>US</td>
<td>US</td>
<td>Argentina</td>
</tr>
</tbody>
</table>

- 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?

Market Value of $1 in cash:
Estimates obtained by regressing Enterprise Value against Cash Balances
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 estimated 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

Value of Cross holdings: Tata Motors

- Tata Steel
- Tata Chemicals
- Non-listed Tata companies
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 cashflows, you cannot count the market value of the asset in your value.
4. A Discount for Complexity: An Experiment

<table>
<thead>
<tr>
<th></th>
<th>Company A</th>
<th>Company B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Income</td>
<td>$ 1 billion</td>
<td>$ 1 billion</td>
</tr>
<tr>
<td>Tax rate</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>ROIC</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>Expected Growth</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Cost of capital</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>Business Mix</td>
<td>Single</td>
<td>Multiple Businesses</td>
</tr>
<tr>
<td>Holdings</td>
<td>Simple</td>
<td>Complex</td>
</tr>
<tr>
<td>Accounting</td>
<td>Transparent</td>
<td>Opaque</td>
</tr>
</tbody>
</table>

Which firm would you value more highly?
# Measuring Complexity: Volume of Data in Financial Statements

<table>
<thead>
<tr>
<th>Company</th>
<th>Number of pages in last 10Q</th>
<th>Number of pages in last 10K</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Electric</td>
<td>65</td>
<td>410</td>
</tr>
<tr>
<td>Microsoft</td>
<td>63</td>
<td>218</td>
</tr>
<tr>
<td>Wal-mart</td>
<td>38</td>
<td>244</td>
</tr>
<tr>
<td>Exxon Mobil</td>
<td>86</td>
<td>332</td>
</tr>
<tr>
<td>Pfizer</td>
<td>171</td>
<td>460</td>
</tr>
<tr>
<td>Citigroup</td>
<td>252</td>
<td>1026</td>
</tr>
<tr>
<td>Intel</td>
<td>69</td>
<td>215</td>
</tr>
<tr>
<td>AIG</td>
<td>164</td>
<td>720</td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
<td>63</td>
<td>218</td>
</tr>
<tr>
<td>IBM</td>
<td>85</td>
<td>353</td>
</tr>
</tbody>
</table>
## Measuring Complexity: A Complexity Score

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

Complexity Score = 48.95

**Note:**
- **Operating Income:**
  - Number of businesses (more than 10% of revenues) = 1
  - Percent of operating income = 10%
  - Percent of operating income = 0%
  - Percent of operating income = 15%

- **Tax Rate:**
  - Percent of revenues from non-domestic locales = 70%
  - Yes or No
    - No = Yes=3
    - Yes = Yes=2

- **Capital Expenditures:**
  - Yes or No
    - Yes = Yes=2
    - Yes = Yes=4

- **Working capital:**
  - Yes or No
    - Yes = Yes=2
    - No = Yes=3

- **Expected Growth rate:**
  - Yes or No
    - Yes = Yes=5

- **Cost of capital:**
  - Number of businesses (more than 10% of revenues) = 1
  - Percent of revenues = 50%
  - Yes or No
    - No = No=2
    - Yes = No=2

- **No-operating assets:**
  - Minority holdings as percent of book assets = 0%

- **Firm to Equity value:**
  - Minority interest as percent of book value of equity = 63%

- **Per share value:**
  - Does the firm have shares with different voting rights? Yes
  - Options outstanding as percent of shares = 0%
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:
    \[ PBV = 0.65 + 15.31 \text{ ROE} - 0.55 \text{ Beta} + 3.04 \text{ Expected growth rate} - 0.003 \ # \text{ Pages in 10K} \]
5. Brand name, great management, superb product ... Are we short changing intangibles?

- There is often a temptation to add on premiums for intangibles. Among them are
  - 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.
## Categorizing Intangibles

<table>
<thead>
<tr>
<th></th>
<th>Independent and Cash flow generating intangibles</th>
<th>Not independent and cash flow generating to the firm</th>
<th>No cash flows now but potential for cashflows in future</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Examples</strong></td>
<td>Copyrights, trademarks, licenses, franchises, professional practices (medical, dental)</td>
<td>Brand names, Quality and Morale of work force, Technological expertise, Corporate reputation</td>
<td>Undeveloped patents, operating or financial flexibility (to expand into new products/markets or abandon existing ones)</td>
</tr>
</tbody>
</table>
| **Valuation approach** | Estimate expected cashflows from the product or service and discount back at appropriate discount rate. | • Compare DCF value of firm with intangible with firm without (if you can find one)  
• Assume that all excess returns of firm are due to intangible.  
• Compare multiples at which firm trades to sector averages. | Option valuation  
• Value the undeveloped patent as an option to develop the underlying product.  
• Value expansion options as call options  
• Value abandonment options as put options. |
| **Challenges**   | • Life is usually finite and terminal value may be small.  
• Cashflows and value may be person dependent (for professional practices) | With multiple intangibles (brand name and reputation for service), it becomes difficult to break down individual components. | • Need exclusivity.  
• Difficult to replicate and arbitrage (making option pricing models dicey). |
## Valuing Brand Name

<table>
<thead>
<tr>
<th>Metric</th>
<th>Coca Cola</th>
<th>With Cott Margins</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Revenues</td>
<td>$21,962.00</td>
<td>$21,962.00</td>
</tr>
<tr>
<td>Length of high-growth period</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Reinvestment Rate</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>Operating Margin (after-tax)</td>
<td>15.57%</td>
<td>5.28%</td>
</tr>
<tr>
<td>Sales/Capital (Turnover ratio)</td>
<td>1.34</td>
<td>1.34</td>
</tr>
<tr>
<td>Return on capital (after-tax)</td>
<td>20.84%</td>
<td>7.06%</td>
</tr>
<tr>
<td>Growth rate during period (g) =</td>
<td>10.42%</td>
<td>3.53%</td>
</tr>
<tr>
<td>Cost of Capital during period =</td>
<td>7.65%</td>
<td>7.65%</td>
</tr>
<tr>
<td>Stable Growth Period</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Growth rate in steady state =</td>
<td>4.00%</td>
<td>4.00%</td>
</tr>
<tr>
<td>Return on capital =</td>
<td>7.65%</td>
<td>7.65%</td>
</tr>
<tr>
<td>Reinvestment Rate =</td>
<td>52.28%</td>
<td>52.28%</td>
</tr>
<tr>
<td>Cost of Capital =</td>
<td>7.65%</td>
<td>7.65%</td>
</tr>
<tr>
<td>Value of Firm =</td>
<td>$79,611.25</td>
<td>$15,371.24</td>
</tr>
</tbody>
</table>
6. 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
For some firms that are in financial trouble, the book value of debt can be substantially higher than the market value of debt. Analysts worry that subtracting out the market value of debt in this case can yield too high a value for equity.

A discounted cashflow valuation is designed to value a going concern. In a going concern, it is the market value of debt that should count, even if it is much lower than book value.

In a liquidation valuation, you can subtract out the book value of debt from the liquidation value of the assets.

Converting book debt into market debt,
But you 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
7. 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
Adris Grupa (Status Quo): 4/2010

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%

Expected Growth
Reinvestment Rate 70.83%
Return on Capital 9.69%

Expected Growth from new inv.
.7083*.0969 = 0.0686
or 6.86%

Stable Growth
g = 4%; Beta = 0.80
Country Premium= 2%
Cost of capital = 9.92%
Tax rate = 20.00%
ROC = 9.92%
Reinvestment Rate = g/ROC
= 4/9.92 = 40.32%

Terminal Value5 = 365/(.0992-.04) = 6170 HRK

Cost of Equity 10.70%
Cost of Debt (4.25%+ 0.5%+2%(1-.20)
= 5.40%
Weights E = 97.4% D = 2.6%

Riskfree Rate: HRK Riskfree Rate = 4.25%

Beta 0.70
Mature market premium 4.5%

Country Default Spread 2%

On May 1, 2010
AG Pfd price = 279 HRK
AG Common = 345 HRK

Average from 2004-09
70.83%
9.69%

Year 1 2 3 4 5
EBIT (1-t) HRK 466 498 532 569 608
- Reinvestment HRK 330 353 377 403 431
FCFF HRK 136 145 155 166 177

Unlevered Beta for Sectors: 0.68
Firm’s D/E Ratio: 2.70%

70.83%
612
461
365

HKR Cashflows
612
246
365

Value non-voting share
335 HRK/share

Discount at $ Cost of Capital (WACC) = 10.7% (.974) + 5.40% (0.026) = 10.55%

Country Default Spread 2%

CRP for Croatia
Lambda 0.68
CRP for Central Europe
Lambda 0.42
Rel Equity Mkt Vol 1.50

On May 1, 2010
AG Pfd price = 279 HRK
AG Common = 345 HRK

Average from 2004-09
70.83%
9.69%
Adris Grupa: 4/2010 (Restructured)

Current Cashflow to Firm

<table>
<thead>
<tr>
<th>Component</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBIT (1-t)</td>
<td>436 HRK</td>
</tr>
<tr>
<td>- Net CpX</td>
<td>3 HRK</td>
</tr>
<tr>
<td>- Chg WC</td>
<td>-118 HRK</td>
</tr>
<tr>
<td>= FCFF</td>
<td>551 HRK</td>
</tr>
</tbody>
</table>

Reinvest Rate = (3-118)/436 = -26.35%;

Tax rate = 17.35%

Return on capital = 8.72%

Reinvestment Rate = 70.83%

Expected Growth from new inv.:

\[ \frac{0.7083 \times 0.01054}{0.0965} = 0.0686 \] or 6.86%

Return on Capital = 10.54%

Terminal Value5 = \( \frac{367}{0.0965 - 0.04} \) = 6508 HRK

HKR Cashflows

<table>
<thead>
<tr>
<th>Year</th>
<th>EBIT (1-t)</th>
<th>Reinvestment</th>
<th>FCFF</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>HRK 469</td>
<td>HRK 137</td>
<td>HRK 108</td>
</tr>
<tr>
<td>2</td>
<td>HRK 503</td>
<td>HRK 147</td>
<td>HRK 156</td>
</tr>
<tr>
<td>3</td>
<td>HRK 541</td>
<td>HRK 158</td>
<td>HRK 180</td>
</tr>
<tr>
<td>4</td>
<td>HRK 581</td>
<td>HRK 175</td>
<td>HRK 204</td>
</tr>
<tr>
<td>5</td>
<td>HRK 623</td>
<td>HRK 194</td>
<td>HRK 230</td>
</tr>
</tbody>
</table>

Discount at $ Cost of Capital (WACC) = 11.12% (.90) + 8.20% (0.10) = 10.55%

Cost of Equity: 11.12%

Cost of Debt:

\( (4.25\% + 4\% + 2\%) (1 - 0.20) = 8.20\% \)

Weights:

E = 90% D = 10%

Riskfree Rate:

HRK Riskfree Rate = 4.25%

Unlevered Beta for Sectors: 0.68

Beta: 0.75

Mature market premium: 4.5%

Lambda 0.68 \times CRP for Croatia (3%)

Lambda 0.42 \times CRP for Central Europe (3%)

Country Default Spread 2%

Rel Equity Mkt Vol 1.50

On May 1, 2010

AG Pfd price = 279 HRK

AG Common = 345 HRK

Average from 2004-09

70.83%

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 = 9.94%

Reinvestment Rate = \( g / ROC = 4 / 9.65 = 41 / 47\% \)

Changed mix of debt and equity to optimal
Value of Control and the Value of Voting Rights

- The value of control at Adris Grupa can be computed as the difference between the status quo value (5484) and the optimal value (5735).

- The value of a voting share derives entirely from the capacity you have to change the way the firm is run. In this case, we have two values for Adris Grupa’s Equity.

  Status Quo Value of Equity = 5,484 million HKR
  All shareholders, common and preferred, get an equal share of the status quo value.

- Value for a non-voting share = \( \frac{5484}{(9.616+6.748)} = 334 \) HKR/share

- Optimal value of Equity = 5,735 million HKR

- Value of control at Adris Grupa = 5,735 – 5484 = 249 million HKR

- Only voting shares get a share of this value of control

  Value per voting share = 334 HKR + \( \frac{249}{9.616} = 362 \) HKR
8. Truncation risk and the Going Concern Assumption

- Traditional valuation techniques are built on the assumption of a going concern, i.e., a firm that has continuing operations and there is no significant threat to these operations.
  - In discounted cashflow valuation, this going concern assumption finds its place most prominently in the terminal value calculation, which usually is based upon an infinite life and ever-growing cashflows.
  - In relative valuation, this going concern assumption often shows up implicitly because a firm is valued based upon how other firms - most of which are healthy - are priced by the market today.

- When there is a significant likelihood of truncation risk (i.e., that the firm will cease to exist or that your equity position will be extinguished), the going concern assumption will overvalue a firm.
Examples of truncation risk

1. Acts of god: For much of recorded time, at least prior to insurance, the biggest risk to businesses came from acts of god – storms, earthquakes etc.

2. Terrorism & War: An otherwise healthy business can be devastated by an act of terrorism or in the event of war.

3. Nationalization: In some countries, successful businesses can be targeted by governments for nationalization, with equity investors getting well below fair value in compensation.

4. Default/Distress/Failure: If a business is unable to generate enough cash flows from operations and/or to raise money from external sources to keep going, the “gig” is up.
Three ways of dealing with truncation risk

- Adjust the expected cash flows: You can adjust the expected cash flows for the likelihood and consequences of catastrophic risk. Note that this will get progressively more difficult to do as you move through time, since you have to consider the cumulative probabilities of events happening over long periods.

- Adjust the discount rate: You can “hike” up the discount rate to cover the likelihood of failure. While it has the desired “intuitive” effect, the “increased” discount rate is often arbitrary and becomes a negotiating tool rather than a measure of expected return.

- Put a decision tree front on the analysis:
  - In one branch of the tree, assume that the “truncation” risk will not occur and value the firm using conventional DCF valuation.
  - In the other branch, assume that truncation risk occurs and value the business/equity if it does.
  - Estimate an expected value across both branches.
9. Equity to Employees: Effect on Value

- In recent years, firms have turned to giving employees (and especially top managers) equity option packages as part of compensation. These options are usually
  - Long term
  - At-the-money when issued
  - On volatile stocks
- Are they worth money? And if yes, who is paying for them?
- Two key issues with employee options:
  - How do options granted in the past affect equity value per share today?
  - How do expected future option grants affect equity value today?
Equity Options and Value

- **Options outstanding**
  - Step 1: List all options outstanding, with maturity, exercise price and vesting status.
  - Step 2: Value the options, taking into account dilution, vesting and early exercise considerations.
  - Step 3: Subtract from the value of equity and divide by the actual number of shares outstanding (not diluted or partially diluted).

- **Expected future option and restricted stock issues**
  - Step 1: Forecast value of options that will be granted each year as percent of revenues that year. (As firm gets larger, this should decrease)
  - Step 2: Treat as operating expense and reduce operating income and cash flows.
  - Step 3: Take present value of cashflows to value operations or equity.
THE DARK SIDE OF VALUATION: VALUING DIFFICULT-TO-VALUE COMPANIES
The fundamental determinants of value...

- What are the cashflows from existing assets?
  - Equity: Cashflows after debt payments
  - Firm: Cashflows before debt payments

- What is the value added by growth assets?
  - Equity: Growth in equity earnings/cashflows
  - Firm: Growth in operating earnings/cashflows

- How risky are the cash flows from both existing assets and growth assets?
  - Equity: Risk in equity in the company
  - Firm: Risk in the firm’s operations

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

Making judgments on revenues/profits difficult because you cannot draw on history. If you have no product/service, it is difficult to gauge market potential or profitability. The company’s entire value lies in future growth but you have little to base your estimate on.

Cash flows from existing assets non-existent or negative.

What are the cashflows from existing assets?

Different claims on cash flows can affect value of equity at each stage.

What is the value of equity in the firm?

What is the value added by growth assets?

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

Limited historical data on earnings, and no market prices for securities makes it difficult to assess risk.

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

Will the firm will make it through the gauntlet of market demand and competition. Even if it does, assessing when it will become mature is difficult because there is so little to go on.
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...
9a. Amazon in January 2000

**Current Revenue** $1,117

**Current Margin:** -36.71%

From previous years

**EBIT** -410m

**NOL:** 500 m

As of January 2000, Amazon was trading at $84.

**Value of Op Assets** $15,170

+ **Cash** $26

= **Value of Firm** $14,937

- **Value of Debt** $349

= **Value of Equity** $14,588

- **Equity Options** $2,892

Based on the current stock price of $84, all existing options are valued as options.

**Cost of Equity** 12.90%

**Cost of Debt** 6.5%+1.5%-8.0%

Tax rate = 0% -> 35%

**Expected Margin**: 10.00%

**Sales Turnover Ratio**: 3.00

**Revenue Growth**: 42%

**Competitive Advantages**

**Revenue** $2,793

**Operating Margin** 13.35%

**EBIT** $373

**EBIT(1-t)** $336

**Reinvestment** $600

**FCFF** $931

**Cost of Equity** 12.90%

**Cost of Debt** 8.00%

**After-tax cost of debt** 7.00%

**Cost of Capital** 12.84%

**Stable Growth**

**Stable Revenue Growth**: 6%

**Stable Operating Margin**: 10.00%

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

Terminal Value = 1881/(0.0961-.06) = 52,148

**Internet/Retail Operating Leverage**

**Current D/E**: 1.21%

**Base Equity Premium**

**Country Risk Premium**

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

**Dot.com retailers for first 5 years**

**Convetional retailers after year 5**

**Riskfree Rate:** T. Bond rate = 6.5%

**Beta** 1.60 -> 1.00

**Risk Premium** 4%

Amazon was trading at $84 in January 2000.

**Pushed debt ratio to retail industry average of 15%.
Lesson 1: Don’t trust regression betas....
Lesson 2: Work backwards and keep it simple...

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

Typically, the revenue growth rate of a newly public company outpaces its industry average for only about five years.

Source: Andrew Metrick
The New York Times
Lesson 4: Don’t forget to pay for growth...

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

Assumed to be =
Lesson 5: There are always scenarios where the market price can be justified...

<table>
<thead>
<tr>
<th></th>
<th>6%</th>
<th>8%</th>
<th>10%</th>
<th>12%</th>
<th>14%</th>
</tr>
</thead>
<tbody>
<tr>
<td>30%</td>
<td>$(1.94)$</td>
<td>$2.95</td>
<td>$7.84</td>
<td>$12.71</td>
<td>$17.57</td>
</tr>
<tr>
<td>35%</td>
<td>$1.41</td>
<td>$8.37</td>
<td>$15.33</td>
<td>$22.27</td>
<td>$29.21</td>
</tr>
<tr>
<td>40%</td>
<td>$6.10</td>
<td>$15.93</td>
<td>$25.74</td>
<td>$35.54</td>
<td>$45.34</td>
</tr>
<tr>
<td>45%</td>
<td>$12.59</td>
<td>$26.34</td>
<td>$40.05</td>
<td>$53.77</td>
<td>$67.48</td>
</tr>
<tr>
<td>50%</td>
<td>$21.47</td>
<td>$40.50</td>
<td>$59.52</td>
<td>$78.53</td>
<td>$97.54</td>
</tr>
<tr>
<td>55%</td>
<td>$33.47</td>
<td>$59.60</td>
<td>$85.72</td>
<td>$111.84</td>
<td>$137.95</td>
</tr>
<tr>
<td>60%</td>
<td>$49.53</td>
<td>$85.10</td>
<td>$120.66</td>
<td>$156.22</td>
<td>$191.77</td>
</tr>
</tbody>
</table>
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).
Forever

Terminal Value = \frac{1064}{0.0876 - 0.05} = 28,310

Cost of Equity = 13.81%

Cost of Debt = 6.5% + 3.5% = 10.0%

Tax rate = 0% -> 35%

Value of Op Assets $8,789

+ Cash & Non-op $1,263

= Value of Firm $10,052

- Value of Debt $1,879

= Value of Equity $8,173

- Equity Options $845

= Value per share $20.83

Cost of Equity 13.81%

Cost of Debt 6.5% + 3.5% = 10.0%

Tax rate = 0% -> 35%

Weights

Debt = 27.3% -> 15%

Riskfree Rate:

T. Bond rate = 5.1%

\text{Beta} = 2.18 -> 1.10

\text{Risk Premium} = 4%

Amazon.com
January 2001
Stock price = $14
And the market is often “more wrong”....
An “option premium”: The option to add a product or enter a market

- Additional Investment to Expand
- Present Value of Expected Cash Flows on Expansion

Firm will not expand in this section

Expansion becomes attractive in this section

PV of Cash Flows from Expansion
An Example of an Expansion Option

- You have completed a DCF valuation of a small anti-virus software company, Secure Mail, and estimated a value of $115 million.

- Assume that there is the possibility that the company could use the customer base that it develops for the anti-virus software and the technology on which the software is based to create a database software program sometime in the next 5 years.
  - It will cost Secure Mail about $500 million to develop a new database program, if they decided to do it today.
  - Based upon the information you have now on the potential for a database program, the company can expect to generate about $40 million a year in after-tax cashflows for ten years. The cost of capital for private companies that provide database software is 12%.
  - The annualized standard deviation in firm value at publicly traded database companies is 50%.
  - The five-year treasury bond rate is 3%.
Valuing the Expansion Option

S = Value of entering the database software market
   = PV of $40 million for 10 years @12% = $226 million
K = Cost of entering the database software market = $ 500 mil
t = Period over which you have the right to enter the market
   = 5 years
σ = Standard deviation of stock prices of database firms = 50%
r = Riskless rate = 3%

Call Value= $ 56 Million
DCF valuation of the firm = $ 115 million
Value of Option to Expand to Database market = $ 56 million
Value of the company with option to expand = $ 171 million
A note of caution: Opportunities are not options...

Is the first investment necessary for the second investment?

Not necessary

A Zero competitive advantage on Second Investment

Pre-Requisit

An Exclusive Right to Second Investment

No option value

Option has no value

100% of option value

Option has high value

Second Investment has zero excess returns

Second investment has large sustainable excess return

First-Mover  Technological  Brand  Telecom  Pharmaceutical
Edge      Name      Licenses         patents

Increasing competitive advantage/ barriers to entry
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

Lots of historical data on earnings and cashflows. Key questions remain if these numbers are volatile over time or if the existing assets are not being efficiently utilized.

What are the cashflows from existing assets?

Equity claims can vary in voting rights and dividends.

What is the value of equity in the firm?

Growth is usually not very high, but firms may still be generating healthy returns on investments, relative to cost of funding. Questions include how long they can generate these excess returns and with what growth rate in operations. Restructuring can change both inputs dramatically and some firms maintain high growth through acquisitions.

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

Operating risk should be stable, but the firm can change its financial leverage. This can affect both the cost of equity and capital.

What is the value added by growth assets?

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

Maintaining excess returns or high growth for any length of time is difficult to do for a mature firm.
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

New and better management

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

Operating Restructuring

<table>
<thead>
<tr>
<th>Year</th>
<th>Operating income after taxes</th>
<th>Expected growth rate</th>
<th>ROC</th>
<th>Reinvestment Rate</th>
<th>Reinvestment</th>
<th>FCFF</th>
<th>Cost of capital</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trailing 12 months</td>
<td>$315</td>
<td>2.75%</td>
<td>14.34%</td>
<td>19.14%</td>
<td>$62</td>
<td>$262</td>
<td>6.79%</td>
<td>$245</td>
</tr>
<tr>
<td>1</td>
<td>$324</td>
<td>2.75%</td>
<td>14.34%</td>
<td>19.14%</td>
<td>$64</td>
<td>$269</td>
<td>6.79%</td>
<td>$236</td>
</tr>
<tr>
<td>2</td>
<td>$333</td>
<td>2.75%</td>
<td>14.34%</td>
<td>19.14%</td>
<td>$65</td>
<td>$276</td>
<td>6.79%</td>
<td>$227</td>
</tr>
<tr>
<td>3</td>
<td>$342</td>
<td>2.75%</td>
<td>14.34%</td>
<td>19.14%</td>
<td>$65</td>
<td>$276</td>
<td>6.79%</td>
<td>$227</td>
</tr>
<tr>
<td>Beyond</td>
<td>$350</td>
<td>2.35%</td>
<td>7.23%</td>
<td>32.52%</td>
<td>$114</td>
<td>$4,840</td>
<td>7.23%</td>
<td>$3,974</td>
</tr>
</tbody>
</table>

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 |

Financial restructuring

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.

Probability of management change = 10%
Expected value = $31.91 (.90) + $37.80 (.10) = $32.50
Lesson 1: Cost cutting and increased efficiency are easier on paper than in practice...

Exhibit 4: Top factors for meeting targets

<table>
<thead>
<tr>
<th>Top factors most responsible for companies meeting cost targets or goals</th>
<th>% of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top-management support</td>
<td>44</td>
</tr>
<tr>
<td>Clear targets</td>
<td>39</td>
</tr>
<tr>
<td>Clear, well-planned approach</td>
<td>31</td>
</tr>
<tr>
<td>Necessary talent and capabilities in place</td>
<td>22</td>
</tr>
<tr>
<td>Sufficient accountability</td>
<td>19</td>
</tr>
<tr>
<td>Fact base necessary to make decisions</td>
<td>15</td>
</tr>
<tr>
<td>Sufficient communication</td>
<td>8</td>
</tr>
<tr>
<td>Less than expected impact of financial crisis</td>
<td>7</td>
</tr>
<tr>
<td>Sufficient investment in critical functional capabilities</td>
<td>3</td>
</tr>
<tr>
<td>Support from unions</td>
<td>3</td>
</tr>
<tr>
<td>Necessary incentives in place</td>
<td>2</td>
</tr>
<tr>
<td>Supportive regulations</td>
<td>0</td>
</tr>
</tbody>
</table>

1 Respondents who answered “don’t know” are not shown.
Lesson 2: Increasing growth is not always an option (or at least not a good option)
Lesson 3: Financial leverage is a double-edged sword..


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

- 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 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...

Historical 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 are the cashflows from existing assets?

What is the value added by growth assets?

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

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

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

Depending upon the risk of the assets being divested and the use of the proceeds from the divestiture (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.

What is the value of equity in the firm?
a. Dealing with Decline

- In decline, firms often see declining revenues and lower margins, translating in negative expected growth over time.

- If these firms are run by good managers, they will not fight decline. Instead, they will adapt to it and shut down or sell investments that do not generate the cost of capital. This can translate into negative net capital expenditures (depreciation exceeds cap ex), declining working capital and an overall negative reinvestment rate. The best case scenario is that the firm can shed its bad assets, make itself a much smaller and healthier firm and then settle into long-term stable growth.

- As an investor, your worst case scenario is that these firms are run by managers in denial who continue to expand the firm by making bad investments (that generate lower returns than the cost of capital). These firms may be able to grow revenues and operating income but will destroy value along the way.
11. Sears Holdings: Status Quo

**Current Cashflow to Firm**

- EBIT(1-t): 1,183
- Nt CpX: -18
- Chg WC: -67
- FCFF: 1,268

Reinvestment Rate = -75/1183 = -7.19%
Return on capital = 4.99%

**Expected Growth in EBIT (1-t)**

-0.30*.05 = -0.015
-1.5%

**Stable Growth**

- g = 2%; Beta = 1.00;
- Country Premium = 0%
- Cost of capital = 7.13%
- ROC = 7.13%; Tax rate = 38%
- Reinvestment Rate = 28.05%

**Terminal Value**

\[\text{Terminal Value} = \frac{868}{0.0713 - 0.02} = 16,921\]

**Discount at Cost of Capital (WACC)**

9.58% * (E/V) + 4.80% * (D/V) = 7.50%

**Op. Assets**

- 17,634
+ Cash: 1,622
- Debt: 7,726
- Equity: 11,528
- Options: 5

**Value/Share**

$87.29

**On July 23, 2008,**

Sears was trading at $76.25 a share.
b. 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).
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:

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

Solving for the probability of bankruptcy, we get:

\[\pi_{\text{Distress}} = \text{Annual probability of default} = 13.54\%
\]

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?
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 = $\sigma^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:
  - $d1 = 1.5994$ \hspace{1cm} $N(d1) = 0.9451$
  - $d2 = 0.3345$ \hspace{1cm} $N(d2) = 0.6310$
- Value of the call = $100 \times 0.9451 - 80 \times \exp(-0.10 \times 10) \times 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:
    - $d_1 = 1.0515$  
      $N(d_1) = 0.8534$
    - $d_2 = -0.2135$  
      $N(d_2) = 0.4155$
  - Value of the call = $50 \times 0.8534 - 80 \exp(-0.10)(10) \times 0.4155 = 30.44$ million
  - Value of the bond = $50 - 30.44 = 19.56$ million
Equity value persists .. As firm value declines..

Value of Equity as Firm Value Changes

![Bar chart showing the value of equity as the value of the firm changes.](chart)

Value of Firm ($80 Face Value of Debt)

- 100
- 90
- 80
- 70
- 60
- 50
- 40
- 30
- 20
- 10

Value of Equity

- 80
- 70
- 60
- 50
- 40
- 30
- 20
- 10
- 0
Real World Approaches to Valuing Equity in Troubled Firms: Getting Inputs

<table>
<thead>
<tr>
<th>Input</th>
<th>Estimation Process</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of the Firm</td>
<td>• Cumulate market values of equity and debt (or)</td>
</tr>
<tr>
<td></td>
<td>• Value the assets in place using FCFF and WACC (or)</td>
</tr>
<tr>
<td></td>
<td>• Use cumulated market value of assets, if traded.</td>
</tr>
<tr>
<td>Variance in Firm Value</td>
<td>• If stocks and bonds are traded,</td>
</tr>
<tr>
<td></td>
<td>$\sigma^2_{\text{firm}} = \sigma^2_{\text{e}} + \sigma^2_{\text{d}} + 2 \sigma_{\text{e}} \sigma_{\text{d}} \rho_{\text{ed}} \sigma_{\text{e}} \sigma_{\text{d}}$</td>
</tr>
<tr>
<td></td>
<td>where $\sigma^2_{\text{e}}$ = variance in the stock price</td>
</tr>
<tr>
<td></td>
<td>$\sigma_{\text{e}}$ = MV weight of Equity</td>
</tr>
<tr>
<td></td>
<td>$\sigma^2_{\text{d}}$ = the variance in the bond price</td>
</tr>
<tr>
<td></td>
<td>$\sigma_{\text{d}}$ = MV weight of debt</td>
</tr>
<tr>
<td></td>
<td>• If not traded, use variances of similarly rated bonds.</td>
</tr>
<tr>
<td></td>
<td>• Use average firm value variance from the industry in which company operates.</td>
</tr>
<tr>
<td>Value of the Debt</td>
<td>• If the debt is short term, you can use only the face or book value of the debt.</td>
</tr>
<tr>
<td></td>
<td>• If the debt is long term and coupon bearing, add the cumulated nominal value of these coupons to the face value of the debt.</td>
</tr>
<tr>
<td>Maturity of the Debt</td>
<td>• Face value weighted duration of bonds outstanding (or)</td>
</tr>
<tr>
<td></td>
<td>• If not available, use weighted maturity</td>
</tr>
</tbody>
</table>
Valuing Equity as an option - Eurotunnel in early 1998

- Eurotunnel has been a financial disaster since its opening
  - In 1997, Eurotunnel had earnings before interest and taxes of -£56 million and net income of -£685 million
  - At the end of 1997, its book value of equity was -£117 million
- It had £8,865 million in face value of debt outstanding
  - The weighted average duration of this debt was 10.93 years

<table>
<thead>
<tr>
<th>Debt Type</th>
<th>Face Value</th>
<th>Duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short term</td>
<td>935</td>
<td>0.50</td>
</tr>
<tr>
<td>10 year</td>
<td>2435</td>
<td>6.7</td>
</tr>
<tr>
<td>20 year</td>
<td>3555</td>
<td>12.6</td>
</tr>
<tr>
<td>Longer</td>
<td>1940</td>
<td>18.2</td>
</tr>
<tr>
<td>Total</td>
<td>£8,865 mil</td>
<td>10.93 years</td>
</tr>
</tbody>
</table>
The Basic DCF Valuation

- The value of the firm estimated using projected cashflows to the firm, discounted at the weighted average cost of capital was £2,312 million.

- This was based upon the following assumptions –
  - Revenues will grow 5% a year in perpetuity.
  - The COGS which is currently 85% of revenues will drop to 65% of revenues in yr 5 and stay at that level.
  - Capital spending and depreciation will grow 5% a year in perpetuity.
  - There are no working capital requirements.
  - The debt ratio, which is currently 95.35%, will drop to 70% after year 5. The cost of debt is 10% in high growth period and 8% after that.
  - The beta for the stock will be 1.10 for the next five years, and drop to 0.8 after the next 5 years.
  - The long term bond rate is 6%.
Other Inputs

- The stock has been traded on the London Exchange, and the annualized std deviation based upon ln (prices) is 41%.

- There are Eurotunnel bonds, that have been traded; the annualized std deviation in ln(price) for the bonds is 17%.
  - The correlation between stock price and bond price changes has been 0.5. The proportion of debt in the capital structure during the period (1992-1996) was 85%.
  - Annualized variance in firm value
    $$= (0.15)^2 (0.41)^2 + (0.85)^2 (0.17)^2 + 2 (0.15)(0.85)(0.5)(0.41)(0.17)= 0.0335$$

- The 15-year bond rate is 6%. (I used a bond with a duration of roughly 11 years to match the life of my option)
Valuing Eurotunnel Equity and Debt

- **Inputs to Model**
  - Value of the underlying asset = $S$ = Value of the firm = £2,312 million
  - Exercise price = $K$ = Face Value of outstanding debt = £8,865 million
  - Life of the option = $t$ = Weighted average duration of debt = 10.93 years
  - Variance in the value of the underlying asset = $\sigma^2$ = Variance in firm value = 0.0335
  - Riskless rate = $r$ = Treasury bond rate corresponding to option life = 6%

- Based upon these inputs, the Black-Scholes model provides the following value for the call:
  - $d_1 = -0.8337$  \quad N(d_1) = 0.2023
  - $d_2 = -1.4392$  \quad N(d_2) = 0.0751

- Value of the call = $2312 \times (0.2023) - 8,865 \exp(-0.06)(10.93)(0.0751) = £122$ million

- Appropriate interest rate on debt = $(8865/2190)^{1/10.93}-1 = 13.65\%$
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.

What are the cashflows from existing assets?

Preferred stock is a significant source of capital.

What is the value of equity in the firm?

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?

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

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.

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

In addition to all the normal constraints, financial service firms also have to worry about maintaining capital ratios that are acceptable to regulators. If they do not, they can be taken over and shut down.
2b. Goldman Sachs: August 2008

Rationale for model
Why dividends? Because FCFE cannot be estimated
Why 3-stage? Because the firm is behaving (reinvesting, growing) like a firm with potential.

Dividends
EPS = $16.77 *
Payout Ratio 8.35%
DPS =$1.40
(Updated numbers for 2008 financial year ending 11/08)

Retention Ratio = 91.65%

Expected Growth in first 5 years = 91.65%*13.19% = 12.09%

Terminal Value= EPS10*Payout/(r-g)
(42.03*1.04*.6)/(.095-.04) = 476.86

Discount at Cost of Equity
Between years 6-10, as growth drops to 4%, payout ratio increases and cost of equity decreases.

Cost of Equity
4.10% + 1.40 (4.5%) = 10.4%

Riskfree Rate:
Treasury bond rate 4.10%

Beta 1.40

Risk Premium
4.5%
Implied Equity Risk premium in 8/08

Average beta for investment banks= 1.40

Mature Market 4.5%
Country Risk 0%

In August 2008, Goldman was trading at $169/share.

Left return on equity at 2008 levels, well below 16% in 2007 and 20% in 2004-2006.
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)
2d. Deutsche Bank: March 2009

**Last 2 years**
- **2007**
  - Net Income: $3,954m
  - Dividends: $2,146m
  - Risk adjusted assets: $312,882m
  - Book Equity: $31,914m
- **2008**
  - Net Income: -$3,855m
  - Dividends: $285m
  - Risk adjusted assets: $31,822m

**Normalized Net Income**
- For base year 3,000 m
- ROE = 9.4%

**Expected growth in asset base**
- 4%

**Target capital ratio**
- 10%

**Target ROE**
- 10.2%

**Stable Growth**
- g = 3%
- Beta = 1.00
- Cost of equity = 10.20%
- Return on equity = 10.20%
- Reinvestment Rate = \(\frac{g}{ROE} = \frac{3}{10.20\%} = 29.41\%\)

**Cashflows**

<table>
<thead>
<tr>
<th>Year</th>
<th>Asset Base</th>
<th>Capital ratio</th>
<th>Regulatory Capital</th>
<th>ROE</th>
<th>Change in capital</th>
<th>Net Income</th>
<th>FCFE</th>
<th>PV of CF</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>325,398 €</td>
<td>10.16%</td>
<td>33,060 €</td>
<td>9.56%</td>
<td>1,146 €</td>
<td>3,161 €</td>
<td>2,014 €</td>
<td>31,383 m</td>
</tr>
<tr>
<td>2</td>
<td>338,414 €</td>
<td>10.12%</td>
<td>34,247 €</td>
<td>9.72%</td>
<td>1,187 €</td>
<td>3,329 €</td>
<td>2,142 €</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>351,950 €</td>
<td>10.08%</td>
<td>35,477 €</td>
<td>9.87%</td>
<td>1,229 €</td>
<td>3,505 €</td>
<td>2,276 €</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>366,028 €</td>
<td>10.04%</td>
<td>36,749 €</td>
<td>9.98%</td>
<td>1,273 €</td>
<td>3,690 €</td>
<td>2,417 €</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>380,669 €</td>
<td>10.00%</td>
<td>38,067 €</td>
<td>10.04%</td>
<td>1,318 €</td>
<td>3,883 €</td>
<td>2,565 €</td>
<td></td>
</tr>
</tbody>
</table>

**In March 2009**
- Deutsche Bank price = 48 Euros/share (down from 89 Euros in early 2008)

**Discount at Cost of equity**
\[3.60\% + 1.162 \times 6\% - 0.60\% = 11.172\%\]

**Riskfree Rate**
- Euro Riskfree Rate = 3.6%

**Beta**
- 1.162

**Mature market premium**
- 6%

**Region**
- Western Europe: 0.68
- United States: 0.42
- Latin America: 0.01
- Africa & Middle East: 0.01
- Asia: 0.11
- Eastern Europe: 0.04
- Deutsche Bank: 0.60

**CRP**
- 0.00%
- 0.00%
- 4.50%
- 7.00%
- 3.50%
- 3.00%
- 0.60%
V. Valuing Companies with “intangible” assets

If capital expenditures are mis-categorized as operating expenses, it becomes very difficult to assess how much a firm is reinvesting for future growth and how well its investments are doing.

What are the cashflows from existing assets?

The capital expenditures associated with acquiring intangible assets (technology, human capital) are mis-categorized as operating expenses, leading to incorrect accounting earnings and measures of capital invested.

What is the value added by growth assets?

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

It can be more difficult to borrow against intangible assets than it is against tangible assets. The risk in operations can change depending upon how stable the intangible asset is.

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

Intangible assets such as brand name and customer loyalty can last for very long periods or dissipate overnight.
Lesson 1: Accounting rules are cluttered with inconsistencies...

- If we start with accounting first principles, capital expenditures are expenditures designed to create benefits over many periods. They should not be used to reduce operating income in the period that they are made, but should be depreciated/amortized over their life. They should show up as assets on the balance sheet.

- Accounting is consistent in its treatment of cap ex with manufacturing firms, but is inconsistent with firms that do not fit the mold.
  - With pharmaceutical and technology firms, R&D is the ultimate cap ex but is treated as an operating expense.
  - With consulting firms and other firms dependent on human capital, recruiting and training expenses are your long term investments that are treated as operating expenses.
  - With brand name consumer product companies, a portion of the advertising expense is to build up brand name and is the real capital expenditure. It is treated as an operating expense.
Lesson 2: And fixing those inconsistencies can alter your view of a company and affect value.

<table>
<thead>
<tr>
<th></th>
<th>No R&amp;D adjustment</th>
<th>R&amp;D adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBIT</td>
<td>$5,071</td>
<td>$7,336</td>
</tr>
<tr>
<td>Invested Capital</td>
<td>$25,277</td>
<td>$33,173</td>
</tr>
<tr>
<td>ROIC</td>
<td>14.58%</td>
<td>18.26%</td>
</tr>
<tr>
<td>Reinvestment Rate</td>
<td>115.68%</td>
<td>106.98%</td>
</tr>
<tr>
<td>Value of firm</td>
<td>$58,617</td>
<td>$95,497</td>
</tr>
<tr>
<td>Value of equity</td>
<td>$50,346</td>
<td>$87,226</td>
</tr>
<tr>
<td>Value/share</td>
<td>$42.73</td>
<td>$74.33</td>
</tr>
</tbody>
</table>
VI. 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 are the cashflows from existing assets?
- What is the value added by growth assets?
- How risky are the cash flows from both existing assets and growth assets?
- When will the firm become a mature firm, and what are the potential roadblocks?

Historical 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

Normalized Earnings

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)

\[ = 22661 \times 0.0733 = 1660.7 \text{ billion yen} \]

Normalized Cost of capital

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%

Normalized Return on capital and Reinvestment

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%

Stable Growth

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)

Operational Assets + Cash + Non-operating assets - Debt - Minority Interests

Value of Equity

\[ = 19,640 \times (1.015)(1-.407)(1-.2946)(.0509-.015) \]

Value of operating assets

\[ = 19,640 \text{ billion} \]

Value per share

\[ = ¥4735 \]

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.
Valuing a commodity company - Exxon in Early 2009

Historical data: Exxon Operating Income vs Oil Price

Regressioning Exxon’s operating income against the oil price per barrel from 1985-2008:

\[
\text{Operating Income} = -6,395 + 911.32 \times \text{Average Oil Price} \quad R^2 = 90.2\%
\]

(2.95)     (14.59)

Exxon Mobil’s operating income increases about $9.11 billion for every $10 increase in the price per barrel of oil and 90% of the variation in Exxon’s earnings over time comes from movements in oil prices.

**Estimate normalized income based on current oil price**

At the time of the valuation, the oil price was $45 a barrel. Exxon’s operating income based on this price is

\[
\text{Normalized Operating Income} = -6,395 + 911.32 \times 45 = 34,614
\]

**Estimate return on capital and reinvestment rate based on normalized income**

This operating income translates into a return on capital of approximately 21% and a reinvestment rate of 9.52%, based upon a 2% growth rate.

Reinvestment Rate = \(g / \text{ROC} = 2 / 21\% = 9.52\%\)

**Exxon’s cost of capital**

Exxon has been a predominantly equity funded company, and is expected to remain so, with a debt ratio of only 2.85%. It’s cost of equity is 8.35% (based on a beta of 0.90) and its pre-tax cost of debt is 3.75% (given AAA rating). The marginal tax rate is 38%.

Cost of capital = 8.35% (.9715) + 3.75% (1-.38) (.0285) = 8.18%.

**Expected growth in operating income**

Since Exxon Mobile is the largest oil company in the world, we will assume an expected growth of only 2% in perpetuity.
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.
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)
Exxon Mobil Valuation: Simulation
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
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 = \( 915 \times (1 - 1.125^{-10}) / .125 \) = $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 Multi-business companies

Figure 1.12: Estimation Issues - Multi-business and Global Businesses

Growth rates can vary widely across businesses and across countries. Trying to estimate “one” growth rate for a firm can be difficult to do.

- What are the cashflows from existing assets?
- What is the value added by growth assets?
- How risky are the cash flows from both existing assets and growth assets?
- When will the firm become a mature firm, and what are the potential roadblocks?

The firm reports aggregate earnings from its investments in many businesses and many countries as well as in many currencies. Breakdown of earnings and operating variables in either incomplete or misleading.

Since risk can vary widely depending upon the cash flow stream, estimating one cost of equity and capital for a multi-business, global company that can be maintained over time is an exercise in futility.

Different parts of the company will reach stable growth at different points in time.
Lesson 1: Value is additive

- We can value a company as a composite entity, with a collective cash flow and single set of fundamentals (growth rates, costs of capital etc.). In doing so, here are some of the issues that we will run into:
  - Changing mix of businesses and geographies will translate into changing costs of capital, growth rates, ROIC etc. over time.
  - All cash flows have to be converted into one currency to do the valuation.

- If we have access to enough unit level information, we can value a company as the sum of its parts, preserving our flexibility to value each part in a different currency and with different fundamentals.
## United Technologies: Raw Data - 2009

<table>
<thead>
<tr>
<th>Division</th>
<th>Business</th>
<th>Revenues</th>
<th>EBITDA</th>
<th>Pre-tax Operating Income</th>
<th>Capital Expenditures</th>
<th>Depreciation</th>
<th>Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrier</td>
<td>Refrigeration systems</td>
<td>$14,944</td>
<td>$1,510</td>
<td>$1,316</td>
<td>$191</td>
<td>$194</td>
<td>$10,810</td>
</tr>
<tr>
<td>Pratt &amp; Whitney</td>
<td>Defense</td>
<td>$12,965</td>
<td>$2,490</td>
<td>$2,122</td>
<td>$412</td>
<td>$368</td>
<td>$9,650</td>
</tr>
<tr>
<td>Otis</td>
<td>Construction</td>
<td>$12,949</td>
<td>$2,680</td>
<td>$2,477</td>
<td>$150</td>
<td>$203</td>
<td>$7,731</td>
</tr>
<tr>
<td>UTC Fire &amp; Security</td>
<td>Security</td>
<td>$6,462</td>
<td>$780</td>
<td>$542</td>
<td>$95</td>
<td>$238</td>
<td>$10,022</td>
</tr>
<tr>
<td>Hamilton Sundstrand</td>
<td>Manufacturing</td>
<td>$6,207</td>
<td>$1,277</td>
<td>$1,099</td>
<td>$141</td>
<td>$178</td>
<td>$8,648</td>
</tr>
<tr>
<td>Sikorsky</td>
<td>Aircraft</td>
<td>$5,368</td>
<td>$540</td>
<td>$478</td>
<td>$165</td>
<td>$62</td>
<td>$3,985</td>
</tr>
</tbody>
</table>

The company also had corporate expenses, unallocated to the divisions of $408 million in the most recent year.
**United Technologies: DCF parts valuation**
**Cost of capital, by business**

<table>
<thead>
<tr>
<th>Division</th>
<th>Unlevered Beta</th>
<th>Debt/Equity Ratio</th>
<th>Levered beta</th>
<th>Cost of equity</th>
<th>After-tax cost of debt</th>
<th>Debt to Capital</th>
<th>Cost of capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrier</td>
<td>0.83</td>
<td>30.44%</td>
<td>0.97</td>
<td>9.32%</td>
<td>2.95%</td>
<td>23.33%</td>
<td>7.84%</td>
</tr>
<tr>
<td>Pratt &amp; Whitney</td>
<td>0.81</td>
<td>30.44%</td>
<td>0.95</td>
<td>9.17%</td>
<td>2.95%</td>
<td>23.33%</td>
<td>7.72%</td>
</tr>
<tr>
<td>Otis</td>
<td>1.19</td>
<td>30.44%</td>
<td>1.39</td>
<td>12.07%</td>
<td>2.95%</td>
<td>23.33%</td>
<td>9.94%</td>
</tr>
<tr>
<td>UTC Fire &amp; Security</td>
<td>0.65</td>
<td>30.44%</td>
<td>0.76</td>
<td>7.95%</td>
<td>2.95%</td>
<td>23.33%</td>
<td>6.78%</td>
</tr>
<tr>
<td>Hamilton Sundstrand</td>
<td>1.04</td>
<td>30.44%</td>
<td>1.22</td>
<td>10.93%</td>
<td>2.95%</td>
<td>23.33%</td>
<td>9.06%</td>
</tr>
<tr>
<td>Sikorsky</td>
<td>1.17</td>
<td>30.44%</td>
<td>1.37</td>
<td>11.92%</td>
<td>2.95%</td>
<td>23.33%</td>
<td>9.82%</td>
</tr>
</tbody>
</table>

UT has $12,919 million in debt outstanding at the company level but does not provide a divisional breakdown. I could have allocated the debt based on capital expenditure or total assets, but have chosen to leave the debt ratio for all divisions = debt ratio for UT (23.33%).

Aswath Damodaran
Estimated total reinvestment for UT as a company to be $2,134 million and have allocated that expense across divisions, based upon the cap ex in each division.

Aswath Damodaran
## United Technologies, DCF valuation Growth Choices

<table>
<thead>
<tr>
<th>Division</th>
<th>Cost of capital</th>
<th>Return on capital</th>
<th>Reinvestment Rate</th>
<th>Expected growth</th>
<th>Length of growth period</th>
<th>Stable growth rate</th>
<th>Stable ROC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrier</td>
<td>7.84%</td>
<td>13.57%</td>
<td>43.28%</td>
<td>5.87%</td>
<td>5</td>
<td>3%</td>
<td>7.84%</td>
</tr>
<tr>
<td>Pratt &amp; Whitney</td>
<td>7.72%</td>
<td>24.51%</td>
<td>57.90%</td>
<td>14.19%</td>
<td>5</td>
<td>3%</td>
<td>12.00%</td>
</tr>
<tr>
<td>Otis</td>
<td>9.94%</td>
<td>35.71%</td>
<td>18.06%</td>
<td>6.45%</td>
<td>5</td>
<td>3%</td>
<td>14.00%</td>
</tr>
<tr>
<td>UTC Fire &amp; Security</td>
<td>6.78%</td>
<td>6.03%</td>
<td>52.27%</td>
<td>3.15%</td>
<td>0</td>
<td>3%</td>
<td>6.78%</td>
</tr>
<tr>
<td>Hamilton Sundstrand</td>
<td>9.06%</td>
<td>14.16%</td>
<td>38.26%</td>
<td>5.42%</td>
<td>5</td>
<td>3%</td>
<td>9.06%</td>
</tr>
<tr>
<td>Sikorsky</td>
<td>9.82%</td>
<td>13.37%</td>
<td>102.95%</td>
<td>13.76%</td>
<td>5</td>
<td>3%</td>
<td>9.82%</td>
</tr>
</tbody>
</table>
## United Technologies, DCF valuation

**Values of the parts**

<table>
<thead>
<tr>
<th>Business</th>
<th>Cost of capital</th>
<th>PV of FCFF</th>
<th>PV of Terminal Value</th>
<th>Value of Operating Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrier</td>
<td>7.84%</td>
<td>$2,190</td>
<td>$9,498</td>
<td>$11,688</td>
</tr>
<tr>
<td>Pratt &amp; Whitney</td>
<td>7.72%</td>
<td>$3,310</td>
<td>$27,989</td>
<td>$31,299</td>
</tr>
<tr>
<td>Otis</td>
<td>9.94%</td>
<td>$5,717</td>
<td>$14,798</td>
<td>$20,515</td>
</tr>
<tr>
<td>UTC Fire &amp; Security</td>
<td>6.78%</td>
<td>$0</td>
<td>$4,953</td>
<td>$4,953</td>
</tr>
<tr>
<td>Hamilton Sundstrand</td>
<td>9.06%</td>
<td>$1,902</td>
<td>$6,343</td>
<td>$8,245</td>
</tr>
<tr>
<td>Sikorsky</td>
<td>9.82%</td>
<td>-$49</td>
<td>$3,598</td>
<td>$3,550</td>
</tr>
<tr>
<td><strong>Sum</strong></td>
<td></td>
<td></td>
<td></td>
<td><strong>$80,250</strong></td>
</tr>
</tbody>
</table>
Lesson 2: When you sum the part, take care of the loose ends

- **Unallocated expenses**: The operating income reported at the divisions/businesses of a company are based upon accounting allocation of corporate expenses. In addition to the allocations being arbitrary, you have to also take care of any unallocated expenses.

- **Double counting**: If there are intra corporate transactions that show up as revenues in one business and expenses in another or as borrowed money in one and lent money in the other, make sure that you are not double counting.

- **Cash, Debt & Cross holdings**: To the extent that the cash, debt or cross holdings are held at the parent level, you have to adjust for this before you estimate the value of equity in the business.
United Technologies: From DCF to value of equity

Value of the parts = $80,250

Value of corporate expenses

\[ \frac{\text{Corporate Expenses}_{\text{Current}} (1 - t)(1 + g)}{(\text{Cost of capital})_{\text{Company}} - g} = \frac{408(1 - .38)(1.03)}{(0.0868 - .03)} = $4,587 \]

Value of operating assets (sum of parts DCF) = $75,663
+ Cash held in United Technologies = $4,327
- Debt in United Technologies = $12,919
- Value of equity options (employees) = $544

Value of equity in common stock = $66,527

Value of equity per share (942.29 m shares) = $70.60
Lesson 3: The conglomerate discount will take care of itself

- If you use a discounted cash flow approach, valuing the pieces and adding up to an aggregate value, you do not have to apply a conglomerate discount to the value, since your inputs should reflect the “inefficiencies” that lead to the discount.

- If you use a relative valuation (apply a peer-group multiple to each division’s earnings, revenues or book value) to get to a sum of the parts valuation, you have to grapple with the question of how much of a discount to apply.
VIII. Valuing Companies across the ownership cycle

Reported income and balance sheet are heavily affected by tax considerations rather than information disclosure requirements. The line between the personal and business expenses is a fine one.

- **What are the cashflows from existing assets?**
  - Equity: Cashflows after debt payments
  - Firm: Cashflows before debt payments

- **What is the value added by growth assets?**
  - Equity: Growth in equity earnings/cashflows
  - Firm: Growth in operating earnings/cashflows

- **How risky are the cash flows from both existing assets and growth assets?**
  - Equity: Risk in equity in the company
  - Firm: Risk in the firm’s operations

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

- **Different buyers can perceive risk differently in the same private business, largely because what they see as risk will be a function of how diversified they are. The fall back positions of using market prices to extract risk measures does not**

Many private businesses are finite life enterprises, not expected to last into perpetuity.
Kristin’s Kandy: Valuation in March 2006

Current Cashflow to Firm
EBIT(1-t) : 300
- Nt CpX 100
- Chg WC 40
= FCFF 160
Reinvestment Rate = 46.67%

Expected Growth in EBIT (1-t)
.4667*.1364 = .0636
6.36%

Reinvestment Rate = 46.67%

Expected Growth
in EBIT (1-t) = .0636
Stable Growth
= 4%; Beta = 3.00;
ROC = 12.54%
Reinvestment Rate = 31.90%

Terminal Value = 289/(.1254 - .04) = 3,403

Cost of Equity
16.26%

Cost of Debt
(4.5% + 1.00)(1-.40)
= 3.30%

Weights
E = 70%; D = 30%

Discount at Cost of Capital (WACC) = 16.26% (.70) + 3.30% (.30) = 12.37%

Firm Value: 2,571
+ Cash 125
- Debt: 900
= Equity 1,796
- Illiq Discount 12.5%
Adj Value 1,571

Riskfree Rate:
Riskfree rate = 4.50%
(10-year T.Bond rate)

Total Beta
2.94

Adjusted for owner non-diversification
Market Beta: 0.98

Unlevered Beta for Sectors: 0.78

Firm’s D/E Ratio: 30/70
Lesson 1: In private businesses, risk in the eyes of the “beholder” (buyer)

<table>
<thead>
<tr>
<th>Private business owner with entire wealth invested in the business</th>
<th>Venture capitalist, with multiple holdings in the sector.</th>
<th>Public company investor with diversified portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exposed to all risk in the company. Total beta measures exposure to total risk. Total Beta = Market Beta/ Correlation of firm with market</td>
<td>Partially diversified. Diversify away some firm specific risk but not all. Beta will fall between total and market beta.</td>
<td>Firm-specific risk is diversified away. Market or macro risk exposure captured in a market beta or betas.</td>
</tr>
</tbody>
</table>
Private Owner versus Publicly Traded Company Perceptions of Risk in an Investment

**Total Beta** measures all risk
= Market Beta/ (Portion of the total risk that is market risk)

- Private owner of business with 100% of your wealth invested in the business
  - Is exposed to all the risk in the firm
  - Demands a cost of equity that reflects this risk

- 80 units of firm specific risk
- 20 units of market risk

**Market Beta** measures just market risk

- Eliminates firm-specific risk in portfolio
- Publicly traded company with investors who are diversified
  - Demands a cost of equity that reflects only 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%
Three assessment tools when the buyer falls in the middle...

- **Build up:** Start with cost of equity for a “diversified” investor and add premiums (based upon historical data) for other variables that capture the additional risk borne by “typical” buyer of a private business.
  - **Strength:** Numbers seem strong because they are backed up by data
  - **Weakness:** (1) Premiums are all from public markets (2) Double counting

- **Total Beta plus:** Look at potential buyer (what else the buyer has in his or her portfolio), assess the correlation of that portfolio with the market and estimate a “customized” total beta.
  - **Strength:** Ties the cost of equity to the buyer, as it should.
  - **Weaknesses:** (1) Buyers are under no obligation to give you this information (2) Treats private markets as extensions of public ones

- **Survey:** Find out what buyers of private businesses are demanding as a rate of return when they value private businesses.
  - **Strength:** Agnostic on risk and return models
  - **Weakness:** (1) Wide differences in what “required” means across survey respondents (2) Circular logic (3) Works if private capital markets are separate and unconnected to public markets.
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.
The “standard” approaches to estimating illiquidity discounts...

- **Restricted stock:** These are stock issued by publicly traded companies to the market that bypass the SEC registration process but the stock cannot be traded for one year after the issue.

- **Pre-IPO transactions:** These are transactions prior to initial public offerings where equity investors in the private firm buy (sell) each other’s stakes.

- In both cases, the discount is estimated to be the difference between the market price of the liquid asset and the observed transaction price of the illiquid asset.
  - Discount Restricted stock = Stock price – Price on restricted stock offering
  - DiscountIPO = IPO offering price – Price on pre-IPO transaction
The “alternative” approaches

- **Bid-ask spreads:** All traded assets are illiquid. The bid ask spread, measuring the difference between the price at which you can buy and sell the asset at the same point in time is the illiquidity measure. I few can extrapolate what we know about bid ask spreads with public companies into the private company space, we could have a more dynamic, complete measure of illiquidity.

  - Spread = 0.145 – 0.0022 ln (Annual Revenues) -0.015 (DERN) – 0.016 (Cash/Firm Value) – 0.11 ($ Monthly trading volume/ Firm Value)

- **Option pricing:** Liquidity can be viewed as a put option, where you get the right to sell at the prevailing market price. Illiquidity can therefore be viewed as the loss of this put option.
V. VALUE, PRICE AND INFORMATION: CLOSING THE DEAL
Are you valuing or pricing?

**Tools for intrinsic analysis**
- Discounted Cashflow Valuation (DCF)
- Intrinsic multiples
- Book value based approaches
- Excess Return Models

**Tools for "the gap"**
- Behavioral finance
- Price catalysts

**Value of cashflows, adjusted for time and risk**

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

**Drivers of "the gap"**
- Information
- Liquidity
- Corporate governance

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

**Tools for pricing**
- Multiples and comparables
- Charting and technical indicators
- Pseudo DCF

**THE GAP**
- Is there one?
- Will it close?

**INTRINSIC VALUE**

**PRICE**
Three views of “the gap”

<table>
<thead>
<tr>
<th>View of the gap</th>
<th>Investment Strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Efficient Marketer</td>
<td>Index funds</td>
</tr>
<tr>
<td>The gaps between price and value, if they do occur, are random.</td>
<td></td>
</tr>
<tr>
<td>The “value” extremist</td>
<td>Buy and hold stocks where value &lt; price</td>
</tr>
<tr>
<td>You view pricers as dilettantes who will move on to fad and fad. Eventually,</td>
<td></td>
</tr>
<tr>
<td>the price will converge on value.</td>
<td></td>
</tr>
<tr>
<td>The pricing extremist</td>
<td>(1) Look for mispriced securities.</td>
</tr>
<tr>
<td>Value is only in the heads of the “eggheads”. Even if it exists (and it is</td>
<td>(2) Get ahead of shifts in demand/momentum.</td>
</tr>
<tr>
<td>questionable), price may never converge on value.</td>
<td></td>
</tr>
</tbody>
</table>
The “pricers” dilemma..

- No anchor: If you do not believe in intrinsic value and make no attempt to estimate it, you have no moorings when you invest. You will therefore be pushed back and forth as the price moves from high to low. In other words, everything becomes relative and you can lose perspective.

- Reactive: Without a core measure of value, your investment strategy will often be reactive rather than proactive.

- Crowds are fickle and tough to get a read on: The key to being successful as a pricer is to be able to read the crowd mood and to detect shifts in that mood early in the process. By their nature, crowds are tough to read and almost impossible to model systematically.
The valuer’s dilemma and ways of dealing with it...

- **Uncertainty about the magnitude of the gap:**
  - Margin of safety: Many value investors swear by the notion of the “margin of safety” as protection against risk/uncertainty.
  - Collect more information: Collecting more information about the company is viewed as one way to make your investment less risky.
  - Ask what if questions: Doing scenario analysis or what if analysis gives you a sense of whether you should invest.
  - Confront uncertainty: Face up to the uncertainty, bring it into the analysis and deal with the consequences.

- **Uncertainty about gap closing:** This is tougher and you can reduce your exposure to it by
  - Lengthening your time horizon
  - Providing or looking for a catalyst that will cause the gap to close.
Option 1: Margin of Safety

- The margin of safety (MOS) is a buffer that you build into your investment decisions to protect yourself from investment mistakes. Thus, if your margin of safety is 30%, you will buy a stock only if the price is more than 30% below its “intrinsic” value.

- While value investors use the “margin of safety” as a shield against risk, keep in mind that:
  - MOS comes into play at the end of the investment process, not at the beginning.
  - MOS does not substitute for risk assessment and intrinsic valuation, but augments them.
  - The MOS cannot and should not be a fixed number, but should be reflective of the uncertainty in the assessment of intrinsic value.
  - Being too conservative can be damaging to your long term investment prospects. Too high a MOS can hurt you as an investor.
Option 2: Collect more information/ Do your homework

- There is a widely held view among value investors that they are not as exposed to risk as the rest of the market, because they do their homework, poring over financial statements or using ratios to screen for risky stocks. Put simply, they are assuming that the more they know about an investment, the less risky it becomes.

- That may be true from some peripheral risks and a few firm specific risks, but it definitely is not for the macro risks. You cannot make a cyclical company less cyclical by studying it more or take the nationalization risk out of Venezuelan company by doing more research.

*Implication 1:* The need for diversification does not decrease just because you are a value investor who picks stocks with much research and care.

*Implication 2:* There is a law of diminishing returns to information. At a point, additional information will only serve to distract you.
Option 3: Build What-if analyses

- A valuation is a function of the inputs you feed into the valuation. To the degree that you are pessimistic or optimistic on any of the inputs, your valuation will reflect it.

- There are three ways in which you can do what-if analyses
  - Best-case, Worst-case analyses, where you set all the inputs at their most optimistic and most pessimistic levels
  - Plausible scenarios: Here, you define what you feel are the most plausible scenarios (allowing for the interaction across variables) and value the company under these scenarios
  - Sensitivity to specific inputs: Change specific and key inputs to see the effect on value, or look at the impact of a large event (FDA approval for a drug company, loss in a lawsuit for a tobacco company) on value.

- Proposition 1: As a general rule, what-if analyses will yield large ranges for value, with the actual price somewhere within the range.
Option 4: Confront uncertainty
Simulations – The Amgen valuation

Correlation = 0.4
The Simulated Values of Amgen: What do I do with this output?
Strategies for managing the risk in the “closing” of the gap

- The “karmic” approach: In this one, you buy (sell short) under (over) valued companies and sit back and wait for the gap to close. You are implicitly assuming that given time, the market will see the error of its ways and fix that error.

- The catalyst approach: For the gap to close, the price has to converge on value. For that convergence to occur, there usually has to be a catalyst.
  - If you are an activist investor, you may be the catalyst yourself. In fact, your act of buying the stock may be a sufficient signal for the market to reassess the price.
  - If you are not, you have to look for other catalysts. Here are some to watch for: a new CEO or management team, a “blockbuster” new product or an acquisition bid where the firm is targeted.
RELATIVE VALUATION
The Essence of relative valuation?

- In relative valuation, the value of an asset is compared to the values assessed by the market for similar or comparable assets.

- To do relative valuation then,
  - we need to identify comparable assets and obtain market values for these assets
  - convert these market values into standardized values, since the absolute prices cannot be compared. This process of standardizing creates price multiples.
  - compare the standardized value or multiple for the asset being analyzed to the standardized values for comparable asset, controlling for any differences between the firms that might affect the multiple, to judge whether the asset is under or over valued.
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
Relative valuation is much more likely to reflect market perceptions and moods than discounted cash flow valuation. This can be an advantage when it is important that the price reflect these perceptions as is the case when
- the objective is to sell a security at that price today (as in the case of an IPO)
- investing on “momentum” based strategies

With relative valuation, there will always be a significant proportion of securities that are under valued and over valued.

Since portfolio managers are judged based upon how they perform on a relative basis (to the market and other money managers), relative valuation is more tailored to their needs

Relative valuation generally requires less information than discounted cash flow valuation (especially when multiples are used as screens)
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: earnings per share in most recent financial year
  - earnings per share in trailing 12 months (Trailing PE)
  - forecasted earnings per share next year (Forward PE)
  - forecasted earnings per share 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”

<table>
<thead>
<tr>
<th></th>
<th>Current PE</th>
<th>Trailing PE</th>
<th>Forward PE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of firms</td>
<td>7871</td>
<td>7871</td>
<td>7871</td>
</tr>
<tr>
<td>Number of firms with PE</td>
<td>3337</td>
<td>3278</td>
<td>2674</td>
</tr>
<tr>
<td>Average</td>
<td>83.86</td>
<td>43.88</td>
<td>24.45</td>
</tr>
<tr>
<td>Median</td>
<td>16.38</td>
<td>15.79</td>
<td>14.87</td>
</tr>
<tr>
<td>Maximum</td>
<td>50,463.64</td>
<td>8,840.31</td>
<td>3,192.76</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>1,299.9</td>
<td>250.87</td>
<td>83.5</td>
</tr>
<tr>
<td>Standard Error</td>
<td>22.5</td>
<td>4.38</td>
<td>1.61</td>
</tr>
<tr>
<td>Skewness</td>
<td>34.26</td>
<td>22.02</td>
<td>28.92</td>
</tr>
<tr>
<td>Kurtosis</td>
<td>1,250.28</td>
<td>620.81</td>
<td>995.61</td>
</tr>
<tr>
<td>25th Percentile</td>
<td>10.56</td>
<td>10.17</td>
<td>11.52</td>
</tr>
<tr>
<td>75th Percentile</td>
<td>26.15</td>
<td>24.15</td>
<td>20.2</td>
</tr>
</tbody>
</table>
3. Markets have a lot in common

PE Ratios: January 2013

<table>
<thead>
<tr>
<th></th>
<th>25th percentile</th>
<th>Median</th>
<th>75th percentile</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>10.56</td>
<td>16.38</td>
<td>26.15</td>
</tr>
<tr>
<td>Europe</td>
<td>9.00</td>
<td>13.93</td>
<td>22.94</td>
</tr>
<tr>
<td>Japan</td>
<td>8.40</td>
<td>12.77</td>
<td>20.14</td>
</tr>
<tr>
<td>Aus, NZ &amp; Canada</td>
<td>7.57</td>
<td>13.35</td>
<td>22.14</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>7.87</td>
<td>14.42</td>
<td>28.81</td>
</tr>
<tr>
<td>Global</td>
<td>8.39</td>
<td>14.36</td>
<td>25.88</td>
</tr>
</tbody>
</table>
3a. And the differences are revealing...
Price to Book Ratios across globe – January 2013

<table>
<thead>
<tr>
<th>Region</th>
<th>25th percentile</th>
<th>Median</th>
<th>75th percentile</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>0.86</td>
<td>1.54</td>
<td>3.16</td>
</tr>
<tr>
<td>Europe</td>
<td>0.67</td>
<td>1.22</td>
<td>2.33</td>
</tr>
<tr>
<td>Japan</td>
<td>0.44</td>
<td>0.67</td>
<td>1.03</td>
</tr>
<tr>
<td>Aus, NZ &amp; Canada</td>
<td>0.62</td>
<td>1.21</td>
<td>2.50</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>0.64</td>
<td>1.18</td>
<td>2.18</td>
</tr>
<tr>
<td>Global</td>
<td>0.63</td>
<td>1.16</td>
<td>2.23</td>
</tr>
</tbody>
</table>
4. Simplistic rules almost always break down...6 times EBITDA was not cheap in 2010
But it may work in 2013... in some markets...

<table>
<thead>
<tr>
<th>Region</th>
<th>25th percentile</th>
<th>Median</th>
<th>75th percentile</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>6.08</td>
<td>9.11</td>
<td>14.17</td>
</tr>
<tr>
<td>Europe</td>
<td>5.49</td>
<td>8.36</td>
<td>13.00</td>
</tr>
<tr>
<td>Japan</td>
<td>2.79</td>
<td>4.91</td>
<td>7.94</td>
</tr>
<tr>
<td>Aus, NZ &amp; Canada</td>
<td>5.05</td>
<td>8.31</td>
<td>13.67</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>5.16</td>
<td>9.23</td>
<td>17.58</td>
</tr>
<tr>
<td>Global</td>
<td>4.91</td>
<td>8.33</td>
<td>14.78</td>
</tr>
</tbody>
</table>
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.
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,

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

- If this had been a FCFE Model,

  \[ P_0 = \frac{FCFE_1}{r - g_n} \]

  \[ \frac{P_0}{EPS_0} = PE = \frac{(FCFE/Earnings) \times (1 + g_n)}{r - g_n} \]
Using the Fundamental Model to Estimate PE For a High Growth Firm

- The price-earnings ratio for a high growth firm can also be related to fundamentals. In the special case of the two-stage dividend discount model, this relationship can be made explicit fairly simply:

\[
P_0 = \frac{\text{EPS}_0 \times \text{Payout Ratio} \times (1 + g) \times \left(1 - \left(\frac{1+g}{1+r}\right)^n\right)}{r-g} + \frac{\text{EPS}_0 \times \text{Payout Ratio}_n \times (1+g)^n \times (1+g_n)}{(r-g_n)(1+r)^n}
\]

- For a firm that does not pay what it can afford to in dividends, substitute FCFE/Earnings for the payout ratio.

- Dividing both sides by the earnings per share:

\[
\frac{P_0}{\text{EPS}_0} = \frac{\text{Payout Ratio} \times (1 + g) \times \left(1 - \left(\frac{1+g}{1+r}\right)^n\right)}{r-g} + \frac{\text{Payout Ratio}_n \times (1+g)^n \times (1+g_n)}{(r-g_n)(1+r)^n}
\]
A Simple Example

Assume that you have been asked to estimate the PE ratio for a firm which has the following characteristics:

<table>
<thead>
<tr>
<th>Variable</th>
<th>High Growth Phase</th>
<th>Stable Growth Phase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected Growth Rate</td>
<td>25%</td>
<td>8%</td>
</tr>
<tr>
<td>Payout Ratio</td>
<td>20%</td>
<td>50%</td>
</tr>
<tr>
<td>Beta</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>Number of years</td>
<td>5 years</td>
<td>Forever after year 5</td>
</tr>
</tbody>
</table>

Riskfree rate = T.Bond Rate = 6%

Required rate of return = 6% + 1(5.5%) = 11.5%

\[
PE = \frac{0.2 \times (1.25) \times \left(1 - \frac{(1.25)^5}{(1.115)^5}\right)}{0.115 - 0.25} + \frac{0.5 \times (1.25)^5 \times (1.08)}{(1.115 - 0.08)(1.115)^5} = 28.75
\]
a. PE and Growth: Firm grows at x% for 5 years, 8% thereafter
b. PE and Risk: A Follow up Example
III. Comparisons of PE across time: PE Ratio for the S&P 500
Is low (high) PE cheap (expensive)?

- A market strategist argues that stocks are expensive because the PE ratio today is high relative to the average PE ratio across time. Do you agree?
  - Yes
  - No

- If you do not agree, what factors might explain the higher PE ratio today?
E/P Ratios, T.Bond Rates and Term Structure

![Graph showing E/P Ratios versus Interest rates: US from 1960 - 2012](chart.png)
Regression Results

- There is a strong positive relationship between E/P ratios and T.Bond rates, as evidenced by the correlation of 0.69 between the two variables.
- In addition, there is evidence that the term structure also affects the PE ratio.
- In the following regression, using 1960-2012 data, we regress E/P ratios against the level of T.Bond rates and a term structure variable (T.Bond - T.Bill rate)
  \[
P/E = 3.45\% + 0.5599 \times \text{T.Bond Rate} - 0.1971 \times (\text{T.Bond Rate} - \text{T.Bill Rate})
  \]
  \[
  (3.98) \quad (5.41) \quad (-0.83)
  \]
  \[
  R\text{ squared} = 37.89\%
  \]
- Given the treasury bond rate and treasury bill rate today, is the market under or over valued today?
- The R squared of this regression has dropped from about 50% in 2008 to about 38% today. How would you interpret this result?
The Determinants of Multiples...

**Value of Stock**

\[ \text{Value of Stock} = \frac{\text{DPS}}{k_e - g} \]

**Equity Multiples**

- \( PE = \frac{\text{Payout Ratio}}{1+g)/(r-g) \)
- \( PEG = \frac{\text{Payout ratio}}{(1+g)/(r-g)} \)
- \( PBV = \frac{\text{ROE} \cdot \text{Payout ratio}}{(1+g)/(r-g)} \)
- \( PS = \frac{\text{Net Margin} \cdot \text{ROE} \cdot \text{Payout ratio}}{1+g)/(r-g)} \)

**Firm Multiples**

- \( V/FCFF = f(g, \text{WACC}) \)
- \( V/EBIT(1-t) = f(g, \text{RIR}, \text{WACC}) \)
- \( V/EBIT = f(g, \text{RIR}, \text{WACC}, t) \)
- \( VS = f(\text{Oper Mgn}, \text{RIR}, g, \text{WACC}) \)

**Value of Firm**

\[ \text{Value of Firm} = \frac{FCFF}{WACC - g} \]
Application Tests

- Given the firm that we 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 we 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.
I. Comparing PE Ratios across a Sector: PE

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

- Dependent variable is: PE

- R squared = 66.2%   R squared (adjusted) = 63.1%

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>SE</th>
<th>t-ratio</th>
<th>prob</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>13.1151</td>
<td>3.471</td>
<td>3.78</td>
<td>0.0010</td>
</tr>
<tr>
<td>Growth rate</td>
<td>121.223</td>
<td>19.27</td>
<td>6.29</td>
<td>≤ 0.0001</td>
</tr>
<tr>
<td>Emerging Market</td>
<td>-13.8531</td>
<td>3.606</td>
<td>-3.84</td>
<td>0.0009</td>
</tr>
</tbody>
</table>

Emerging Market is a dummy: 1 if emerging market
0 if not
Is Telebras under valued?

- Predicted PE = 13.12 + 121.22 (.075) - 13.85 (1) = 8.35
- At an actual price to earnings ratio of 8.9, Telebras is slightly overvalued.
II. Price to Book vs ROE: Largest Market Cap Firms in the United States: January 2010
Missing growth?
PBV, ROE and Risk: Large Cap US firms
Bringing it all together… Largest US stocks

### Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.819&lt;sup&gt;a&lt;/sup&gt;</td>
<td>.670</td>
<td>.661</td>
<td>1.19253</td>
</tr>
</tbody>
</table>

<sup>a</sup> Predictors: (Constant), ROE, Expected Growth in EPS: next 5 years, Regression Beta

### Coefficients<sup>a</sup>

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>1 (Constant)</td>
<td>.406</td>
<td>.424</td>
<td>.958</td>
<td>.340</td>
</tr>
<tr>
<td>Regression Beta</td>
<td>-.065</td>
<td>.253</td>
<td>-.015</td>
<td>-.256</td>
</tr>
<tr>
<td>Expected Growth in EPS: next 5 years</td>
<td>9.340</td>
<td>2.366</td>
<td>.228</td>
<td>3.947</td>
</tr>
<tr>
<td>ROE</td>
<td>10.546</td>
<td>.771</td>
<td>.777</td>
<td>13.672</td>
</tr>
</tbody>
</table>

<sup>a</sup> Dependent Variable: PBV Ratio
Updated PBV Ratios – Largest Market Cap US companies: Updated to January 2013
## III. Value/EBITDA Multiple: Trucking Companies

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Value</th>
<th>EBITDA</th>
<th>Value/EBITDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>KLLM Trans. Svcs.</td>
<td>$114.32</td>
<td>$48.81</td>
<td>2.34</td>
</tr>
<tr>
<td>Ryder System</td>
<td>$5,158.04</td>
<td>$1,838.26</td>
<td>2.81</td>
</tr>
<tr>
<td>Rollins Truck Leasing</td>
<td>$1,368.35</td>
<td>$447.67</td>
<td>3.06</td>
</tr>
<tr>
<td>Cannon Express Inc.</td>
<td>$83.57</td>
<td>$27.05</td>
<td>3.09</td>
</tr>
<tr>
<td>Hunt (J.B.)</td>
<td>$982.67</td>
<td>$310.22</td>
<td>3.17</td>
</tr>
<tr>
<td>Yellow Corp.</td>
<td>$931.47</td>
<td>$292.82</td>
<td>3.18</td>
</tr>
<tr>
<td>Roadway Express</td>
<td>$554.96</td>
<td>$169.36</td>
<td>3.28</td>
</tr>
<tr>
<td>Marten Transport, Ltd.</td>
<td>$116.93</td>
<td>$35.62</td>
<td>3.28</td>
</tr>
<tr>
<td>Kenan Transport Co.</td>
<td>$67.66</td>
<td>$19.44</td>
<td>3.48</td>
</tr>
<tr>
<td>M.S. Carriers</td>
<td>$344.93</td>
<td>$97.85</td>
<td>3.53</td>
</tr>
<tr>
<td>Old Dominion Freight</td>
<td>$170.42</td>
<td>$45.13</td>
<td>3.78</td>
</tr>
<tr>
<td>Trimac Ltd.</td>
<td>$661.18</td>
<td>$174.28</td>
<td>3.79</td>
</tr>
<tr>
<td>Matlack Systems</td>
<td>$112.42</td>
<td>$28.94</td>
<td>3.88</td>
</tr>
<tr>
<td>XTRA Corp.</td>
<td>$1,708.57</td>
<td>$427.30</td>
<td>4.00</td>
</tr>
<tr>
<td>Covenant Transport Inc.</td>
<td>$259.16</td>
<td>$64.35</td>
<td>4.03</td>
</tr>
<tr>
<td>Builders Transport</td>
<td>$221.09</td>
<td>$51.44</td>
<td>4.30</td>
</tr>
<tr>
<td>Werner Enterprises</td>
<td>$844.39</td>
<td>$196.15</td>
<td>4.30</td>
</tr>
<tr>
<td>Landstar Sys.</td>
<td>$422.79</td>
<td>$95.20</td>
<td>4.44</td>
</tr>
<tr>
<td>AMERCO</td>
<td>$1,632.30</td>
<td>$345.78</td>
<td>4.72</td>
</tr>
<tr>
<td>USA Truck</td>
<td>$141.77</td>
<td>$29.93</td>
<td>4.74</td>
</tr>
<tr>
<td>Frozen Food Express</td>
<td>$164.17</td>
<td>$34.10</td>
<td>4.81</td>
</tr>
<tr>
<td>Arnold Inds.</td>
<td>$472.27</td>
<td>$96.88</td>
<td>4.87</td>
</tr>
<tr>
<td>Greyhound Lines Inc.</td>
<td>$437.71</td>
<td>$89.61</td>
<td>4.88</td>
</tr>
<tr>
<td>USFreightways</td>
<td>$983.86</td>
<td>$198.91</td>
<td>4.95</td>
</tr>
<tr>
<td>Golden Eagle Group Inc.</td>
<td>$12.50</td>
<td>$2.33</td>
<td>5.37</td>
</tr>
<tr>
<td>Arkansas Best</td>
<td>$578.78</td>
<td>$107.15</td>
<td>5.40</td>
</tr>
<tr>
<td>Airlease Ltd.</td>
<td>$73.64</td>
<td>$13.46</td>
<td>5.46</td>
</tr>
<tr>
<td>Landair Group</td>
<td>$182.30</td>
<td>$32.72</td>
<td>5.57</td>
</tr>
<tr>
<td>Amer. Freightways</td>
<td>$716.15</td>
<td>$120.94</td>
<td>5.92</td>
</tr>
<tr>
<td>Transfinancial Holdings</td>
<td>$56.92</td>
<td>$6.79</td>
<td>8.47</td>
</tr>
<tr>
<td>Xtran Corp. 'A'</td>
<td>$140.68</td>
<td>$21.51</td>
<td>6.54</td>
</tr>
<tr>
<td>Interpool Inc.</td>
<td>$1,002.20</td>
<td>$151.18</td>
<td>6.63</td>
</tr>
<tr>
<td>Internet Inc.</td>
<td>$70.23</td>
<td>$10.38</td>
<td>6.77</td>
</tr>
<tr>
<td>Swift Transportation</td>
<td>$835.58</td>
<td>$121.34</td>
<td>6.89</td>
</tr>
<tr>
<td>Landair Services</td>
<td>$212.95</td>
<td>$30.38</td>
<td>7.01</td>
</tr>
<tr>
<td>CNF Transportation</td>
<td>$2,700.69</td>
<td>$366.99</td>
<td>7.36</td>
</tr>
<tr>
<td>Budget Group Inc</td>
<td>$1,247.30</td>
<td>$166.71</td>
<td>7.48</td>
</tr>
<tr>
<td>Callender System</td>
<td>$2,514.99</td>
<td>$333.13</td>
<td>7.55</td>
</tr>
<tr>
<td>Knight Transportation Inc.</td>
<td>$269.01</td>
<td>$28.20</td>
<td>9.54</td>
</tr>
<tr>
<td>Heartland Express</td>
<td>$727.50</td>
<td>$64.62</td>
<td>11.26</td>
</tr>
<tr>
<td>Greyhound EDA Transn Corp.</td>
<td>$83.25</td>
<td>$6.99</td>
<td>11.91</td>
</tr>
<tr>
<td>Mark VII</td>
<td>$160.45</td>
<td>$12.96</td>
<td>12.38</td>
</tr>
<tr>
<td>Coach USA Inc.</td>
<td>$678.38</td>
<td>$51.76</td>
<td>13.11</td>
</tr>
<tr>
<td>LS 1 Inds Inc.</td>
<td>$5.60</td>
<td>(0.17)</td>
<td>NA</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td>$5.61</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
A Test on EBITDA

- Ryder System looks very cheap on a Value/EBITDA multiple basis, relative to the rest of the sector. What explanation (other than misvaluation) might there be for this difference?
Whole Foods: In 2007: Net Margin was 3.41% and Price/Sales ratio was 1.41
Predicted Price to Sales = 0.07 + 10.49 (0.0341) = 0.43
Reversion to normalcy: Grocery Stores - US in January 2009

Whole Foods: In 2009, Net Margin had dropped to 2.77% and Price to Sales ratio was down to 0.31.

Predicted Price to Sales = 0.07 + 10.49 (.0277) = 0.36
And again in 2010..

Whole Foods: In 2010, Net Margin had dropped to 1.44% and Price to Sales ratio increased to 0.50. Predicted Price to Sales = 0.06 + 11.43 (0.0144) = 0.22
Here is 2011...

\[ \text{PS Ratio} = -0.585 + 55.50 \times \text{(Net Margin)} \quad R^2 = 48.2\% \]

\[ \text{PS Ratio for WFMI} = -0.585 + 55.50 \times (0.0273) = 0.93 \]

At a PS ratio of 0.98, WFMI is slightly overvalued.
V. Back to the Multibusiness company
United Technologies: Raw Data - 2009

<table>
<thead>
<tr>
<th>Division</th>
<th>Business</th>
<th>Revenues</th>
<th>EBITDA</th>
<th>Pre-tax Operating Income</th>
<th>Capital Expenditures</th>
<th>Depreciation</th>
<th>Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrier</td>
<td>Refrigeration systems</td>
<td>$14,944</td>
<td>$1,510</td>
<td>$1,316</td>
<td>$191</td>
<td>$194</td>
<td>$10,810</td>
</tr>
<tr>
<td>Pratt &amp; Whitney</td>
<td>Defense</td>
<td>$12,965</td>
<td>$2,490</td>
<td>$2,122</td>
<td>$412</td>
<td>$368</td>
<td>$9,650</td>
</tr>
<tr>
<td>Otis</td>
<td>Construction</td>
<td>$12,949</td>
<td>$2,680</td>
<td>$2,477</td>
<td>$150</td>
<td>$203</td>
<td>$7,731</td>
</tr>
<tr>
<td>UTC Fire &amp; Security</td>
<td>Security</td>
<td>$6,462</td>
<td>$780</td>
<td>$542</td>
<td>$95</td>
<td>$238</td>
<td>$10,022</td>
</tr>
<tr>
<td>Hamilton Sundstrand</td>
<td>Manufacturing</td>
<td>$6,207</td>
<td>$1,277</td>
<td>$1,099</td>
<td>$141</td>
<td>$178</td>
<td>$8,648</td>
</tr>
<tr>
<td>Sikorsky</td>
<td>Aircraft</td>
<td>$5,368</td>
<td>$540</td>
<td>$478</td>
<td>$165</td>
<td>$62</td>
<td>$3,985</td>
</tr>
</tbody>
</table>

The company also had corporate expenses, unallocated to the divisions of $408 million in the most recent year.
## United Technologies: Relative Valuation Median Multiples

<table>
<thead>
<tr>
<th>Division</th>
<th>Business</th>
<th>EBITDA</th>
<th>EV/EBITDA for sector</th>
<th>Value of Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrier</td>
<td>Refrigeration systems</td>
<td>$1,510</td>
<td>5.25</td>
<td>$7,928</td>
</tr>
<tr>
<td>Pratt &amp; Whitney</td>
<td>Defense</td>
<td>$2,490</td>
<td>8.00</td>
<td>$19,920</td>
</tr>
<tr>
<td>Otis</td>
<td>Construction</td>
<td>$2,680</td>
<td>6.00</td>
<td>$16,080</td>
</tr>
<tr>
<td>UTC Fire &amp; Security</td>
<td>Security</td>
<td>$780</td>
<td>7.50</td>
<td>$5,850</td>
</tr>
<tr>
<td>Hamilton Sundstrand</td>
<td>Industrial Products</td>
<td>$1,277</td>
<td>5.50</td>
<td>$7,024</td>
</tr>
<tr>
<td>Sikorsky</td>
<td>Aircraft</td>
<td>$540</td>
<td>9.00</td>
<td>$4,860</td>
</tr>
<tr>
<td>Sum of the parts value for business =</td>
<td></td>
<td></td>
<td></td>
<td>$61,661</td>
</tr>
</tbody>
</table>
# United Technologies: Relative Valuation Plus Scaling variable & Choice of Multiples

<table>
<thead>
<tr>
<th>Division</th>
<th>Business</th>
<th>Revenues</th>
<th>EBITDA</th>
<th>Operating Income</th>
<th>Capital Invested</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrier</td>
<td>Refrigeration systems</td>
<td>$14,944</td>
<td>$1,510</td>
<td>$1,316</td>
<td>$6,014</td>
</tr>
<tr>
<td>Pratt &amp; Whitney</td>
<td>Defense</td>
<td>$12,965</td>
<td>$2,490</td>
<td>$2,122</td>
<td>$5,369</td>
</tr>
<tr>
<td>Otis</td>
<td>Construction</td>
<td>$12,949</td>
<td>$2,680</td>
<td>$2,477</td>
<td>$4,301</td>
</tr>
<tr>
<td>UTC Fire &amp; Security</td>
<td>Security</td>
<td>$6,462</td>
<td>$780</td>
<td>$542</td>
<td>$5,575</td>
</tr>
<tr>
<td>Hamilton Sundstrand</td>
<td>Industrial Products</td>
<td>$6,207</td>
<td>$1,277</td>
<td>$1,099</td>
<td>$4,811</td>
</tr>
<tr>
<td>Sikorsky</td>
<td>Aircraft</td>
<td>$5,368</td>
<td>$540</td>
<td>$478</td>
<td>$2,217</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>$58,895</strong></td>
<td><strong>$9,277</strong></td>
<td><strong>$8,034</strong></td>
<td><strong>$28,287</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Business</th>
<th>Best Multiple</th>
<th>Regression</th>
<th>R²</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refrigeration systems</td>
<td>EV/EBITDA 4.2</td>
<td>EV/EBITDA = 5.35 – 3.55 Tax Rate + 14.17 ROC</td>
<td>42%</td>
</tr>
<tr>
<td>Defense</td>
<td>EV/Revenues 4.7</td>
<td>EV/Revenues = 0.85 + 7.32 Pre-tax Operating Margin</td>
<td>47%</td>
</tr>
<tr>
<td>Construction</td>
<td>EV/EBITDA 5.1</td>
<td>EV/EBITDA = 3.17 – 2.87 Tax Rate + 14.66 ROC</td>
<td>36%</td>
</tr>
<tr>
<td>Security</td>
<td>EV/Capital 6.5</td>
<td>EV/ Capital = 0.55 + 8.22 ROC</td>
<td>55%</td>
</tr>
<tr>
<td>Industrial Products</td>
<td>EV/Revenues 5.0</td>
<td>EV/Revenues = 0.51 + 6.13 Pre-tax Operating Margin</td>
<td>48%</td>
</tr>
<tr>
<td>Aircraft</td>
<td>EV/Capital 6.0</td>
<td>EV/ Capital = 0.65 + 6.98 ROC</td>
<td>40%</td>
</tr>
</tbody>
</table>
### United Technologies: Relative Valuation

#### Sum of the Parts value

<table>
<thead>
<tr>
<th>Division</th>
<th>Scaling Variable</th>
<th>Current value for scaling variable</th>
<th>ROC</th>
<th>Operating Margin</th>
<th>Tax Rate</th>
<th>Predicted Multiple</th>
<th>Estimated Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrier</td>
<td>EBITDA</td>
<td>$1,510</td>
<td>13.57%</td>
<td>8.81%</td>
<td>38%</td>
<td>$5.35 – 3.55 (.38) + 14.17 (.1357) = 5.92</td>
<td>$8,944.47</td>
</tr>
<tr>
<td>Pratt &amp; Whitney</td>
<td>Revenues</td>
<td>$12,965</td>
<td>24.51%</td>
<td>16.37%</td>
<td>38%</td>
<td>$0.85 + 7.32 (.1637) = 2.05</td>
<td>$26,553.29</td>
</tr>
<tr>
<td>Otis</td>
<td>EBITDA</td>
<td>$2,680</td>
<td>35.71%</td>
<td>19.13%</td>
<td>38%</td>
<td>$3.17 – 2.87 (.38) + 14.66 (.3571) = 7.31</td>
<td>$19,601.70</td>
</tr>
<tr>
<td>UTC Fire &amp; Security</td>
<td>Capital</td>
<td>$5,575</td>
<td>6.03%</td>
<td>8.39%</td>
<td>38%</td>
<td>$0.55 + 8.22 (.0603) = 1.05</td>
<td>$5,828.76</td>
</tr>
<tr>
<td>Hamilton Sundstrand</td>
<td>Revenues</td>
<td>$6,207</td>
<td>14.16%</td>
<td>17.71%</td>
<td>38%</td>
<td>$0.51 + 6.13 (.1771) = 1.59</td>
<td>$9,902.44</td>
</tr>
<tr>
<td>Sikorsky</td>
<td>Capital</td>
<td>$2,217</td>
<td>13.37%</td>
<td>8.90%</td>
<td>38%</td>
<td>$0.65 + 6.98 (.1337) = 1.58</td>
<td>$3,509.61</td>
</tr>
</tbody>
</table>

Sum of the parts value for operating assets = $74,230.37
VI. Nothing’s working!!! Internet Stocks in early 2000
PS Ratios and Margins are not highly correlated

- Regressing PS ratios against current margins yields the following
  \[ PS = 81.36 - 7.54(\text{Net Margin}) \quad R^2 = 0.04 \]
  \[ (0.49) \]
- This is not surprising. These firms are priced based upon expected margins, rather than current margins.
Solution 1: Use proxies for survival and growth: Amazon in early 2000

- Hypothesizing that firms with higher revenue growth and higher cash balances should have a greater chance of surviving and becoming profitable, we ran the following regression: (The level of revenues was used to control for size)

  \[ PS = 30.61 - 2.77 \ln(\text{Rev}) + 6.42 (\text{Rev Growth}) + 5.11 (\text{Cash/Rev}) \]

  \[
  \begin{array}{ccc}
  \text{(0.66)} & \text{(2.63)} & \text{(3.49)} \\
  \end{array}
  \]

- R squared = 31.8%

- Predicted PS = 30.61 - 2.77(7.1039) + 6.42(1.9946) + 5.11 (.3069) = 30.42

- Actual PS = 25.63

- Stock is undervalued, relative to other internet stocks.
Solution 2: Use forward multiples

- Global Crossing lost $1.9 billion in 2001 and is expected to continue to lose money for the next 3 years. In a discounted cashflow valuation (see notes on DCF valuation) of Global Crossing, we estimated an expected EBITDA for Global Crossing in five years of $1,371 million.

- The average enterprise value/EBITDA multiple for healthy telecomm firms is 7.2 currently.

- Applying this multiple to Global Crossing’s EBITDA in year 5, yields a value in year 5 of
  - Enterprise Value in year 5 = 1371 * 7.2 = $9,871 million
  - Enterprise Value today = $9,871 million / 1.1385 = $5,172 million
  - (The cost of capital for Global Crossing is 13.80%)
  - The probability that Global Crossing will not make it as a going concern is 77%.
  - Expected Enterprise value today = 0.23 (5172) = $1,190 million
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 versus Expected EPS Growth: January 2013

![Scatter plot showing relationship between Current PE and Expected Growth in EPS: next 5 years. The plot includes a linear trend line with an R^2 value of 0.134.](image)
PE Ratio: Standard Regression for US stocks - January 2013

Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.595&lt;sup&gt;a&lt;/sup&gt;</td>
<td>.354</td>
<td>.352</td>
<td>780.421220</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), Payout Ratio, Expected Growth in EPS: next 5 years, 3-yr Regression Beta

Coefficients<sup>a,b</sup>

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expected Growth in EPS: next 5 years</td>
<td>7.949</td>
<td>.748</td>
<td>.470</td>
<td>10.625</td>
</tr>
<tr>
<td>3-yr Regression Beta</td>
<td>57.720</td>
<td>3.184</td>
<td></td>
<td>18.128</td>
</tr>
<tr>
<td>Payout Ratio</td>
<td>-3.596</td>
<td>.447</td>
<td>-.231</td>
<td>-8.040</td>
</tr>
<tr>
<td></td>
<td>11.480</td>
<td>.905</td>
<td>.349</td>
<td>12.686</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Current PE
b. Weighted Least Squares Regression – Weighted by Market Cap
The value of growth

<table>
<thead>
<tr>
<th>Time Period</th>
<th>PE Value of extra 1% of growth</th>
<th>Equity Risk Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 2013</td>
<td>0.577</td>
<td>5.78%</td>
</tr>
<tr>
<td>January 2012</td>
<td>0.408</td>
<td>6.04%</td>
</tr>
<tr>
<td>January 2011</td>
<td>0.836</td>
<td>5.20%</td>
</tr>
<tr>
<td>January 2010</td>
<td>0.550</td>
<td>4.36%</td>
</tr>
<tr>
<td>January 2009</td>
<td>0.780</td>
<td>6.43%</td>
</tr>
<tr>
<td>January 2008</td>
<td>1.427</td>
<td>4.37%</td>
</tr>
<tr>
<td>January 2007</td>
<td>1.178</td>
<td>4.16%</td>
</tr>
<tr>
<td>January 2006</td>
<td>1.131</td>
<td>4.07%</td>
</tr>
<tr>
<td>January 2005</td>
<td>0.914</td>
<td>3.65%</td>
</tr>
<tr>
<td>January 2004</td>
<td>0.812</td>
<td>3.69%</td>
</tr>
<tr>
<td>January 2003</td>
<td>2.621</td>
<td>4.10%</td>
</tr>
<tr>
<td>January 2002</td>
<td>1.003</td>
<td>3.62%</td>
</tr>
<tr>
<td>January 2001</td>
<td>1.457</td>
<td>2.75%</td>
</tr>
<tr>
<td>January 2000</td>
<td>2.105</td>
<td>2.05%</td>
</tr>
</tbody>
</table>
## PE ratio regressions across markets

<table>
<thead>
<tr>
<th>Region</th>
<th>Regression – January 2013</th>
<th>R squared</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe</td>
<td>PE = 11.39 + 50.75 Expected Growth – 2.77 Beta + 8.53 Payout</td>
<td>32.2%</td>
</tr>
<tr>
<td>Japan</td>
<td>PE = 8.29 + 31.39 Expected Growth + 17.98 Payout</td>
<td>44.9%</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>PE = 15.22 + 43.52 Expected Growth – 3.67 Beta + 2.01 Payout</td>
<td>32.9%</td>
</tr>
</tbody>
</table>

*Expected Growth*: Expected growth in EPS/ 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
### III. Price to Book Ratio

Fundamentals hold in every market: - January 2013

<table>
<thead>
<tr>
<th>Region</th>
<th>Regression – January 2013</th>
<th>R squared</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>PBV = 0.18 + 1.17 Payout – 0.77 Beta + 11.28 ROE + 6.44 Expected Growth</td>
<td>60.6%</td>
</tr>
<tr>
<td>Europe</td>
<td>PBV = 2.13 Payout – 0.57 Beta + 2.20 Expected Growth + 12.33 ROE</td>
<td>67.6%</td>
</tr>
<tr>
<td>Japan</td>
<td>PBV = 1.13 – 0.13 Beta + 2.57 ROE</td>
<td>16.4%</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>PBV = 0.43 + 0.95 Payout – 0.42 Beta + 2.57 Expected Growth + 8.86 ROE</td>
<td>47.9%</td>
</tr>
</tbody>
</table>

*Expected Growth:* Expected growth in EPS/ 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  
*ROE:* Net Income/ Book value of equity in most recent year.
### IV. EV/EBITDA – January 2013

<table>
<thead>
<tr>
<th>Region</th>
<th>Regression – January 2011</th>
<th>R squared</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>$EV/EBITDA= 13.68 + 69.213 \text{ Expected Revenue Growth} – 10.067 \text{ Tax Rate} – 87.517 \text{ Cost of Capital}$</td>
<td>27.3%</td>
</tr>
<tr>
<td>Europe</td>
<td>$EV/EBITDA= 10.59 - 8.39 \text{Tax Rate} - 11.82 \text{Cost of Capital} + 31.11 \text{ Expected Revenue Growth} + 2.40 \text{Return on Capital}$</td>
<td>20.9%</td>
</tr>
<tr>
<td>Japan</td>
<td>$EV/EBITDA= 23.76 - 16.32 \text{Tax Rate} - 139.39 \text{Cost of Capital} + 5.97 \text{Expected Revenue Growth}$</td>
<td>45.0%</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>$EV/EBITDA= 22.16 - 20.70 \text{Tax Rate} - 67.57 \text{Cost of Capital} + 4.87 \text{Expected Revenue Growth}$</td>
<td>9.2%</td>
</tr>
</tbody>
</table>

*Expected Revenue Growth*: Expected growth in revenues: Near term (2 or 5 years)

*Cost of capital*: Cost of capital in US $ terms (*Use dollar risk free + ERP for country*)

*Tax Rate*: Effective tax rate in most recent year

*Return on Capital*: After-tax Operating Income/ (BV of debt + BV of equity – Cash)
V. EV/Sales Regressions across markets...

<table>
<thead>
<tr>
<th>Region</th>
<th>Regression – January 2011</th>
<th>R Squared</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>EV/Sales = 2.43 + 8.548 Expected Revenue Growth – 20.266 Cost of Capital -2.964 Tax Rate + 8.292 Pre-tax Operating Margin</td>
<td>53.3%</td>
</tr>
<tr>
<td>Europe</td>
<td>EV/Sales = 3.93 - 2.73 Tax rate + 7.36 Pre-tax Operating Margin – 33.13 Cost of Capital + 6.41 Expected Revenue Growth</td>
<td>27.7%</td>
</tr>
<tr>
<td>Japan</td>
<td>EV/Sales = 4.03 - 1.77 Tax rate + 6.69 Pre-tax Operating Margin – 38.49 Cost of Capital</td>
<td>29.9%</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>EV/Sales = 6.03 - 2.27 Tax rate + 7.17 Pre-tax Operating Margin – 48.37 Cost of Capital + 0.425 Expected Revenue Growth</td>
<td>26.7%</td>
</tr>
</tbody>
</table>

*Expected Revenue Growth*: Expected growth in revenues: Near term (2 or 5 years)

*Cost of capital*: Cost of capital in US $ terms (Use dollar risk free + ERP for country)

*Tax Rate*: Effective tax rate in most recent year

*Operating Margin*: Operating Income/ Sales
Relative Valuation: Some closing propositions

- Proposition 1: In a relative valuation, all that you are concluding is that a stock is under or over valued, relative to your comparable group.
  - Your relative valuation judgment can be right and your stock can be hopelessly over valued at the same time.

- Proposition 2: In asset valuation, there are no similar assets. Every asset is unique.
  - If you don’t control for fundamental differences in risk, cashflows and growth across firms when comparing how they are priced, your valuation conclusions will reflect your flawed judgments rather than market misvaluations.
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 number 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.
A More Intuitive Approach

- Managers in every sector tend to focus on specific variables when analyzing strategy and performance. The multiple used will generally reflect this focus. Consider three examples.
  - In retailing: The focus is usually on same store sales (turnover) and profit margins. Not surprisingly, the revenue multiple is most common in this sector.
  - In financial services: The emphasis is usually on return on equity. Book Equity is often viewed as a scarce resource, since capital ratios are based upon it. Price to book ratios dominate.
  - In technology: Growth is usually the dominant theme. PEG ratios were invented in this sector.
## Conventional usage...

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

- Define the multiple
  - Check for consistency
  - Make sure that they are estimated uniformly

- Describe the multiple
  - Multiples have skewed distributions: The averages are seldom good indicators of typical multiples
  - Check for bias, if the multiple cannot be estimated

- Analyze the multiple
  - Identify the companion variable that drives the multiple
  - Examine the nature of the relationship

- Apply the multiple
A closing thought...