



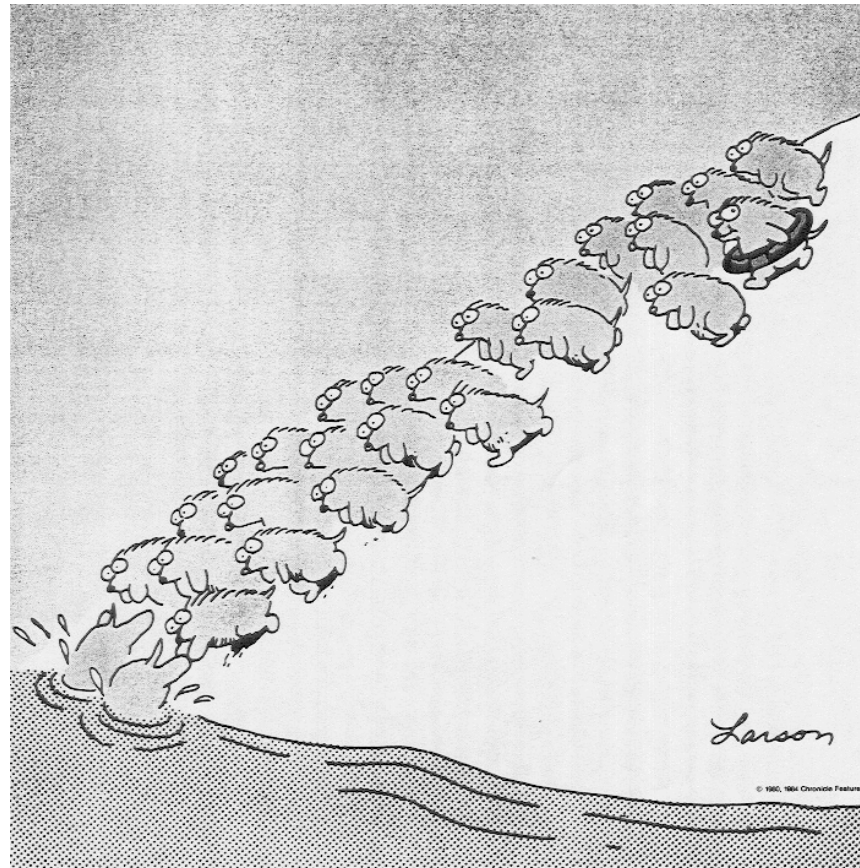
~~Advanced~~ Valuation

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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.

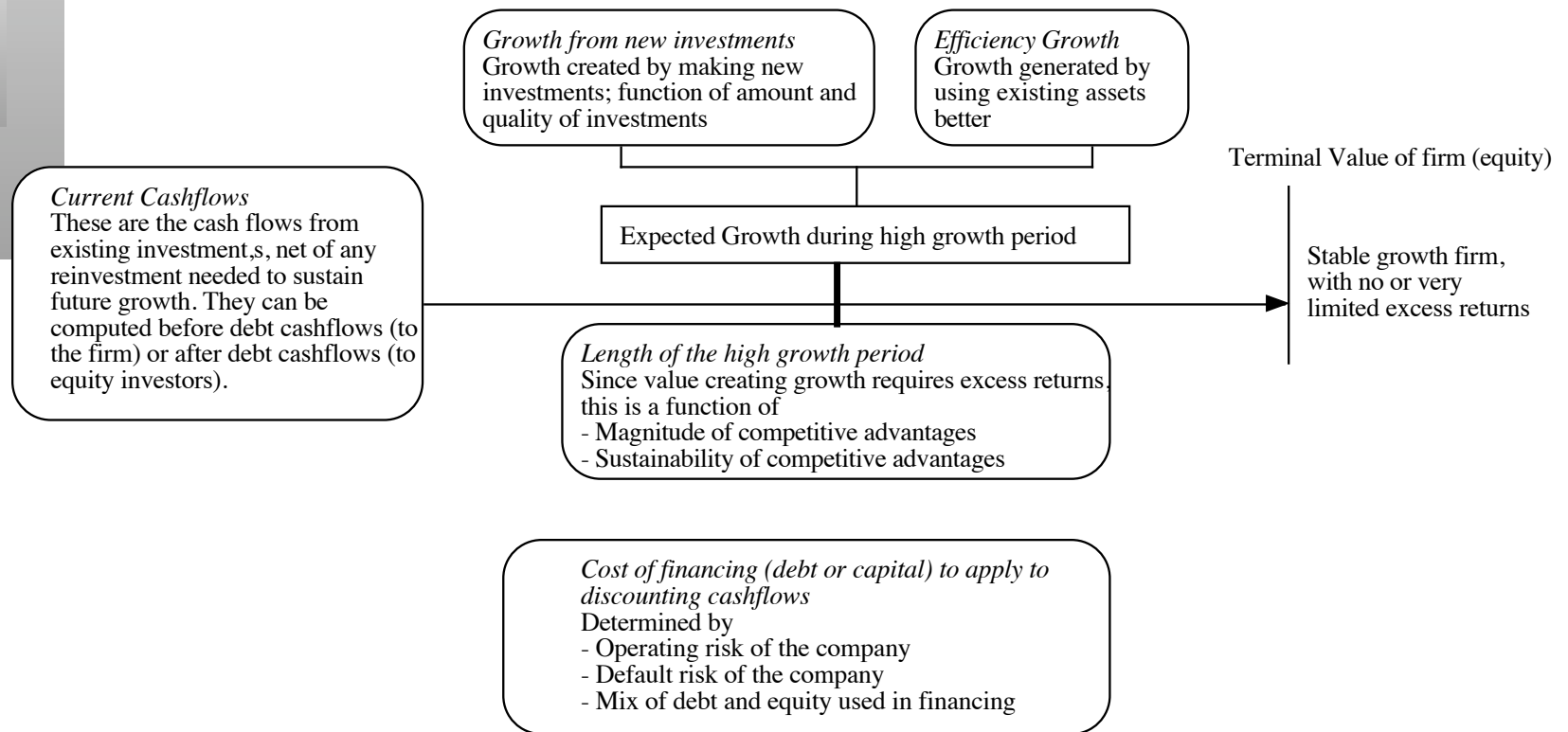
DCF Choices: Equity Valuation versus Firm Valuation

Firm Valuation: Value the entire business

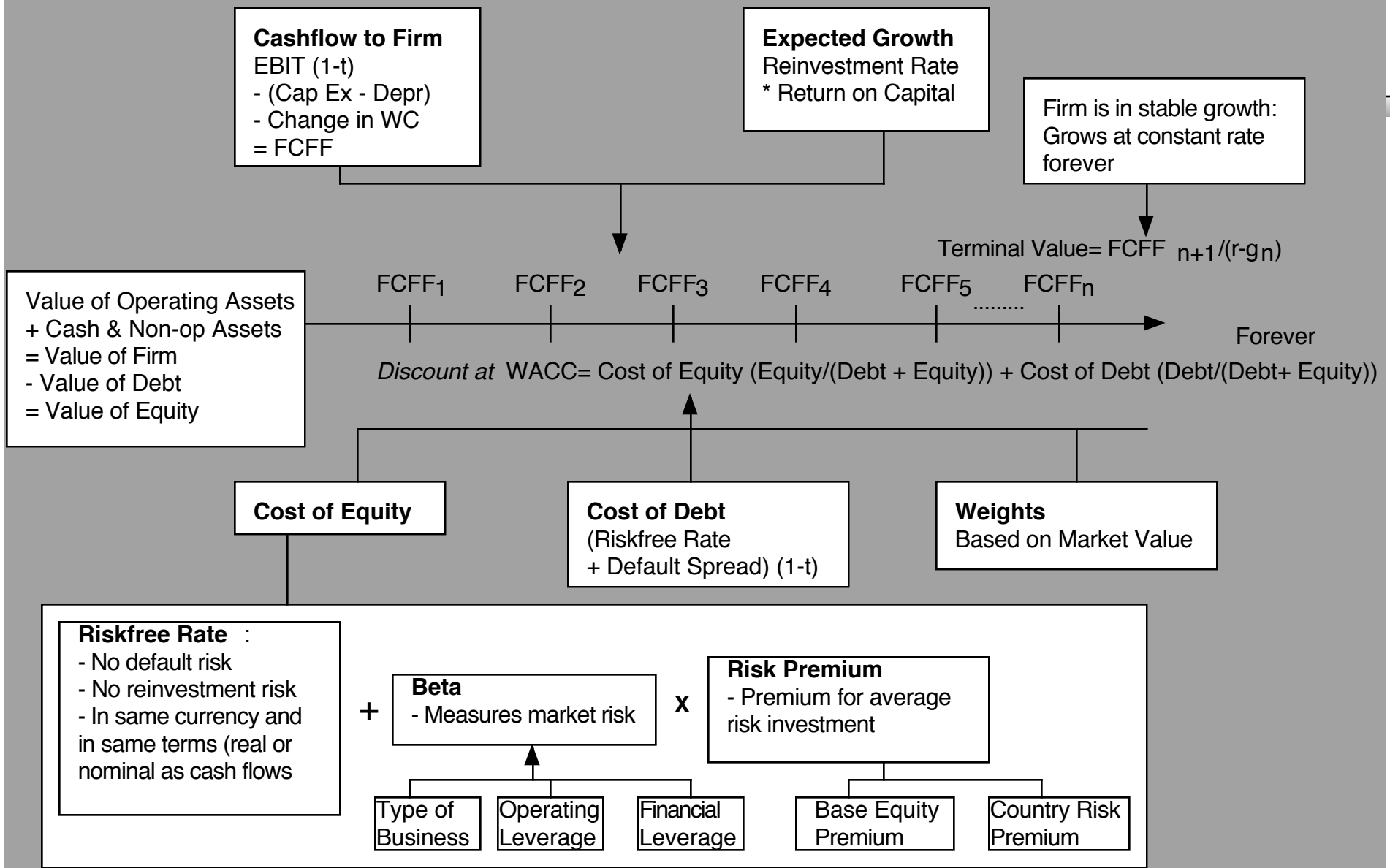
Assets		Liabilities	
Existing Investments Generate cashflows today Includes long lived (fixed) and short-lived (working capital) assets	Assets in Place	Debt	Fixed Claim on cash flows Little or No role in management <i>Fixed Maturity</i> <i>Tax Deductible</i>
Expected Value that will be created by future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

Equity valuation: Value just the equity claim in the business

The Drivers of Value...



DISCOUNTED CASHFLOW VALUATION



Cementos Pacasmayo: \$ in 2009

Current Cashflow to Firm

EBIT(1-t) :	PEN 112.35
- Nt CpX	PEN 49.50
- Chg WC	PEN 4.65
= FCFF	PEN 58.20
PEN/ US \$	3.23
Reinv Rate = (49.5+4.65)/112.35	= 48.2%

Reinvestment Rate
48.2%

Expected Growth
in EBIT (1-t)
..482*.1645=0.0793
7.93%

Return on Capital
16.45%

Stable Growth
g = 3.5%; Beta = 1.00
Country Premium= 2.5%
Cost of capital = 11.55%
ROC= 11.55%;
Reinvestment Rate=g/ROC
=3.5/ 11.55= 30.30%

Terminal Value₅ = 33.14(.1155-.035) = \$411.6

Op. Assets \$289.06
+ Cash: 12.06
- Debt 77.04
- Minor. Int. 0.60
=Equity \$223.48
Exchange 3.01
Equity PEN 672.67
Value/Share PEN 1.60

Year	1	2	3	4	5	
EBIT (1-t)	PEN 121	PEN 131	PEN 141	PEN 152	PEN 165	170.30
- Reinvestment	PEN 58	PEN 63	PEN 68	PEN 73	PEN 79	51.60
FCFF	PEN 63	PEN 68	PEN 73	PEN 79	PEN 85	118.70
Exchange rate	3.10	3.19	3.28	3.38	3.48	3.58
FCFF (In US \$)	\$20.27	\$21.26	\$22.29	\$23.37	\$24.50	\$ 33.14

Discount at \$ Cost of Capital (WACC) = 15.48% (.849) + 5.95 (0.151) = 14.04%

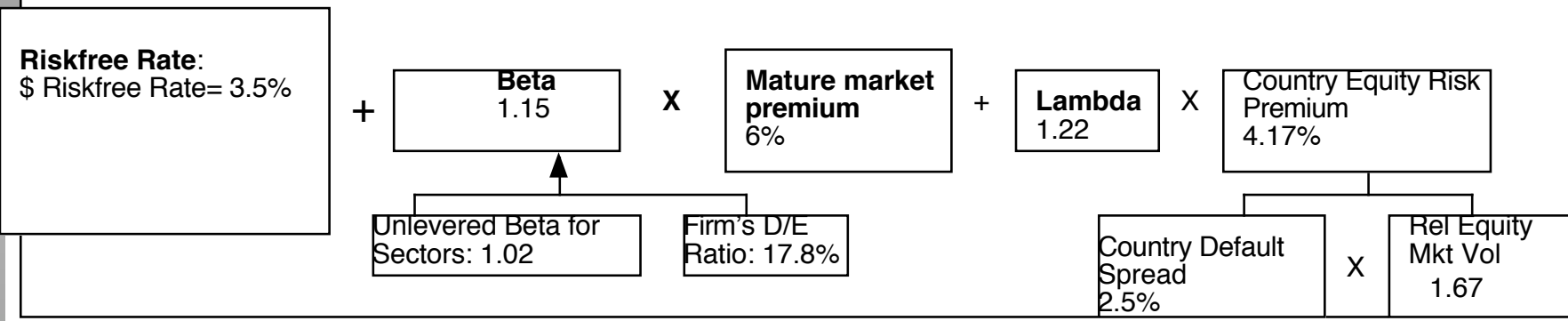
Expected inflation
US = 2%
Peru= 5%

Cost of Equity
15.48%

Cost of Debt
(3.5%+ 2.5%+ 2.5%)(1-.30)
= 5.95%

Weights
E = 84.9% D = 15.1%

On July 1, 2009
Cementos Price = PEN 3.01



Sociedad Minera: \$ in 2009

5-year average

Current Cashflow to Firm
 EBIT(1-t) : \$ 708.00
 - Nt CpX \$ 48.00
 - Chg WC \$ 103.00
 = FCFF \$ 557.00
 Reinv Rate = (48+103)/708
 = 21.34%%

Reinvestment Rate
20%

Expected Growth in EBIT (1-t)
 = .75 * .20
15.0%

Return on Capital
75%

Stable Growth
 g = 3.5%; Beta = 0.80
 Country Premium = 2.5%
 Cost of capital = 9.8%
 ROC = 9.8%
 Reinvestment Rate = g/ROC
 = 3.5/9.8 = 35.71%

Op. Assets \$ 6,788
 + Cash: 482
 - Debt 0
 = Equity \$ 7,161
 E Value/Share \$20.46

\$ Cashflows

Year	1	2	3	4	5	Term yr
EBIT (1-t)	\$ 814	\$ 936	\$ 1,076	\$ 1,238	\$ 1,423	1,473
- Reinvestment	\$ 163	\$ 187	\$ 215	\$ 248	\$ 285	526
FCFF (in \$)	\$ 651	\$ 749	\$ 861	\$ 990	\$ 1,139	947

Terminal Value₅ = 947 * (.098 - .035) = \$5,617

Discount at \$ Cost of Capital (WACC) = 10.2% (.1.00) + 5.95 (0.00) = 10.20%

Expected inflation
 US = 2%
 Peru = 5%

Cost of Equity
10.2%

Cost of Debt
 (3.5% + 2.5% + 1.25%) (1 - .30)
 = 5.15%

Weights
 E = 100% D = 0%

On July 1, 2009
 Sociedad Price = \$ 19.2

Riskfree Rate:
 \$ Riskfree Rate = 3.5%

+

Beta
0.70

X

Mature market premium
6%

+

Lambda
0.60

X

Country Equity Risk Premium
4.17%

Unlevered Beta for Sectors: 0.70

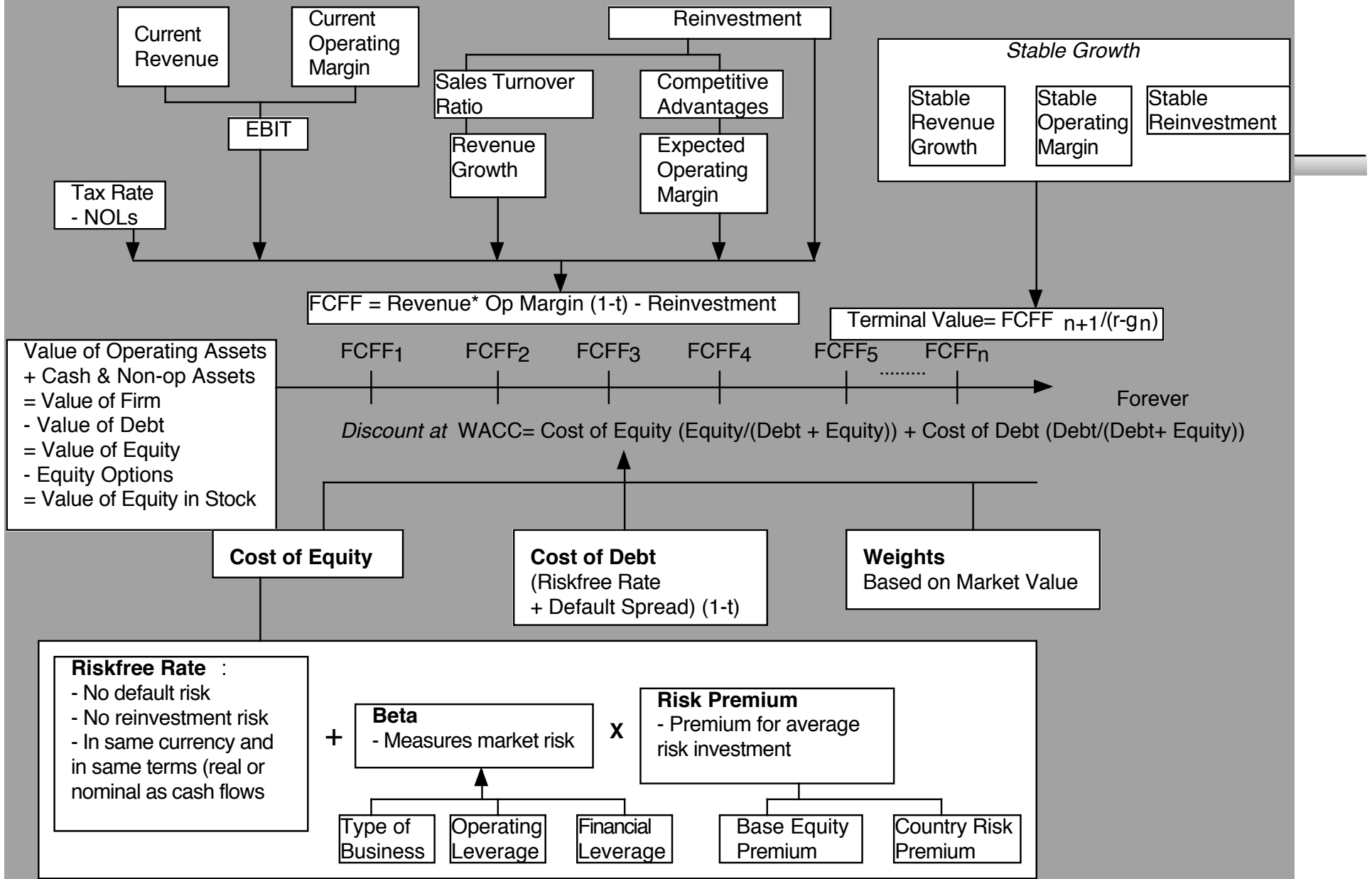
Firm's D/E Ratio: 0%

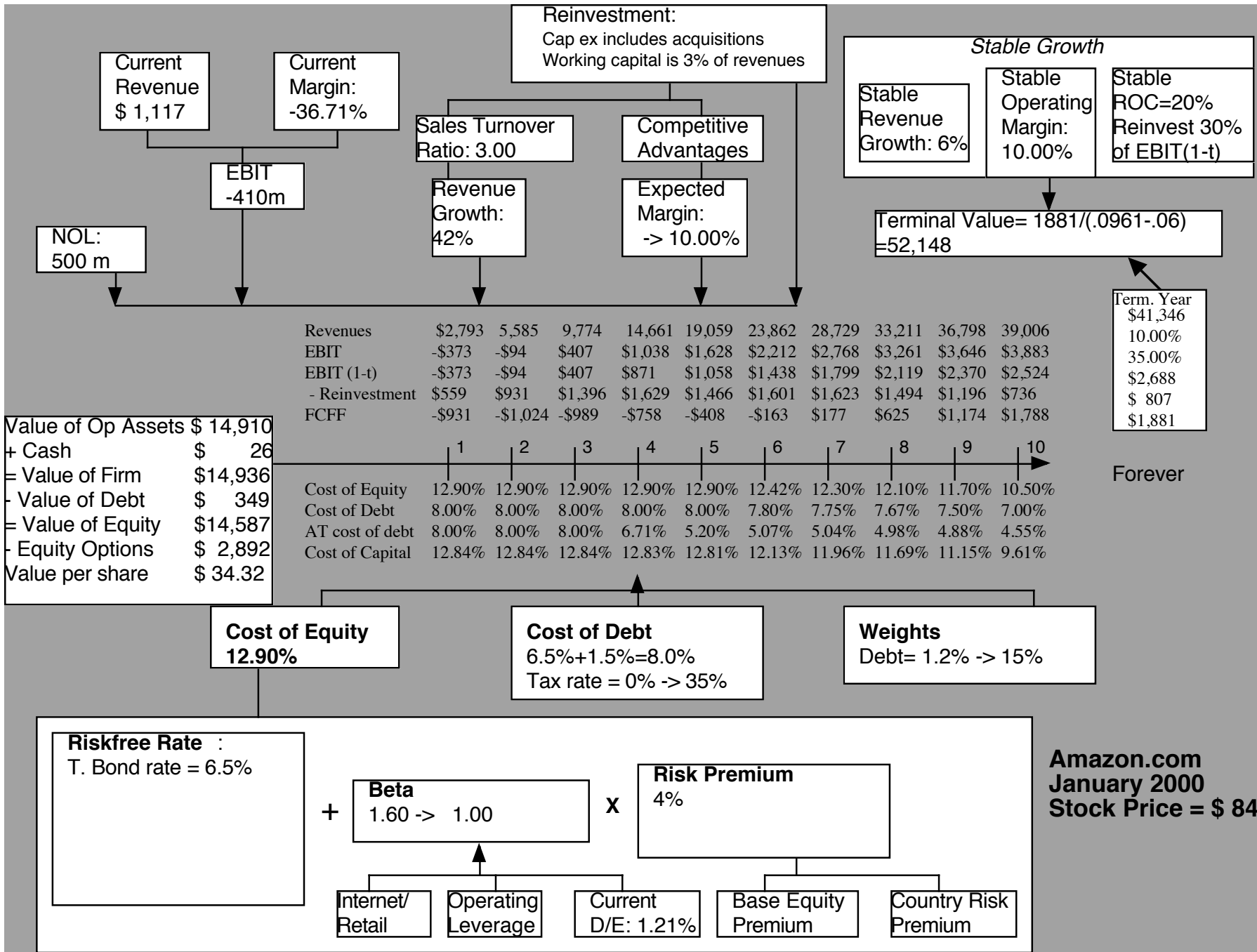
Country Default Spread
2.5%

X

Rel Equity Mkt Vol
1.67

Discounted Cash Flow Valuation: High Growth with Negative Earnings





I. Choose a currency... and a riskfree rate..

The riskfree rate is what you can earn on a long term, default free investment in that currency.

■ In US dollars...

- The ten-year US treasury bond rate is the riskfree rate. In July 2009, it was priced to yield 3.5%.
- In July 2009, the Peruvian government had 10-year US dollar denominated bonds that were priced to yield 6%. Why should this not be used as the riskfree rate? (The Peruvian foreign currency rating was Ba1)

■ In Peruvian sul..

- The ten-year sul-denominated Peruvian government bond was priced to yield about 10% in July 2009.
- The Peruvian government has a local currency rating of Baa3. The default spread on Baa3 rated sovereign bonds is approximately 2.2%.
- Riskfree rate in Suls = $10\% - 2^{\text{TM}}\%$
= 7.8%

Cementos Pacasmayo: PEN in 2009

Current Cashflow to Firm

EBIT(1-t) :	PEN 112.35
- Nt CpX	PEN 49.50
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Reinvestment Rate
48.2%

Expected Growth
in EBIT (1-t)
 $.482 \cdot 16.45 = 0.0793$
7.93%

Return on Capital
16.45%

Stable Growth
g = 6.54%; Beta = 1.00
Country Premium = 2.5%
Cost of capital = 14.83%
ROC = 14.83%;
Reinvestment Rate = $g/ROC = 6.54/14.83 = 30.30\%$

Terminal Value₅ = $118.7 \cdot (1.1483 - 1.0654) = 1,432$

Year	1	2	3	4	5	
EBIT (1-t)	PEN 121	PEN 131	PEN 141	PEN 152	PEN 165	170.30
- Reinvestment	PEN 58	PEN 63	PEN 68	PEN 73	PEN 79	51.60
FCFF	PEN 63	PEN 68	PEN 73	PEN 79	PEN 85	118.70

Op. Assets 870.07
+ Cash: 36.30
- Debt 231.09
- Minor. Int. 1.80
= Equity 672.67
Value/Share PEN 1.60

PEN Cost of Capital = $(1.1404) (1.05/1.02) - 1 = 17.39\%$
\$ Cost of Capital (WACC) = $15.48\% (.849) + 5.95 (0.151) = 14.04\%$

Expected inflation
US = 2%
Peru = 5%

Cost of Equity
15.48%

Cost of Debt
 $(3.5\% + 2.5\% + 2.5\%) (1 - .30) = 5.95\%$

Weights
E = 84.9% D = 15.1%

On July 1, 2009
Cementos Price = PEN 3.01

Riskfree Rate:
\$ Riskfree Rate = 3.5%

+ Beta 1.15 X Mature market premium 6% + Lambda 1.22 X Country Equity Risk Premium 4.17%

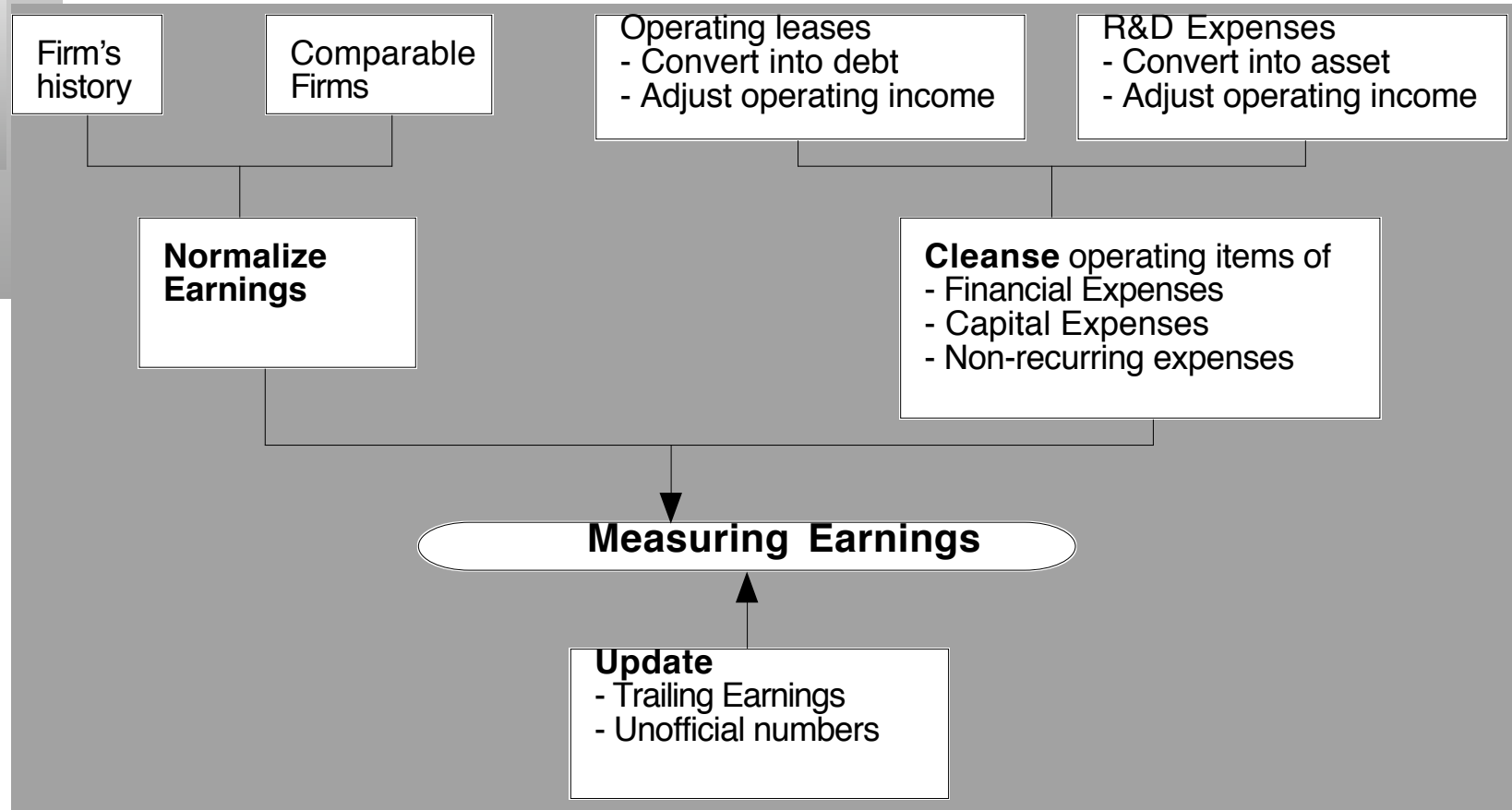
Unlevered Beta for Sectors: 1.02

Firm's D/E Ratio: 17.8%

Country Default Spread 2.5%

Rel Equity Mkt Vol 1.67

II. Measure earnings right..



A. Normalizing Earnings: Sociedad

	2004	2005	2006	2007	2008
Revenues	\$295	\$359	\$668	\$1,795	\$1,840
EBIT	\$140	\$204	\$432	\$1,164	\$1,011
BV of debt	\$4	\$5	\$25	\$184	\$74
BV of equity	\$193	\$266	\$794	\$1,261	\$1,446
Cash holdings	\$29	\$157	\$265	\$355	\$630
Invested Capital	\$168	\$114	\$554	\$1,090	\$890
Pre-tax ROIC	\$1	\$2	\$1	\$1	\$1
Copper Prices	\$2,726	\$3,773	\$5,363	\$6,503	\$4,873
Deflated EBIT	\$140	\$147	\$220	\$488	\$566
Deflated Revenue	\$295	\$259	\$340	\$752	\$1,029

Almost half of the historical growth in earnings has come from rising copper prices. Looking forward, it is important that we separate how much of the growth is due to real output and how much can be attributed to commodity prices.

Historical growth rate in revenues = 58%

Adjusted for commodity price increase = 38%

B. Dealing with Operating Leases – An Example with the Gap

- The Gap has conventional debt of about \$ 1.97 billion on its balance sheet and its pre-tax cost of debt is about 6%. Its operating lease payments in the 2003 were \$978 million and its commitments for the future are below:

Year	Commitment (millions)	Present Value (at 6%)
1	\$899.00	\$848.11
2	\$846.00	\$752.94
3	\$738.00	\$619.64
4	\$598.00	\$473.67
5	\$477.00	\$356.44
6&7	\$982.50 each year	\$1,346.04
Debt Value of leases =		\$4,396.85 (Also value of leased asset)

- Debt outstanding at The Gap = \$1,970 m + \$4,397 m = \$6,367 m
- Adjusted Operating Income = Stated OI + OL exp this year - Deprec'n
= \$1,012 m + 978 m - 4397 m /7 = \$1,362 million (7 year life for assets)
- Approximate OI = \$1,012 m + \$ 4397 m (.06) = \$1,276 m

The Collateral Effects of Treating Operating Leases as Debt

<i>Conventional Accounting</i>	<i>Operating Leases Treated as Debt</i>								
<p><i>Income Statement</i></p> <p>EBIT & Leases = 1,990 - Op Leases = 978 EBIT = 1,012</p>	<p><i>Income Statement</i></p> <p>EBIT & Leases = 1,990 - Deprecn: OL = 628 EBIT = 1,362</p> <p>Interest expense will rise to reflect the conversion of operating leases as debt. Net income should not change.</p>								
<p><i>Balance Sheet</i></p> <p>Off balance sheet (Not shown as debt or as an asset). Only the conventional debt of \$1,970 million shows up on balance sheet</p>	<p><i>Balance Sheet</i></p> <table> <tr> <td>Asset</td> <td></td> <td>Liability</td> <td></td> </tr> <tr> <td>OL Asset</td> <td>4397</td> <td>OL Debt</td> <td>4397</td> </tr> </table> <p>Total debt = 4397 + 1970 = \$6,367 million</p>	Asset		Liability		OL Asset	4397	OL Debt	4397
Asset		Liability							
OL Asset	4397	OL Debt	4397						
<p>Cost of capital = 8.20%(7350/9320) + 4%(1970/9320) = 7.31%</p> <p>Cost of equity for The Gap = 8.20%</p> <p>After-tax cost of debt = 4%</p> <p>Market value of equity = 7350</p>	<p>Cost of capital = 8.20%(7350/13717) + 4%(6367/13717) = 6.25%</p>								
<p>Return on capital = 1012 (1-.35)/(3130+1970) = 12.90%</p>	<p>Return on capital = 1362 (1-.35)/(3130+6367) = 9.30%</p>								

C. Capitalizing R&D Expenses: An Example with SAP

- R & D was assumed to have a 5-year life.

<i>Year</i>	<i>R&D Expense</i>	<i>Unamortized portion</i>	<i>Amortization this year</i>
Current	1020.02	1.00	1020.02
-1	993.99	0.80	€ 198.80
-2	909.39	0.60	€ 181.88
-3	898.25	0.40	€ 179.65
-4	969.38	0.20	€ 193.88
-5	744.67	0.00	€ 148.93

Value of research asset = € 2,914 million

Amortization of research asset in 2004 = € 903 million

Increase in Operating Income = 1020 - 903 = € 117 million

The Effect of Capitalizing R&D at SAP

<i>Conventional Accounting</i>	<i>R&D treated as capital expenditure</i>				
<p><i>Income Statement</i></p> <p>EBIT& R&D = 3045 - R&D = 1020 EBIT = 2025 EBIT (1-t) = 1285 m</p>	<p><i>Income Statement</i></p> <p>EBIT& R&D = 3045 - Amort: R&D = 903 EBIT = 2142 (Increase of 117 m) EBIT (1-t) = 1359 m</p> <p>Ignored tax benefit = $(1020-903)(.3654) = 43$ Adjusted EBIT (1-t) = $1359+43 = 1402$ m (Increase of 117 million) Net Income will also increase by 117 million</p>				
<p><i>Balance Sheet</i></p> <p>Off balance sheet asset. Book value of equity at 3,768 million Euros is understated because biggest asset is off the books.</p>	<p><i>Balance Sheet</i></p> <table> <tr> <td>Asset</td> <td>Liability</td> </tr> <tr> <td>R&D Asset 2914</td> <td>Book Equity +2914</td> </tr> </table> <p>Total Book Equity = $3768+2914= 6782$ mil</p>	Asset	Liability	R&D Asset 2914	Book Equity +2914
Asset	Liability				
R&D Asset 2914	Book Equity +2914				
<p><i>Capital Expenditures</i></p> <p>Conventional net cap ex of 2 million Euros</p>	<p><i>Capital Expenditures</i></p> <p>Net Cap ex = $2+ 1020 - 903 = 119$ mil</p>				
<p><i>Cash Flows</i></p> <p>EBIT (1-t) = 1285 - Net Cap Ex = 2 FCFF = 1283</p>	<p><i>Cash Flows</i></p> <p>EBIT (1-t) = 1402 - Net Cap Ex = 119 FCFF = 1283 m</p>				
<p>Return on capital = $1285/(3768+530)$ = 29.90%</p>	<p>Return on capital = $1402/(6782+530)$ = 19.93%</p>				

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

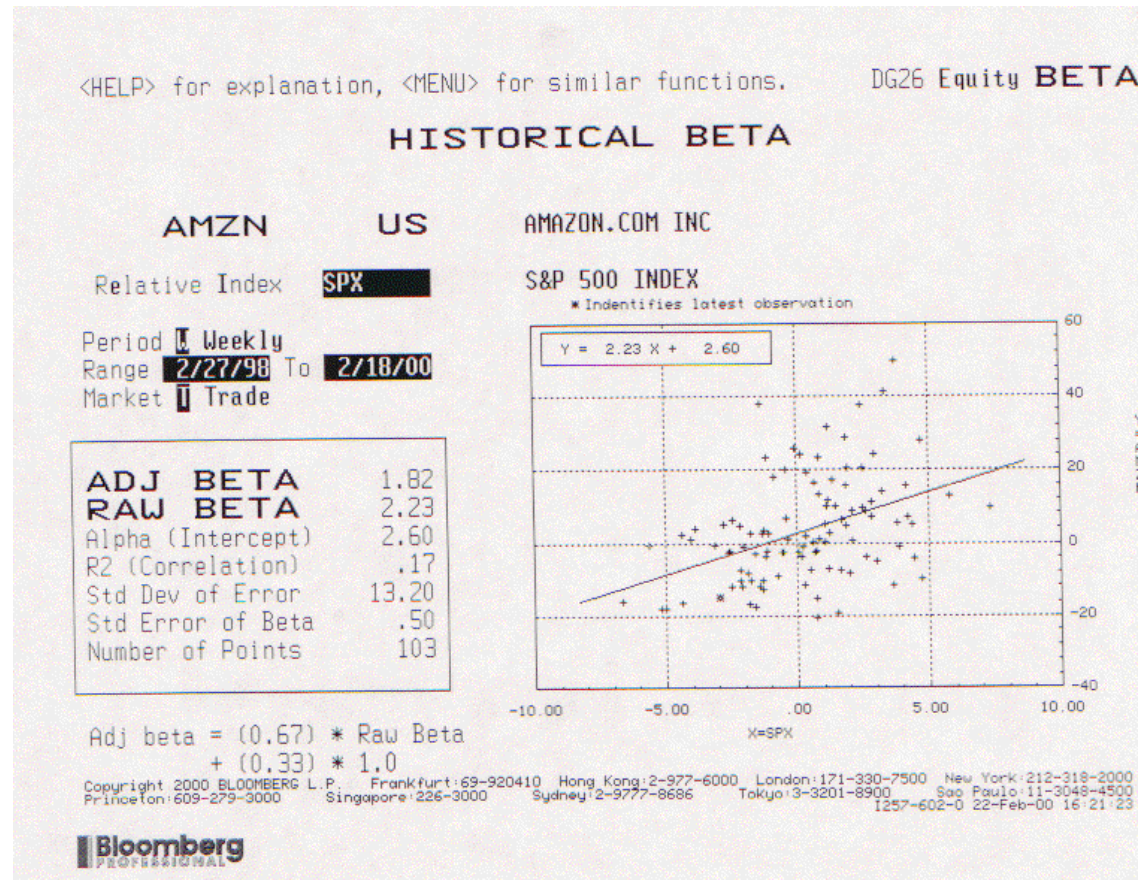
- Capital expenditures should include
 - Research and development expenses, once they have been re-categorized as capital expenses.
 - Acquisitions of other firms, whether paid for with cash or stock.
- Working capital should be defined not as the difference between current assets and current liabilities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

Cisco's Net Capital Expenditures in 1999

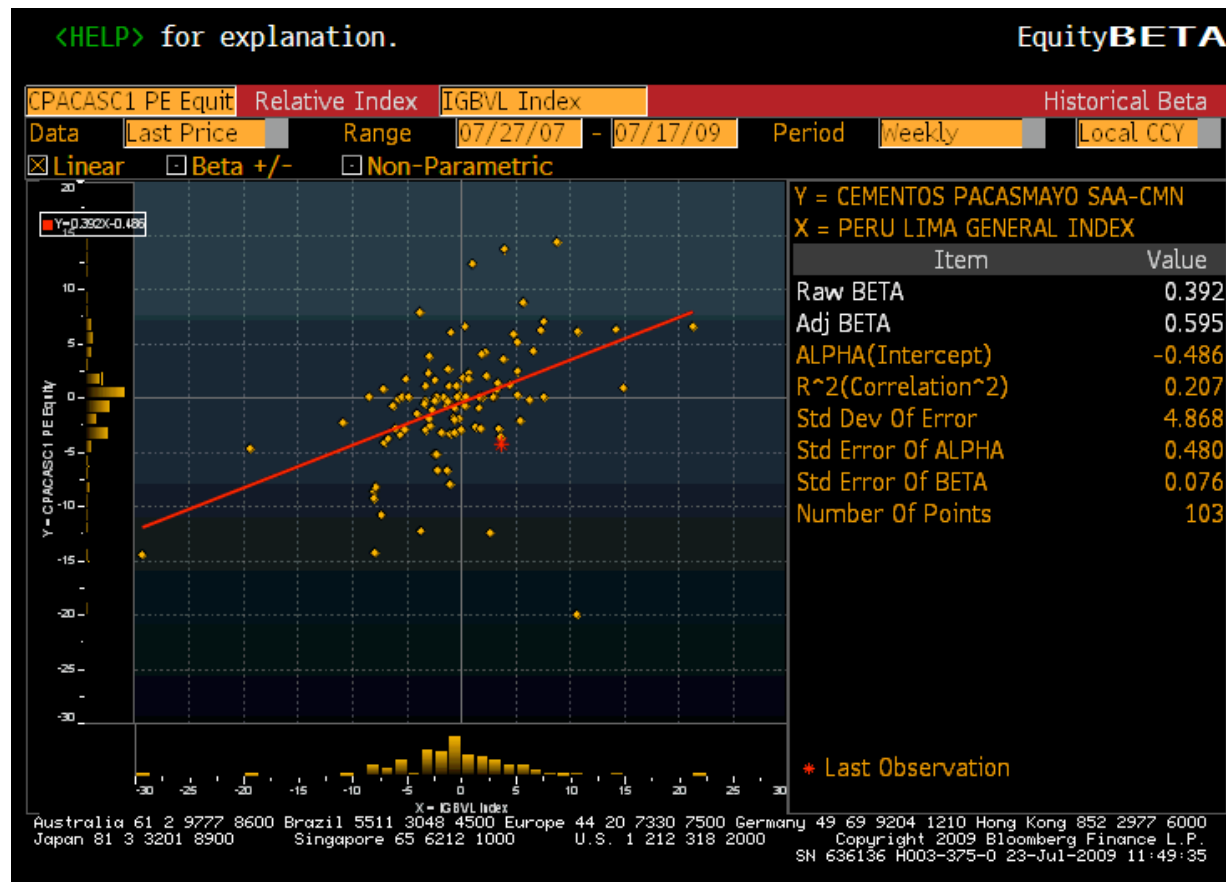
Cap Expenditures (from statement of CF)	= \$ 584 mil
- Depreciation (from statement of CF)	= \$ 486 mil
Net Cap Ex (from statement of CF)	= \$ 98 mil
+ R & D expense	= \$ 1,594 mil
- Amortization of R&D	= \$ 485 mil
+ Acquisitions	= \$ 2,516 mil
Adjusted Net Capital Expenditures	= \$3,723 mil

(Amortization was included in the depreciation number)

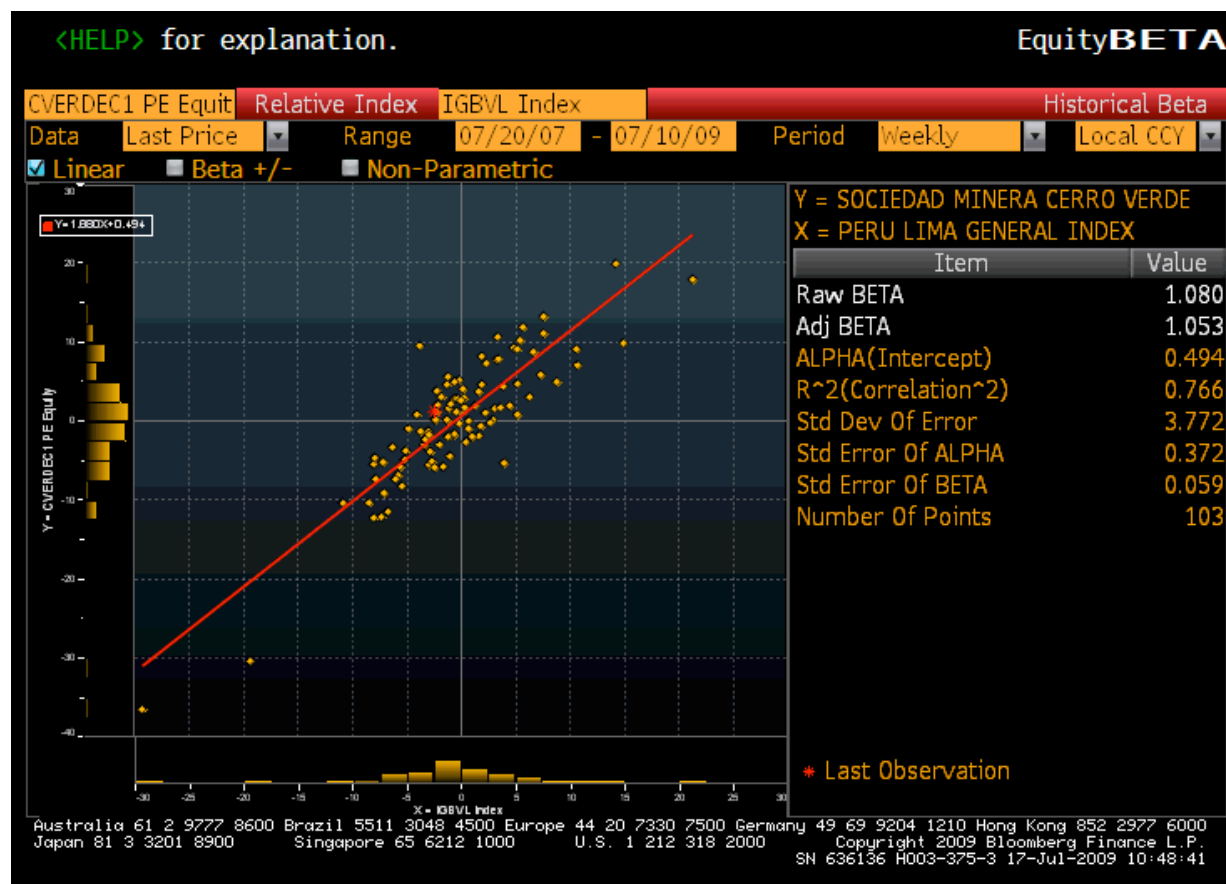
IV. Betas do not come from regressions...



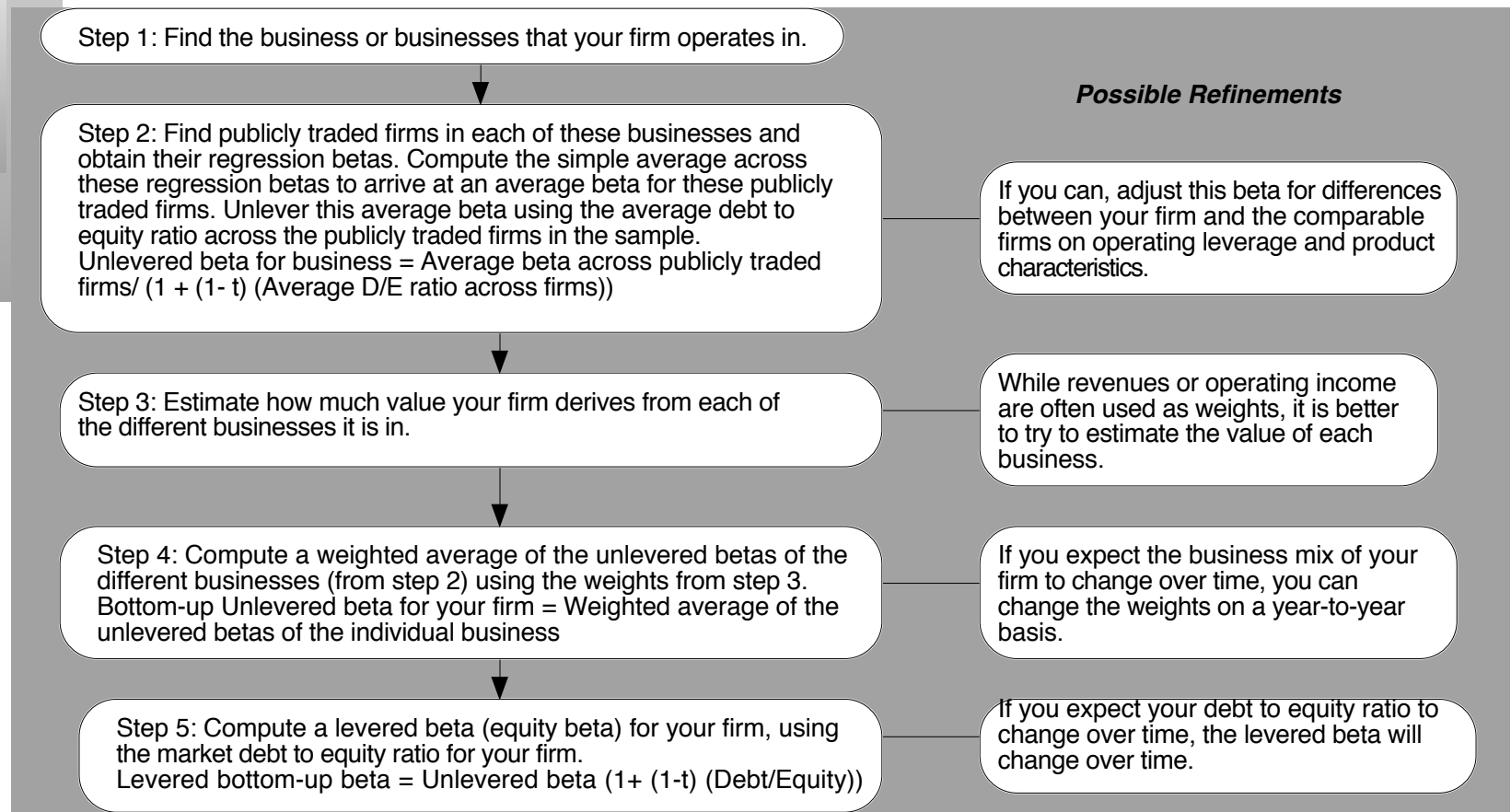
Carry much noise...



And cannot be trusted even when they look good...



Bottom-up Betas



Two examples...

■ **Sociedad Minera**

- The company is in only one business – copper mining – and the average unlevered beta for copper mining companies is 0.70.
- The debt to equity ratio is zero,.
- Levered beta for the firm = Unlevered beta = 0.70

■ **Cementos Pacasmayo**

<i>Business</i>	<i>Revenues</i>	<i>EV/Sales</i>	<i>Estimated Value</i>	<i>Weights</i>	<i>Unlevered Beta</i>
Cement	436	1.2	523.2	65.75%	1.09
Construction Material	188	1.45	272.6	34.25%	0.89
Cementos Pacasmayo			795.8		1.02

- The marginal tax rate in Peru is 30% and the debt to equity ratio for Cementos is 17.81%.
- Bottom-up Beta = 1.02 (1 + (1 - .30)(.1781)) = 1.15

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

- It is standard practice to use historical premiums as forward looking premiums. :

	Arithmetic Average		Geometric Average	
	Stocks - T. Bills	Stocks - T. Bonds	Stocks - T. Bills	Stocks - T. Bonds
1928-2008	7.30%	5.65%	5.32%	3.88%
	(2.29%)	(2.40%)		
1959-2008	5.14%	3.33%	3.77%	2.29%
	(2.39%)	(2.63%)		
1999-2008	-2.53%	-6.26%	-4.53%	-7.96%
	(6.36%)	(8.85%)		

- An alternative is to back out the premium from market prices:

In 2008, the actual cash returned to stockholders was 68.72. However, there was a 41% dropoff in buybacks in Q4. We reduced the total buybacks for the year by that amount.

Analysts expect earnings to grow 4% a year for the next 5 years. We will assume that dividends & buybacks will keep pace..
Last year's cashflow (52.58) growing at 4% a year

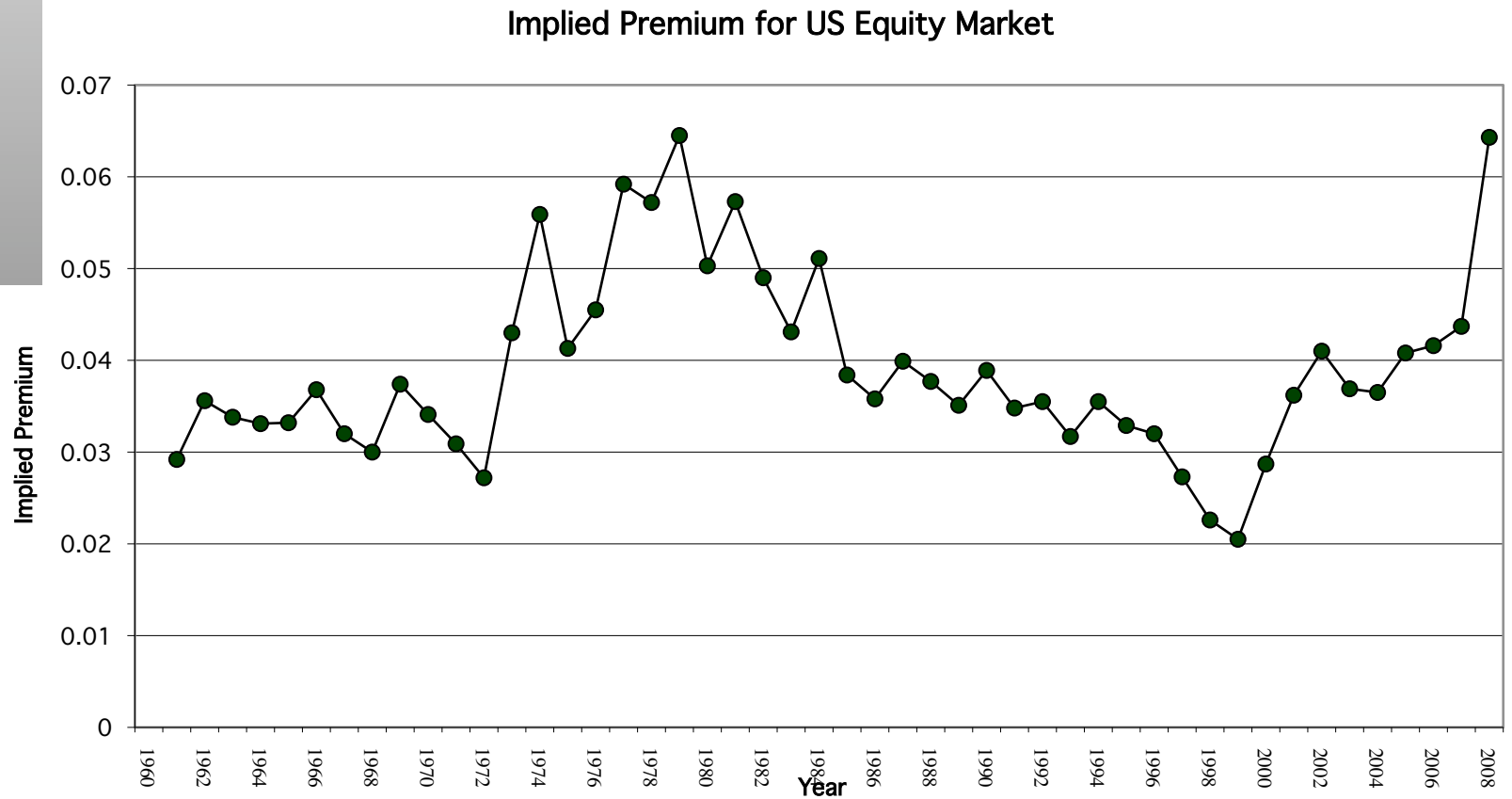
After year 5, we will assume that earnings on the index will grow at 2.21%, the same rate as the entire economy (= riskfree rate).

$$903.25 = \frac{54.69}{(1+r)} + \frac{56.87}{(1+r)^2} + \frac{59.15}{(1+r)^3} + \frac{61.52}{(1+r)^4} + \frac{63.98}{(1+r)^5} + \frac{63.98(1.0221)}{(r-.0221)(1+r)^5}$$

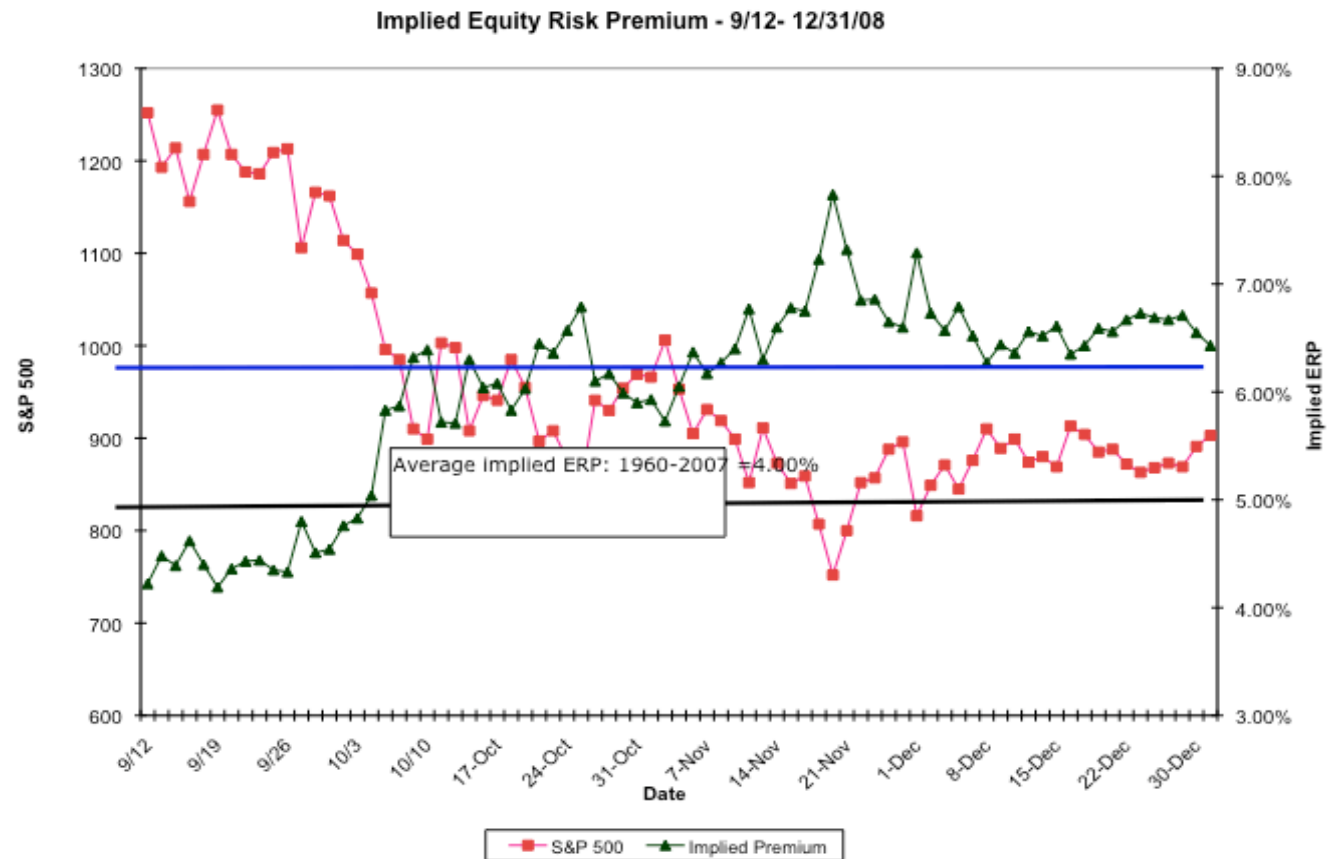
January 1, 2009
S&P 500 is at 903.25
Adjusted Dividends & Buybacks for 2008 = 52.58

Expected Return on Stocks (1/1/09) = 8.64%
Equity Risk Premium = 8.64% - 2.21% = 6.43%

Implied Premiums in the US



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

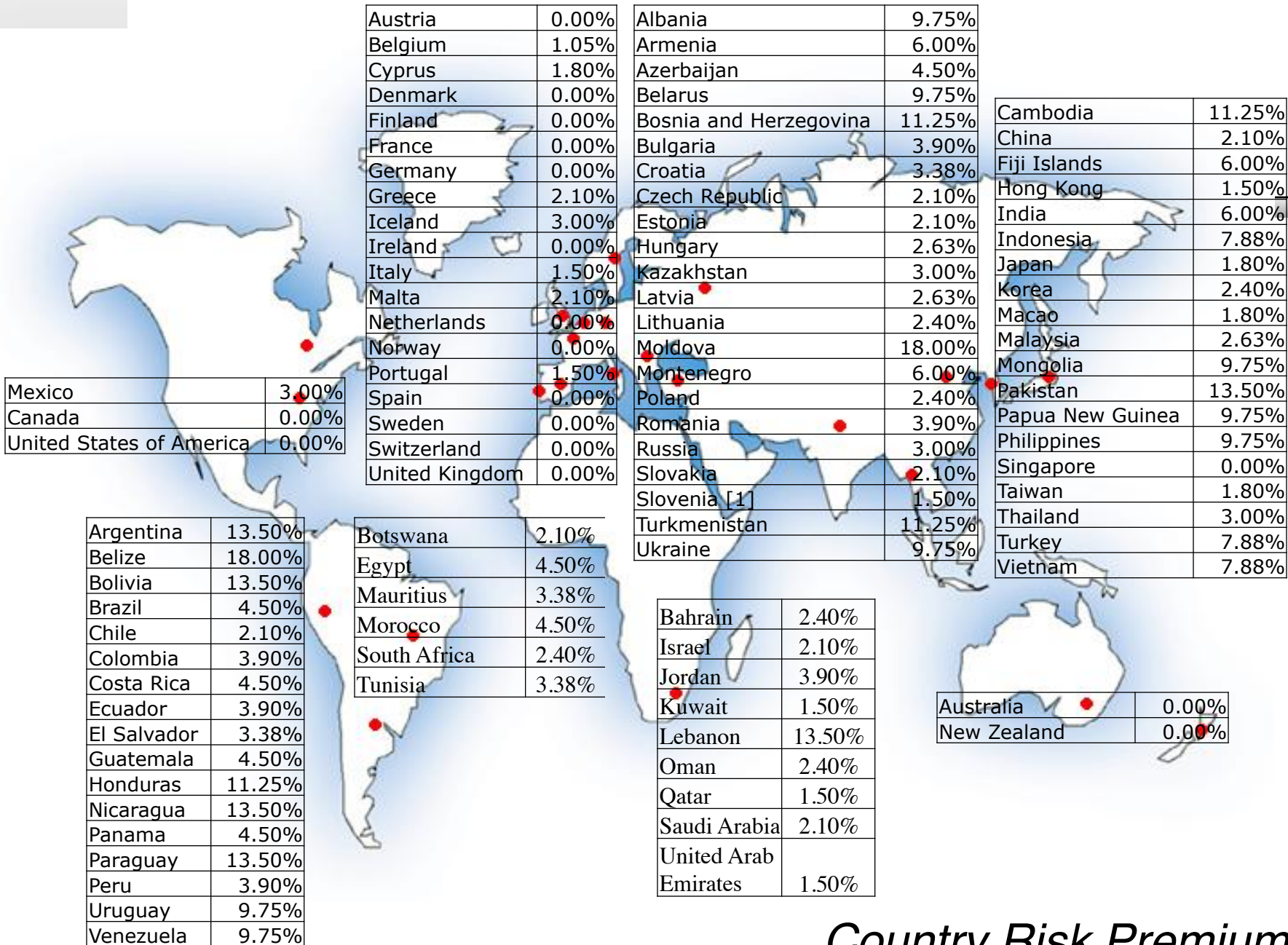


Implied Premium for Peruvian Equities: July 2009

- Level of the Index = 13,317
- FCFE on the Index = 7.55% (Estimated FCFE for companies in index as % of market value of equity)
- Other parameters
 - Riskfree Rate = 3.5% (in US dollars)
 - Expected Growth (in US dollars)
 - Next 5 years = 8% (Used expected growth rate in Earnings)
 - After year 5 = 3.5%
- Solving for the expected return:
 - Expected return on Equity = 12.88%
 - Implied Equity premium = 12.88% - 3.5% = 9.38%
- The implied equity risk premium in the United States at the same time was approximately 6%, leading to an additional country risk premium of 3.38% for Peru.

VI. There is a downside to globalization...

- Country bond default spread: The rate on a 10-year Peruvian dollar denominated bond, rated Baa3 in July 2009, was 6%. The US 10-year treasury bond rate was 3.5%
Default Spread = 6% - 3.5% = **2.5%** = Country Equity Risk Premium
- Relative Equity Market volatility: The standard deviation in the Lima General Index between July 2007-July 2009 was 50%. The standard deviation in the S&P 500 over the same period was 36%. If we assume that 6% is the premium for a mature equity market (like the S&P 500):
Total Equity Risk premium for Peru = 6% (50/32) = 9.375%
Country Equity Risk Premium = 9.375% - 6% = **3.375%**
- Melded Approach: The default spread for Peru can be scaled up to reflect the additional risk of equity in Peru. The standard deviation in the Peruvian 10-year bond (yield) between July 2007-July 2009 was 30%.
Country Equity Risk Premium = 2.5% (50/30) = **4.17%**



Country Risk Premiums January 2009

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

- If we 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)

$$E(\text{Return}) = \text{Riskfree Rate} + \beta (\text{US premium}) + \lambda (\text{Country ERP})$$

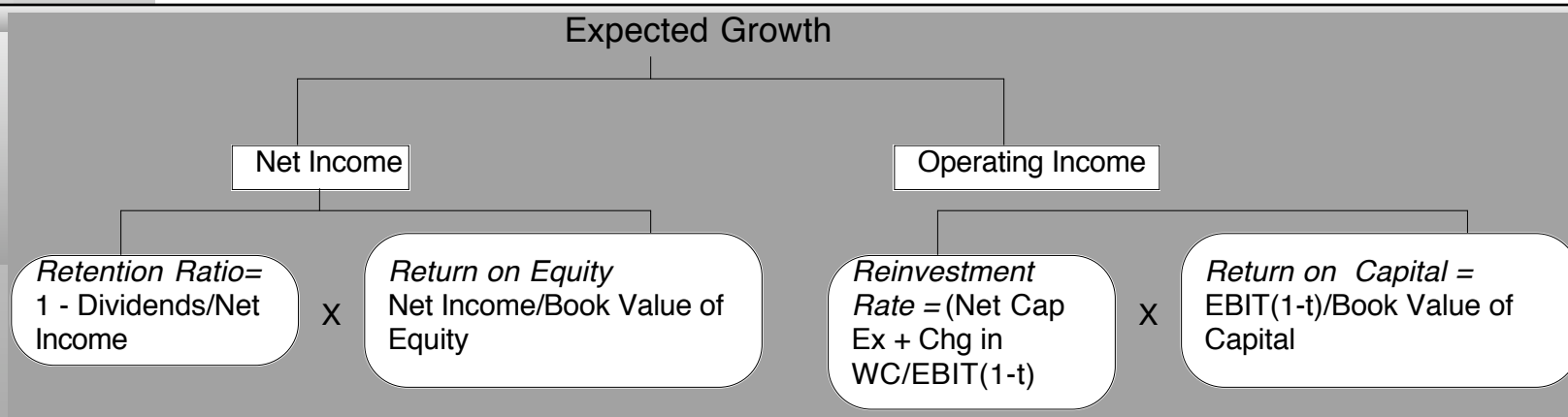
- The lambda should be a function of
 - Revenue sources: While both Sociedad and Cementos are Peruvian companies, Sociedad derives almost much of its revenues in developed markets whereas Cementos gets all of its revenues in Peru.
 - Production/ Manufacturing: Both Sociedad and Cementos have all of their production in Peru, and neither firm has much flexibility in moving their production.

Lambda for Sociedad = 0.60

Lambda for Cementos = 1.22

- 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 exposures

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



Adjust EBIT for

- Extraordinary or one-time expenses or income
- Operating leases and R&D
- Cyclicality in earnings (Normalize)
- 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

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

Adjust book equity for

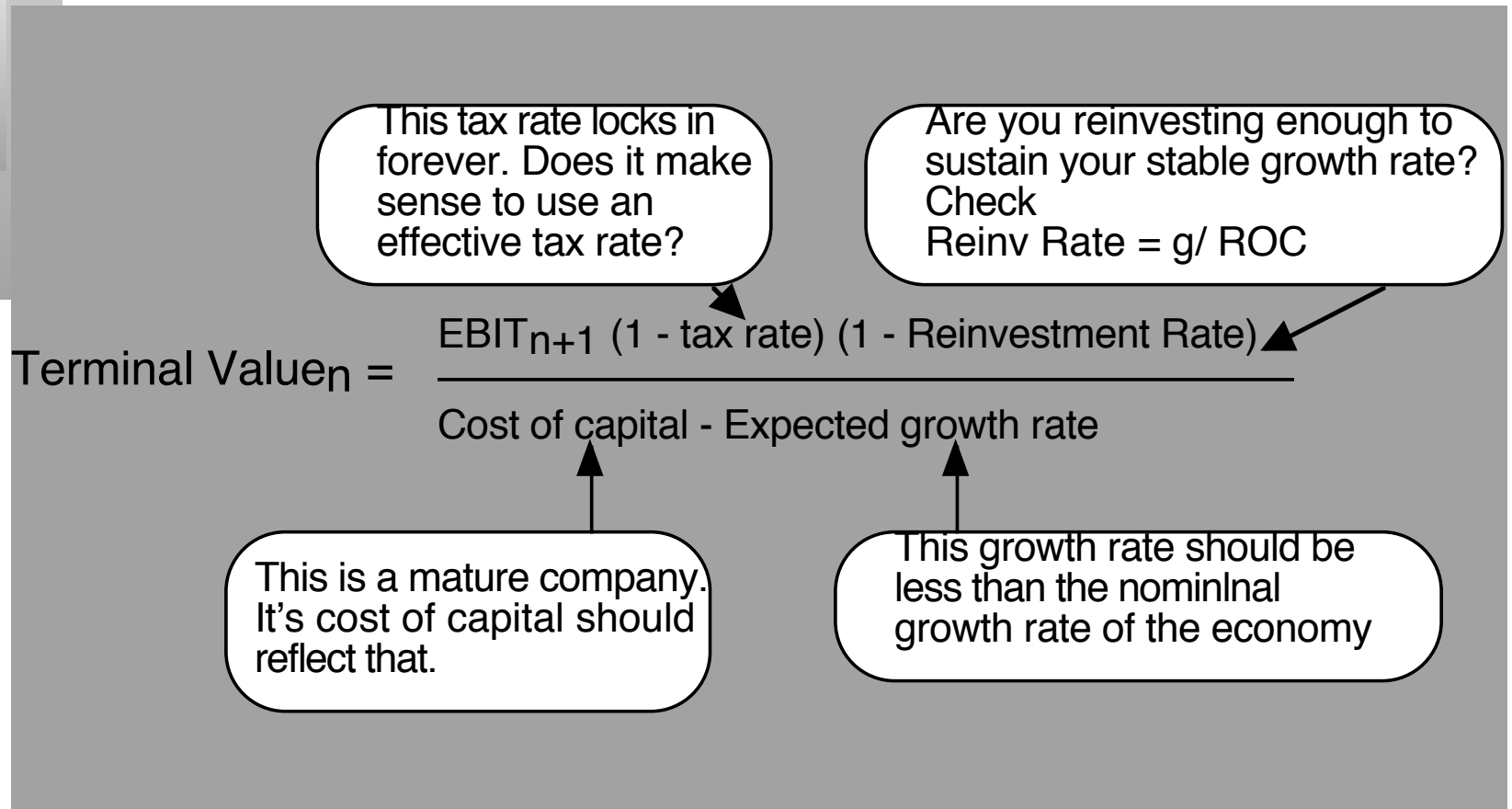
- Capitalized R&D
- Acquisition Debris (Goodwill)

Adjust book value of debt for

- Capitalized operating leases

Use end of prior year numbers or average over the year but be consistent in your application

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



Cementos: Terminal Value and Growth

Growth Rate	Reinvestment Rate	FCFF	Terminal value
0%	0.00%	\$47.55	\$411.61
1%	8.66%	\$43.43	\$411.61
2%	17.31%	\$39.31	\$411.61
3%	25.97%	\$35.20	\$411.61
4%	34.63%	\$31.08	\$411.61
5%	43.29%	\$26.96	\$411.61

As growth increases, value does not change. Why?

Under what conditions will value increase as growth increases?

Under what conditions will value decrease as growth increases?

X. The loose ends matter...

Value of Operating Assets	Since this is a discounted cashflow valuation, should there be a real option premium?
+ Cash and Marketable Securities	Operating versus Non-operating cash Should cash be discounted for earning a low return?
+ Value of Cross Holdings	How do you value cross holdings in other companies? What if the cross holdings are in private businesses?
+ Value of Other Assets	What about other valuable assets? How do you consider under utilized assets?
Value of Firm	Should you discount this value for opacity or complexity? How about a premium for synergy? What about a premium for intangibles (brand name)?
- Value of Debt	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?
= Value of Equity	Should there be a premium/discount for control? Should there be a discount for distress
- Value of Equity Options	What equity options should be valued here (vested versus non-vested)? How do you value equity options?
= Value of Common Stock	Should you divide by primary or diluted shares?
/ Number of shares	
= Value per share	Should there be a discount for illiquidity/ marketability? Should there be a discount for minority interests?

1. The Value of Cash

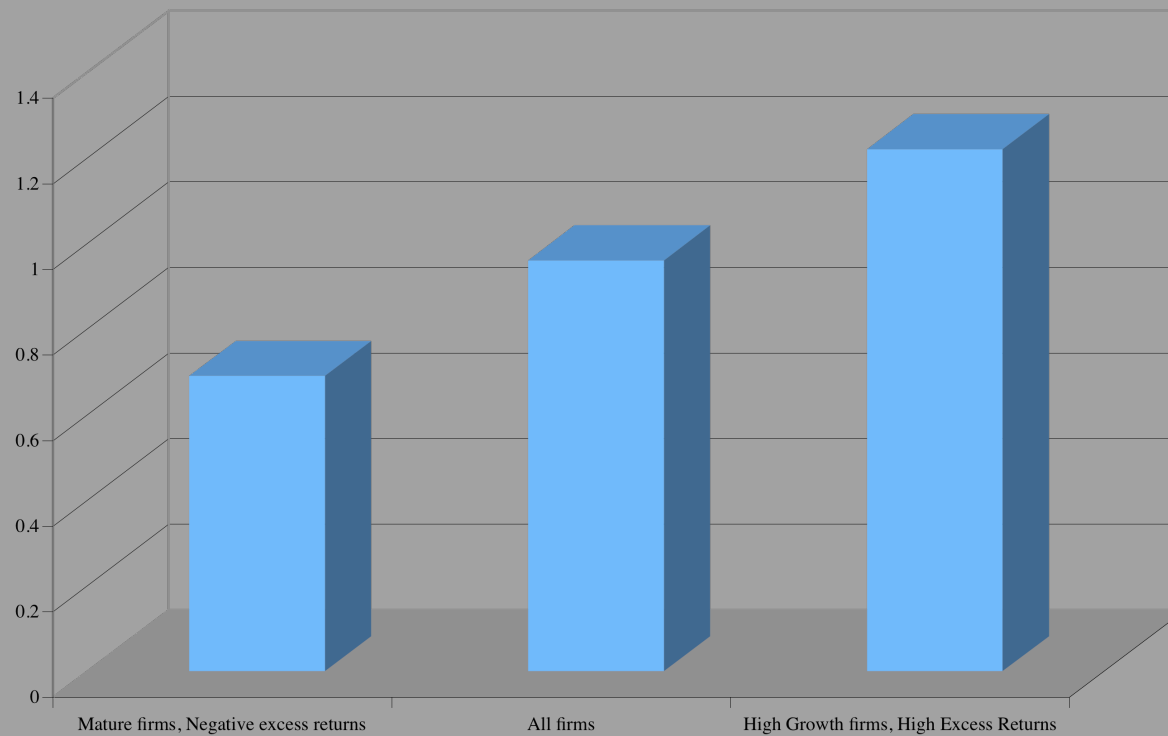
An Exercise in Cash Valuation

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

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

Cash: Discount or Premium?

*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.

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

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

- *Which firm would you value more highly?*

Measuring Complexity: Volume of Data in Financial Statements

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

Measuring Complexity: A Complexity Score

Item	Factors	Follow-up Question	Answer	Weighting factor	Gerdau Score	GE Score
Operating Income	1. Multiple Businesses	Number of businesses (with more than 10% of revenues) =	1	2.00	2	30
	2. One-time income and expenses	Percent of operating income =	10%	10.00	1	0.8
	3. Income from unspecified sources	Percent of operating income =	0%	10.00	0	1.2
	4. Items in income statement that are volatile	Percent of operating income =	15%	5.00	0.75	1
Tax Rate	1. Income from multiple locales	Percent of revenues from non-domestic locales =	70%	3.00	2.1	1.8
	2. Different tax and reporting books	Yes or No	No	Yes=3	0	3
	3. Headquarters in tax havens	Yes or No	No	Yes=3	0	0
	4. Volatile effective tax rate	Yes or No	Yes	Yes=2	2	0
Capital Expenditures	1. Volatile capital expenditures	Yes or No	Yes	Yes=2	2	2
	2. Frequent and large acquisitions	Yes or No	Yes	Yes=4	4	4
	3. Stock payment for acquisitions and investments	Yes or No	No	Yes=4	0	4
Working capital	1. Unspecified current assets and current liabilities	Yes or No	No	Yes=3	0	0
	2. Volatile working capital items	Yes or No	Yes	Yes=2	2	2
Expected Growth rate	1. Off-balance sheet assets and liabilities (operating leases and R&D)	Yes or No	No	Yes=3	0	3
	2. Substantial stock buybacks	Yes or No	No	Yes=3	0	3
	3. Changing return on capital over time	Is your return on capital volatile?	Yes	Yes=5	5	5
	4. Unsustainably high return	Is your firm's ROC much higher than industry average?	No	Yes=5	0	0
Cost of capital	1. Multiple businesses	Number of businesses (more than 10% of revenues) =	1	1.00	1	20
	2. Operations in emerging markets	Percent of revenues=	50%	5.00	2.5	2.5
	3. Is the debt market traded?	Yes or No	No	No=2	2	0
	4. Does the company have a rating?	Yes or No	Yes	No=2	0	0
	5. Does the company have off-balance sheet debt?	Yes or No	No	Yes=5	0	5
No-operating assets	Minority holdings as percent of book assets	Minority holdings as percent of book assets	0%	20.00	0	0.8
Firm to Equity value	Consolidation of subsidiaries	Minority interest as percent of book value of equity	63%	20.00	12.6	1.2
Per share value	Shares with different voting rights	Does the firm have shares with different voting rights?	Yes	Yes = 10	10	0
	Equity options outstanding	Options outstanding as percent of shares	0%	10.00	0	0.25
		Complexity Score =			48.95	90.55

Dealing with Complexity

In Discounted Cashflow Valuation

- The Aggressive Analyst: Trust the firm to tell the truth and value the firm based upon the firm's statements about their value.
- The Conservative Analyst: Don't value what you cannot see.
- The Compromise: Adjust the value for complexity
 - Adjust cash flows for complexity
 - Adjust the discount rate for complexity
 - Adjust the expected growth rate/ length of growth period
 - Value the firm and then discount value for complexity

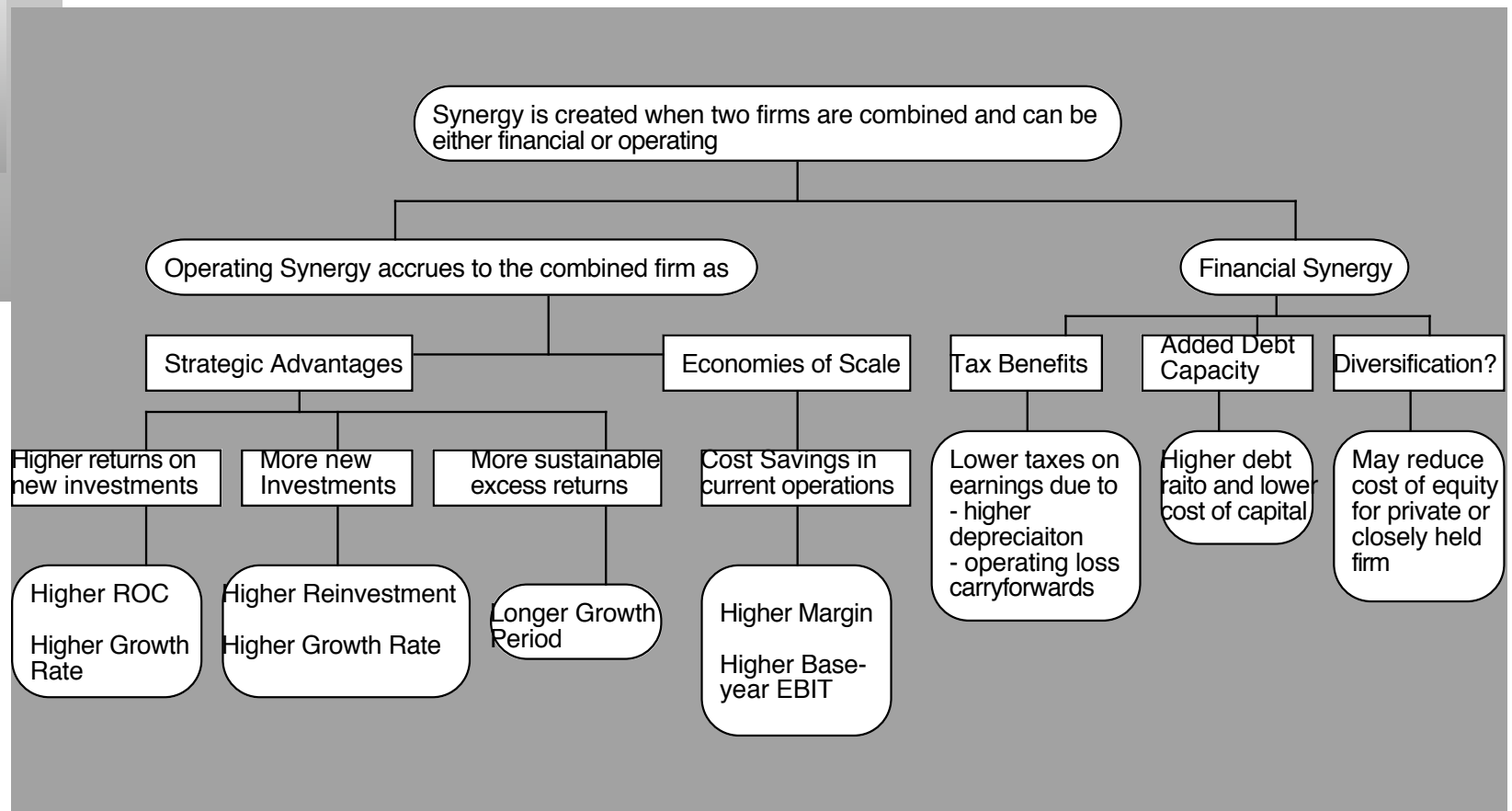
In relative valuation

In a relative valuation, you may be able to assess the price that the market is charging for complexity:

With the hundred largest market cap firms, for instance:

$PBV = 0.65 + 15.31 ROE - 0.55 \text{ Beta} + 3.04 \text{ Expected growth rate} - 0.003 \# \text{ Pages in 10K}$

5. The Value of Synergy



Valuing Synergy

- (1) the firms involved in the merger are **valued independently**, by discounting expected cash flows to each firm at the weighted average cost of capital for that firm.
- (2) the **value of the combined firm, with no synergy**, is obtained by adding the values obtained for each firm in the first step.
- (3) The **effects of synergy are built into expected growth rates and cashflows**, and the combined firm is re-valued with synergy.

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

J.P. Morgan's estimate of total synergies in Labatt/Ambev Merger

Valuation methodology for synergies

Cost synergies

- Achievement of full synergies by 2008
 - Synergies are gradually phased in over four years with 0%, 30%, 30%, 40% and 100% being realized in 2004 through 2008
 - Realization of synergies requires cash outlays in the 2005-2007 period which are reflected in the net present value
 - Capex synergies only begin in 2008
- Decreased tax shield taken into account at full statutory tax rate, does not take into account potential additional upside as a result of lower effective historical tax rate
- Synergies realized in Canada discounted at Labatt Canada's WACC (6.5%) while synergies realized in Brazil discounted at AmBev's WACC (12.4%)

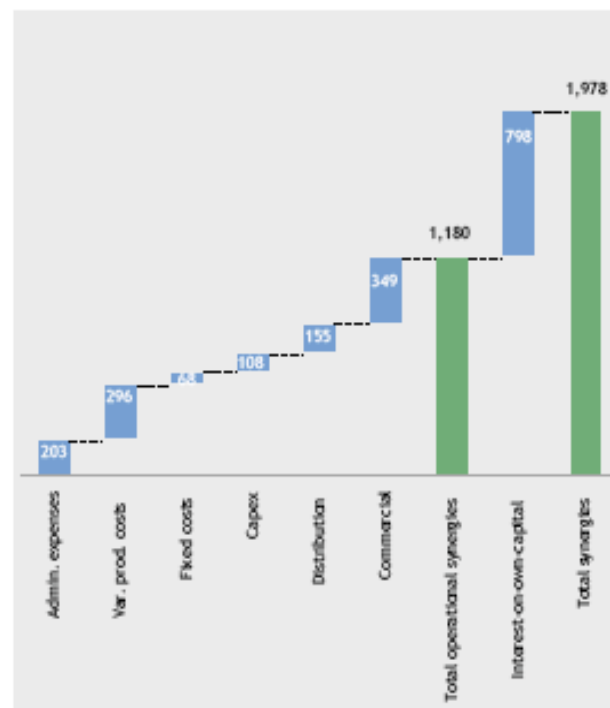
Revenue synergies

- Achievement of full synergies by 2008
 - Synergies are gradually phased in over four years with 0%, 30%, 30%, 40% and 100% being realized in 2004 through 2008
- Discounted at 14.4%, reflecting AmBev's WACC plus an additional spread to reflect higher risk of realizing such synergies

Interest on own capital

- Tax benefits generated through increased interest on AmBev's capital payments due to AmBev's increased shareholders' equity after acquisition of Labatt
- Discounted at AmBev's cost of equity (13.6%)

Present value of potential synergies¹ (US\$ mm)



5. Brand name, great management, superb product ...Are we short changing the 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

	<i>Independent and Cash flow generating intangibles</i>	<i>Not independent and cash flow generating to the firm</i>	<i>No cash flows now but potential for cashflows in future</i>
Examples	Copyrights, trademarks, licenses, franchises, professional practices (medical, dental)	Brand names, Quality and Morale of work force, Technological expertise, Corporate reputation	Undeveloped patents, operating or financial flexibility (to expand into new products/markets or abandon existing ones)
Valuation approach	Estimate expected cashflows from the product or service and discount back at appropriate discount rate.	<ul style="list-style-type: none"> • 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 <ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> • 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.	<ul style="list-style-type: none"> • Need exclusivity. • Difficult to replicate and arbitrage (making option pricing models dicey)

Valuing Brand Name

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

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

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

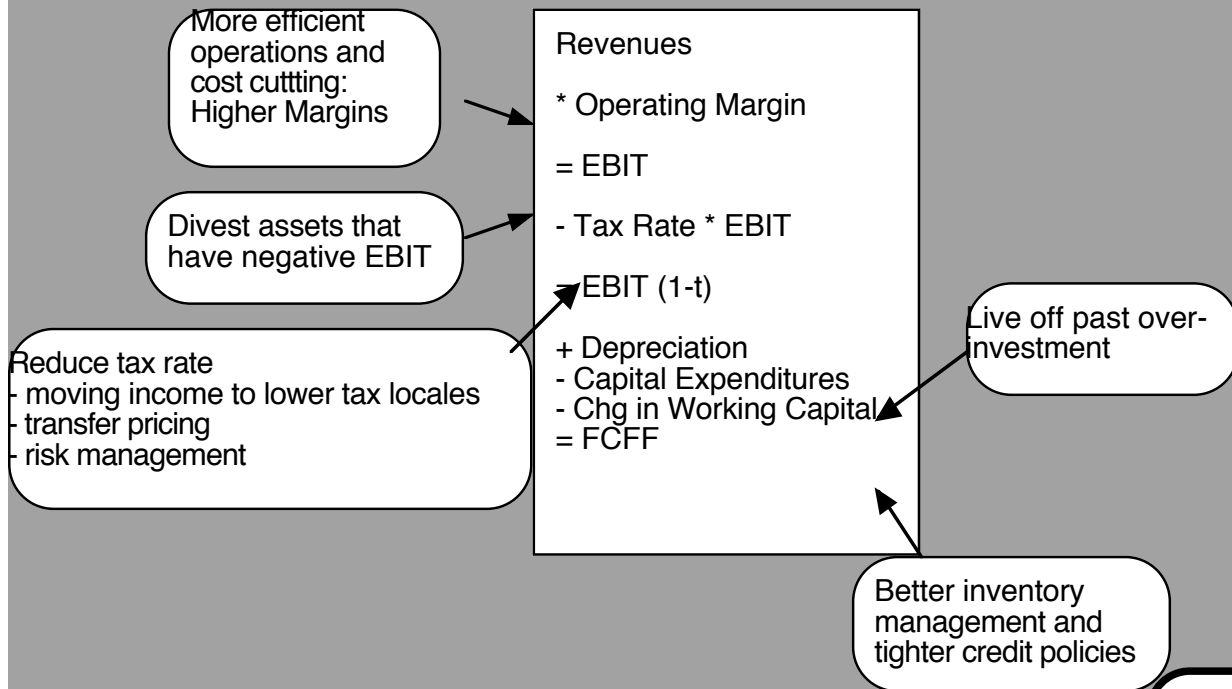
- If you have under funded pension fund or health care plans, you should consider the under funding at this stage in getting to the value of equity.
 - If you do so, you should not double count by also including a cash flow line item reflecting cash you would need to set aside to meet the unfunded obligation.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

7. The Value of Control

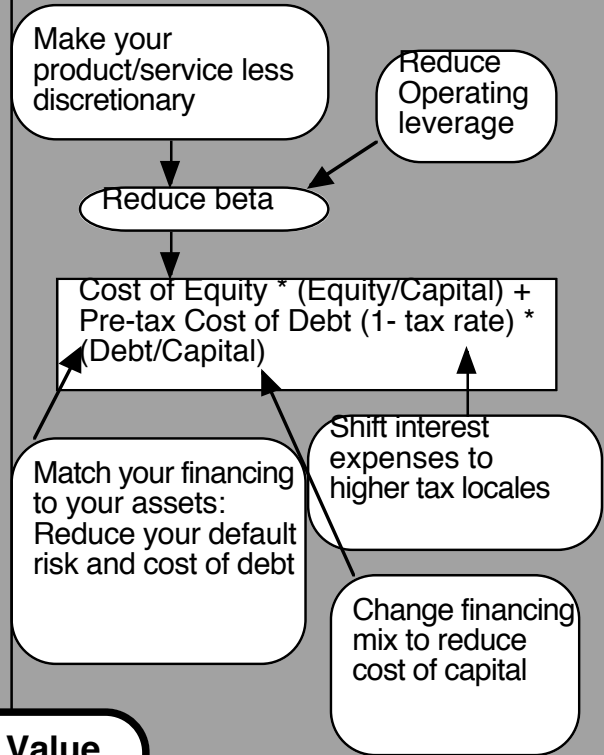
- The value of the control premium that will be paid to acquire a block of equity will depend upon two factors -
 - **Probability that control of firm will change:** This refers to the probability that incumbent management will be replaced. this can be either through acquisition or through existing stockholders 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

Increase Cash Flows

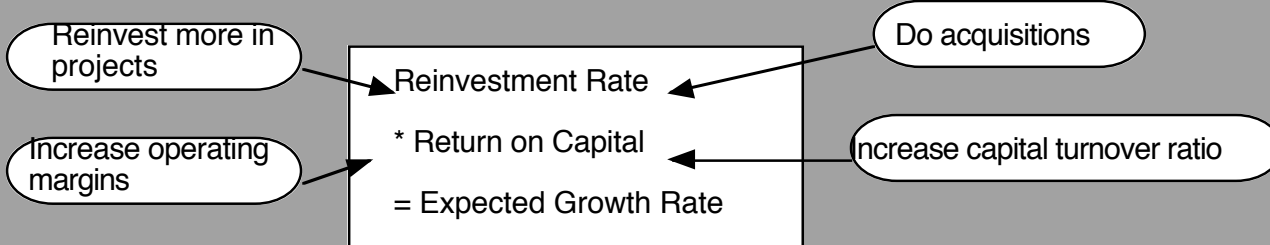


Reduce the cost of capital

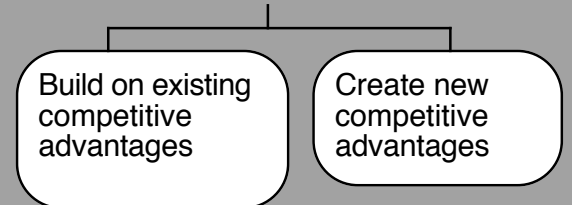


Firm Value

Increase Expected Growth



Increase length of growth period



Optimal Capital Structure: Cementos

Debt Ratio	Beta	Cost of Equity	Bond Rating	Interest rate on debt	Tax Rate	Cost of Debt (after-tax)	WACC	Firm Value (G)
0%	0.98	13.46%	AAA	7.25%	30.00%	5.08%	13.46%	PEN 1,618
10%	1.06	14.24%	AAA	7.25%	30.00%	5.08%	13.32%	PEN 1,642
20%	1.15	15.21%	A-	9.00%	30.00%	6.30%	13.43%	PEN 1,625
30%	1.27	16.45%	B+	12.00%	30.00%	8.40%	14.04%	PEN 1,527
40%	1.44	18.11%	B-	14.50%	30.00%	10.15%	14.93%	PEN 1,404
50%	1.67	20.44%	CC	18.00%	30.00%	12.60%	16.52%	PEN 1,225
60%	2.03	24.16%	CC	18.00%	28.45%	12.88%	17.39%	PEN 1,145
70%	2.79	31.85%	C	21.00%	20.90%	16.61%	21.18%	PEN 887
80%	4.32	47.43%	D	26.00%	14.77%	22.16%	27.21%	PEN 647
90%	8.64	91.36%	D	26.00%	13.13%	22.59%	29.46%	PEN 586

Cementos Pacasmayo- Restructured: \$ in 2009

Current Cashflow to Firm

EBIT(1-t) :	PEN 112.35
- Nt CpX	PEN 49.50
- Chg WC	PEN 4.65
= FCFF	PEN 58.20
PEN/ US \$	3.23
Reinv Rate = (49.5+4.65)/112.35	= 48.2%

Reinvestment Rate
60%

Expected Growth
in EBIT (1-t)
 $.60 \times .18 = 0.108$
10.8%

Return on Capital
18%

Stable Growth
 $g = 3.5\%$; Beta = 1.00
Country Premium = 2.5%
Cost of capital = 11.55%
ROC = 11.55%;
Reinvestment Rate = g/ROC
 $= 3.5/11.55 = 30.30\%$

Terminal Value₅ = $37.79 \times (.1155 - .035) = \469.34

Op. Assets \$307.36
+ Cash: 12.06
- Debt 77.04
- Minor. Int. 0.60
= Equity \$241.78
Exchange 3.01
Equity PEN 727.74
Value/Share PEN 1.73

Year	1	2	3	4	5	
EBIT (1-t)	PEN 124	PEN 138	PEN 153	PEN 169	PEN 188	PEN 194.18
- Reinvestment	PEN 75	PEN 83	PEN 92	PEN 102	PEN 113	58.83
FCFF	PEN 50	PEN 55	PEN 61	PEN 68	PEN 75	135.35
Exchange rate	3.10	3.19	3.28	3.38	3.48	3.58
FCFF (In US \$)	\$16.07	\$17.30	\$18.62	\$20.04	\$21.57	\$37.79

Discount at \$ Cost of Capital (WACC) = $14.94\% (.90) + 5.08 (0.10) = 14.04\%$

Expected inflation
US = 2%
Peru = 5%

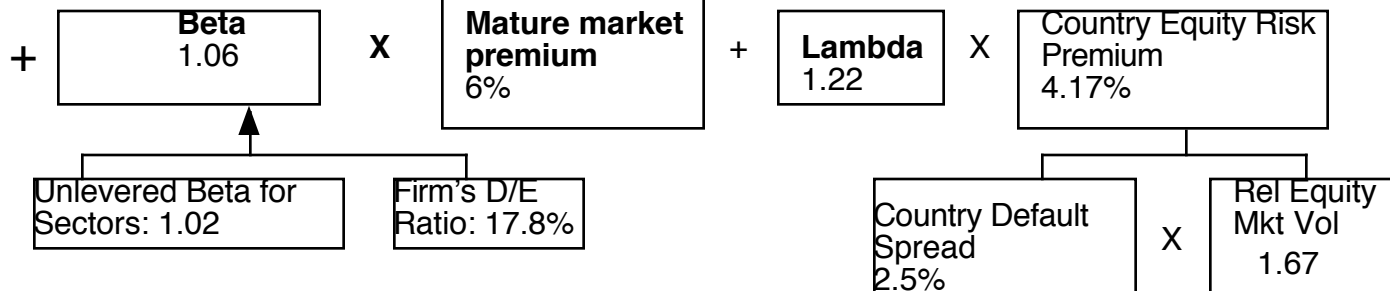
Cost of Equity
14.94%

Cost of Debt
 $(3.5\% + 2.5\% + 1.25\%) (1 - .30)$
 $= 5.08\%$

Weights
E = 90% D = 10%

On July 1, 2009
Cementos Price = PEN 3.01

Riskfree Rate:
\$ Riskfree Rate = 3.5%



Implications of the Value of Control

- If the value of a firm run optimally is significantly higher than the value of the firm with the status quo (or incumbent management), you can write the value that you should be willing to pay as:

Value of control = Value of firm optimally run - Value of firm with status quo

Value of control at Cementos = 1.73 PEN - 1.60 PEN = 0.13 PEN per share

- Implications:

- In an acquisition, this is the most that you would be willing to pay as a premium (assuming no other synergy)
- As a stockholder, you will be willing to pay a value between 1.60 and 1.73 PEN, depending upon your views on whether control will change.
- If there are voting and non-voting shares, the difference in prices between the two should reflect the value of control.

8. Distress 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 that a firm will not survive the immediate future (next few years), traditional valuation models may yield an over-optimistic estimate of value.

Current Revenue
\$ 4,390

Current Margin:
4.76%

EBIT
\$ 209m

Reinvestment:
Capital expenditures include cost of new casinos and working capital

Extended reinvestment break, due to investment in past

Industry average

Expected Margin:
-> 17%

Stable Growth

Stable Revenue Growth: 3%

Stable Operating Margin: 17%

Stable ROC=10%
Reinvest 30% of EBIT(1-t)

Terminal Value = $758(.0743-.03)$
= \$ 17,129

Value of Op Assets \$ 9,793
+ Cash & Non-op \$ 3,040
= Value of Firm \$ 12,833
- Value of Debt \$ 7,565
= Value of Equity \$ 5,268

Value per share \$ 8.12

Revenues	\$4,434	\$4,523	\$5,427	\$6,513	\$7,815	\$8,206	\$8,616	\$9,047	\$9,499	\$9,974
Oper margin	5.81%	6.86%	7.90%	8.95%	10%	11.40%	12.80%	14.20%	15.60%	17%
EBIT	\$258	\$310	\$429	\$583	\$782	\$935	\$1,103	\$1,285	\$1,482	\$1,696
Tax rate	26.0%	26.0%	26.0%	26.0%	26.0%	28.4%	30.8%	33.2%	35.6%	38.00%
EBIT * (1 - t)	\$191	\$229	\$317	\$431	\$578	\$670	\$763	\$858	\$954	\$1,051
- Reinvestment	-\$19	-\$11	\$0	\$22	\$58	\$67	\$153	\$215	\$286	\$350
FCFF	\$210	\$241	\$317	\$410	\$520	\$603	\$611	\$644	\$668	\$701
Beta	3.14	3.14	3.14	3.14	3.14	2.75	2.36	1.97	1.59	1.20
Cost of equity	21.82%	21.82%	21.82%	21.82%	21.82%	19.50%	17.17%	14.85%	12.52%	10.20%
Cost of debt	9%	9%	9%	9%	9%	8.70%	8.40%	8.10%	7.80%	7.50%
Debt/ratio	73.50%	73.50%	73.50%	73.50%	73.50%	68.80%	64.10%	59.40%	54.70%	50.00%
Cost of capital	9.88%	9.88%	9.88%	9.88%	9.88%	9.79%	9.50%	9.01%	8.32%	7.43%

Term. Year
\$10,273
17%
\$ 1,746
38%
\$1,083
\$ 325
\$758

Forever

Cost of Equity
21.82%

Cost of Debt
3%+6%= 9%
9% (1-.38)=5.58%

Weights
Debt= 73.5% ->50%

Riskfree Rate:
T. Bond rate = 3%

+ **Beta**
3.14-> 1.20

Risk Premium
6%

Casino
1.15

Current
D/E: 277%

Base Equity
Premium

Country Risk
Premium

Las Vegas Sands
February 2009
Trading @ \$4.25

The Distress Factor

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

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

- 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 = $\$8.12 (1 - .7666) + \$0/.00 (.7666) = \$1.92$

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 accounting 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.

10. Analyzing the Effect of Illiquidity on Value

- Investments which are less liquid should trade for less than otherwise similar investments which are more liquid.
- The size of the illiquidity discount should vary across firms and also across time. The conventional practice of relying upon studies of restricted stocks or IPOs will fail sooner rather than later.
 - Restricted stock studies are based upon small samples of troubled firms
 - The discounts observed in IPO studies are too large for these to be arms length transactions. They just do not make sense.

Illiquidity Discounts from Bid-Ask Spreads

- Using data from the end of 2000, for instance, we regressed the bid-ask spread against annual revenues, a dummy variable for positive earnings (DERN: 0 if negative and 1 if positive), cash as a percent of firm value and trading volume.

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

- We could substitute in the revenues of Kristin Kandy (\$5 million), the fact that it has positive earnings and the cash as a percent of revenues held by the firm (8%):

$$\begin{aligned} \text{Spread} &= 0.145 - 0.0022 \ln(\text{Annual Revenues}) - 0.015 (\text{DERN}) - 0.016 (\text{Cash/Firm Value}) - \\ & 0.11 (\text{\$ Monthly trading volume/ Firm Value}) \\ &= 0.145 - 0.0022 \ln(5) - 0.015 (1) - 0.016 (.08) - 0.11 (0) = .12.52\% \end{aligned}$$

- Based on this approach, we would estimate an illiquidity discount of 12.52% for Kristin Kandy.



Relative Valuation

Aswath Damodaran

Relative valuation is pervasive...

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

The Reasons for the allure...

“If you think I’m crazy, you should see the guy who lives across the hall”

Jerry Seinfeld talking about Kramer in a Seinfeld episode

“ A little inaccuracy sometimes saves tons of explanation”

H.H. Munro

“ If you are going to screw up, make sure that you have lots of company”

Ex-portfolio manager

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

$$\text{PE} = \text{Market Price per Share} / \text{Earnings per Share}$$

- 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.

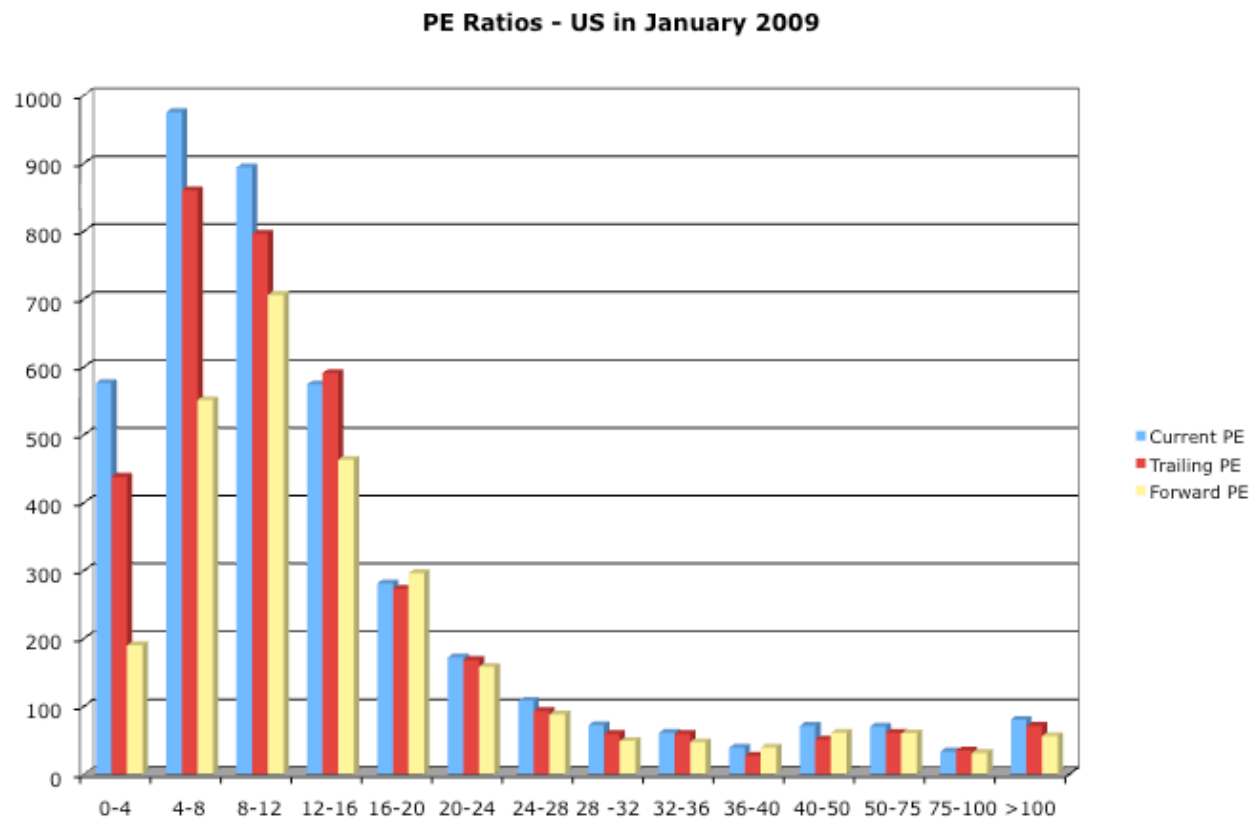
$$\frac{\text{Enterprise Value}}{\text{EBITDA}} = \frac{\text{Market Value of Equity} + \text{Market Value of Debt} - \text{Cash}}{\text{Earnings before Interest, Taxes and Depreciation}}$$

- 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?

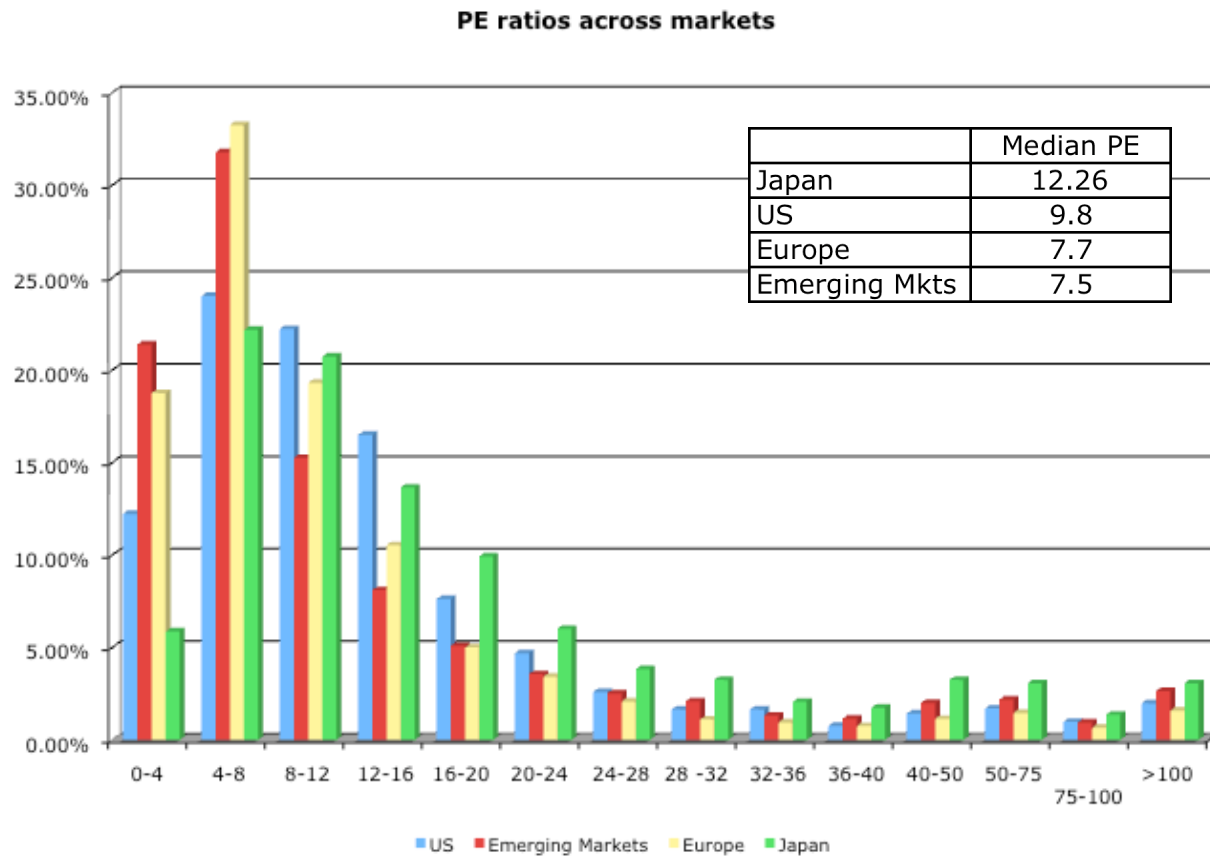
Looking at the distribution of PE ratios... in the US



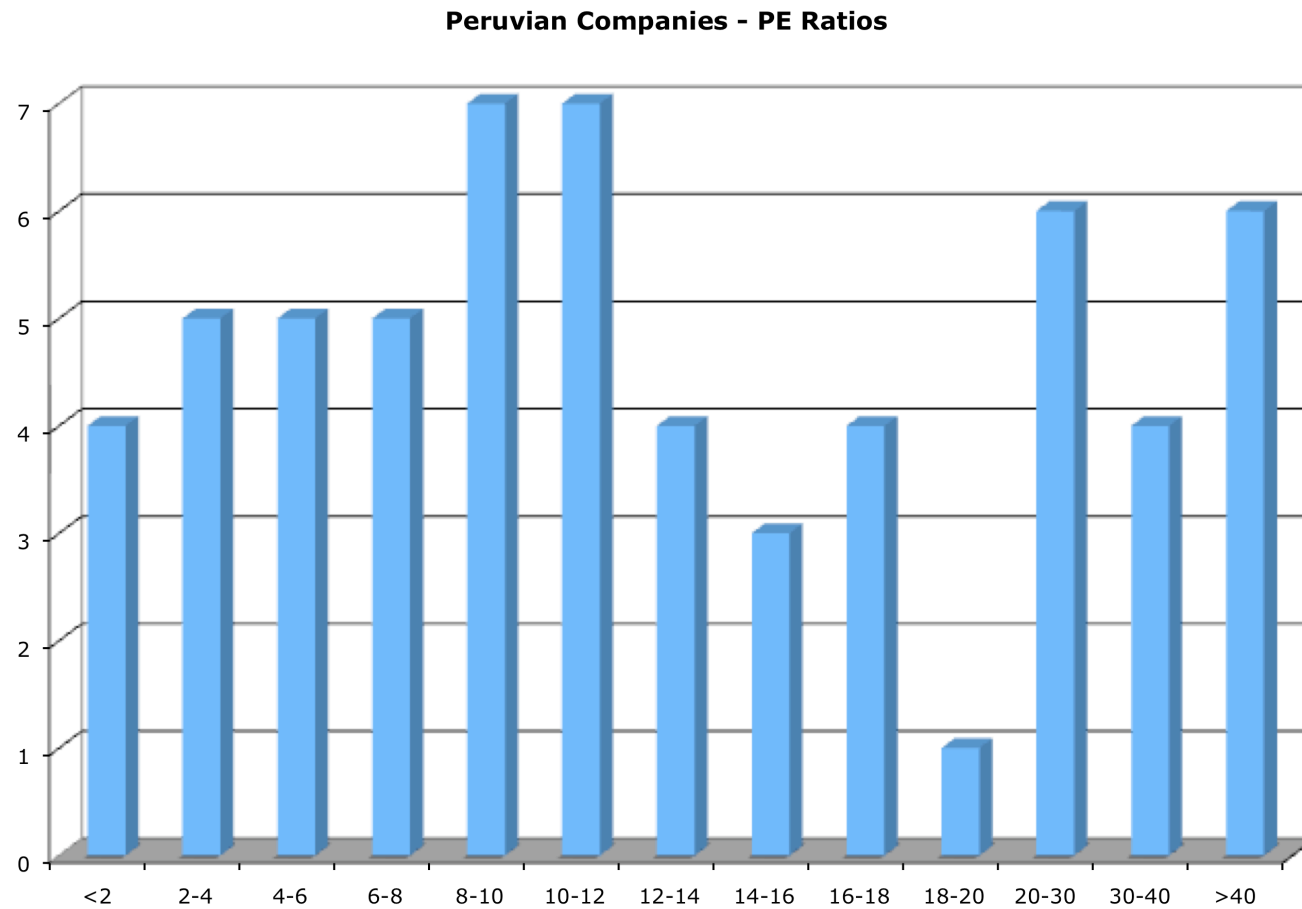
PE: Deciphering the Distribution

	<i>Jan-09</i>			Jan-08		
	Current PE	Trailing PE	Forward PE	Current PE	Trailing PE	Forward PE
Mean	18.91	17.48	20.04	45.02	32.44	32.21
Standard Error	0.98	0.91	0.87	4.64	1.96	1.47
Median	9.80	9.89	11.69	18.16	17.00	17.28
Standard Deviation	61.97	55.61	45.74	299.11	123.29	80.82
Kurtosis	668.30	1073.76	174.18	1618.20	1241.97	269.80
Skewness	21.06	27.18	11.66	35.41	30.30	14.23
Maximum	2442.83	2475.71	933.00	15126.20	5713.00	1912.33
Count	4010	3737	2795	4155	3944	3004
Sample size	6871	6871	6871	7155	7155	7155
Largest(400)	29.50	26.18	25.06			
Smallest(400)	3.00	2.76	5.74			

Comparing PE Ratios: US, Europe, Japan and Emerging Markets

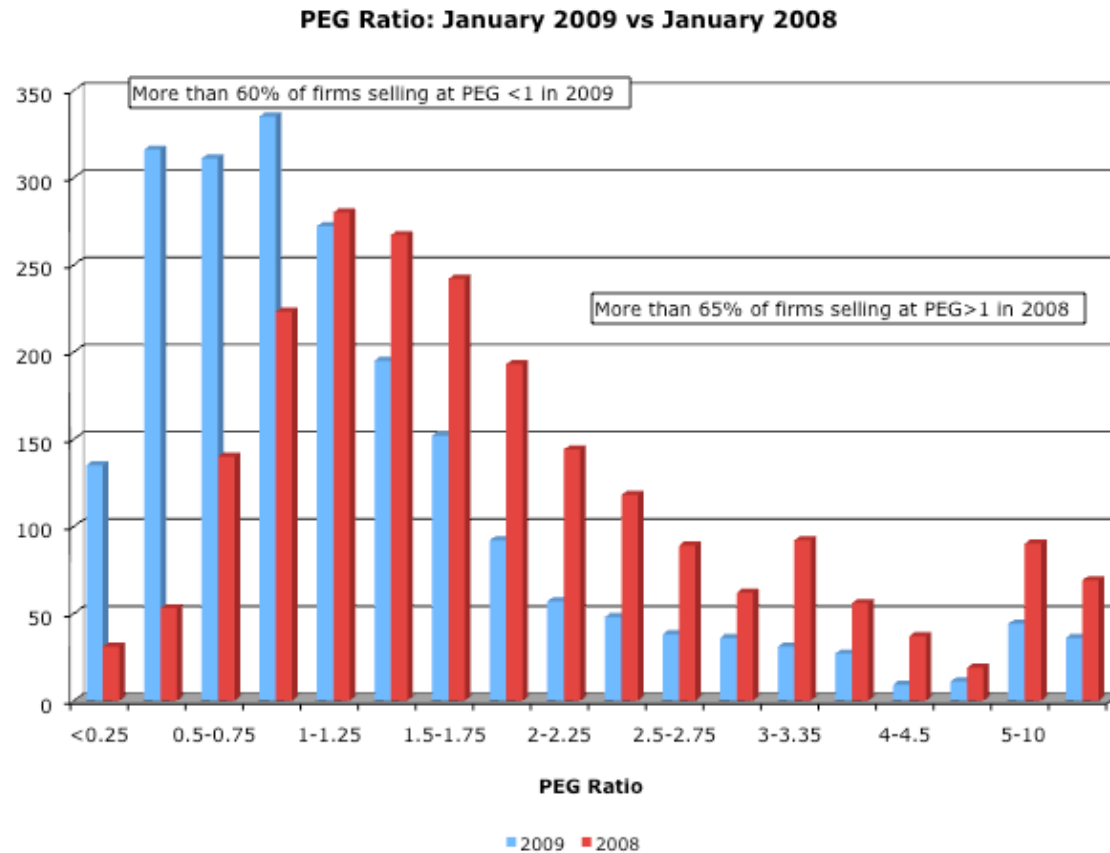


And PE ratios just for Peru...

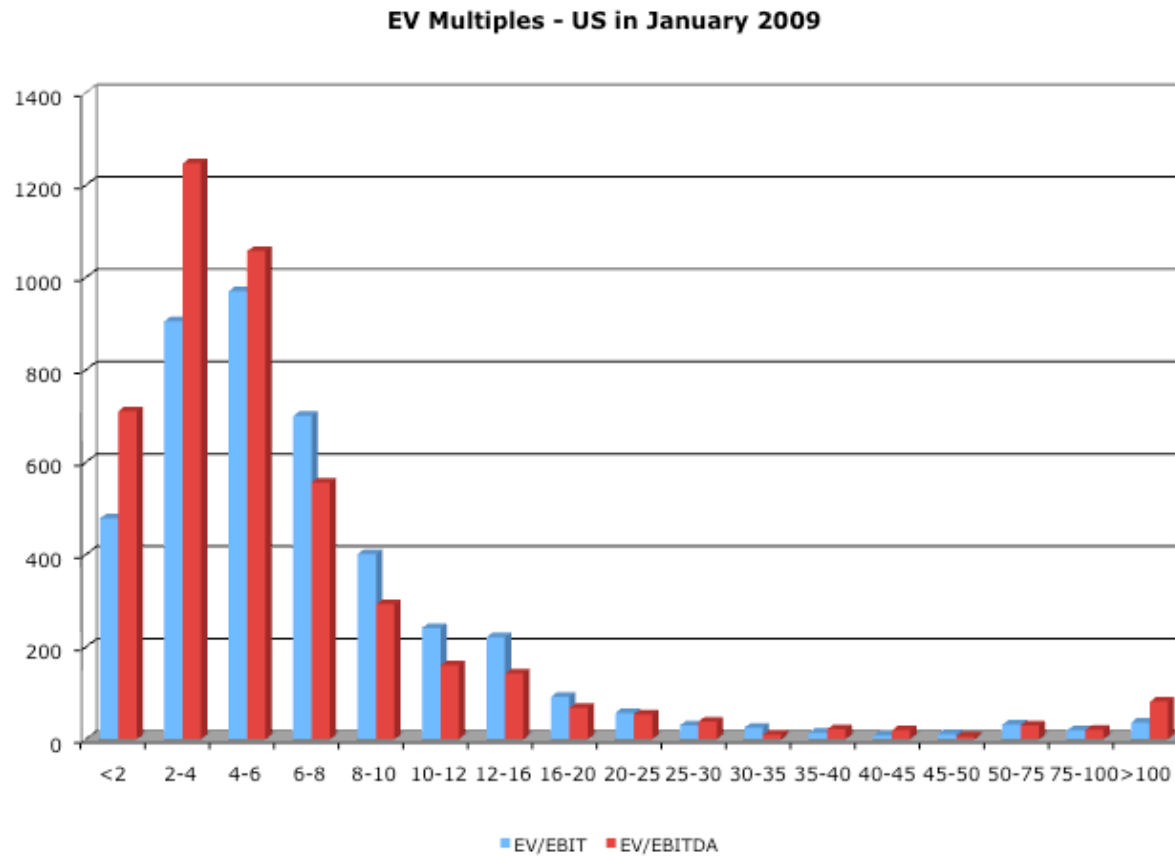


Simplistic rules almost always break down...

The PEG<1 = Cheap test?



And 6 times EBITDA may not be cheap...



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,

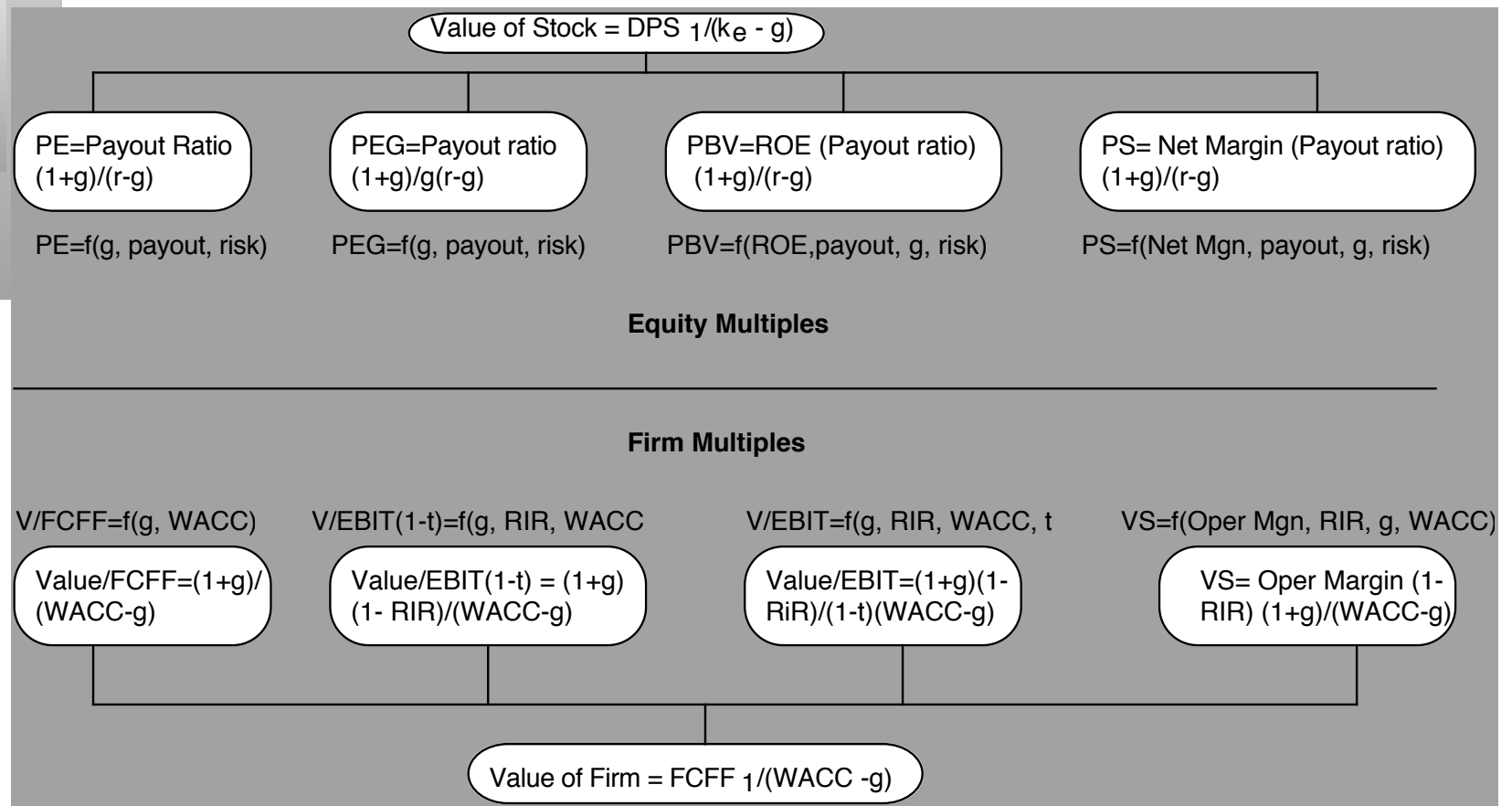
$$\frac{P_0}{EPS_0} = PE = \frac{\text{Payout Ratio} * (1 + g_n)}{r - g_n}$$

- If this had been a FCFE Model,

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

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

The Determinants of Multiples...



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.**

An Example: Comparing PE Ratios across a Sector: Telecom ADRs

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

PE, Growth and Risk

Dependent variable is: PE

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

Variable	Coefficient	SE	t-ratio	prob
Constant	13.1151	3.471	3.78	0.0010
Growth rate	121.223	19.27	6.29	≤ 0.0001
Emerging Market	-13.8531	3.606	-3.84	0.0009

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.

Sociedad's Relative Value: PBV and ROE

<i>Security</i>	<i>TICKER</i>	<i>PBV Ratio</i>	<i>ROE</i>	<i>Beta</i>
GOAU4 BZ Equity	GOAU4	5.84	35.69%	1.08
CMPC CI Equity	CMPC	1.76	14.61%	1.26
USIM3 BZ Equity	USIM3	2.19	22.03%	1.24
GMEXICOB MM Equity	GMEXICOB	8.13	16.91%	1.15
MINSURI1 PE Equity	MINSURI1	4.44	25.16%	1.31
SPCCI1 PE Equity	SPCCI1	3.30	27.10%	1.54
PE&OLES* MM Equity	PE&OLES*	1.15	3.65%	0.98
CAP CI Equity	CAP	0.53	18.14%	1.46
VOLCABC1 PE Equity	VOLCABC1	4.14	16.21%	1.60
BUENAVI1 PE Equity	BUENAVI1	2.63	54.32%	1.22
CVERDEC1 PE Equity	CVERDEC1	3.40	23.66%	1.55
MILPOI1 PE Equity	MILPOI1	2.32	26.86%	1.06
Average		3.32	23.69%	1.29

Comparisons to the entire market: Why not?

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

PE Ratio: Standard Regression for US stocks - January 2009

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.535 ^a	.287	.286	7.0614177E2

a. Predictors: (Constant), Payout Ratio, Expected Growth in EPS: next 5 years, Value Line Beta

Coefficients^{ab}

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	7.623	.869		8.773	.000
	Expected Growth in EPS: next 5 years	77.983	2.920	.508	26.707	.000
	Value Line Beta	-5.371	.745	-.138	-7.212	.000
	Payout Ratio	7.670	.586	.255	13.094	.000

a. Dependent Variable: Current PE

b. Weighted Least Squares Regression - Weighted by Market Cap

And for other markets...

Region	Regression – January 2009	R squared
Europe	PE = 10.07 – 5.23 Beta + 7.78 Payout + 27.51 Expected growth rate	53.8%
Japan	PE = 9.28 – 4.50 Beta + 42.29 Payout + 62	48.3%
Emerging Markets	PE = 5.63 + 062 Beta + 9.65 Payout + 13.05 Expected growth rate	27.4%

PBV ratio regression just for Peru...

- Regressing P/BV ratios against ROE for Peruvian companies, we obtain the following:

$$\text{PBV} = 1.98 + 9.48 (\text{ROE}) \qquad R^2 = 43\%$$

- This regression can be used to estimate the PBV ratios for Cementos and Sociedad Minera:
 - Sociedad Minera
 - Return on equity = 79%
 - Predicted P/BV Ratio = $1.98 + 9.48 (.79) = 9.47$
 - Actual P/BV Ratio = 7.61
 - Under / Over Valuation = Overvalued by about 23%
 - Cementos
 - Return on equity = 16.45%
 - Predicted P/BV Ratio = $1.98 + 9.48 (.1645) = 3.54$
 - Actual P/BV Ratio = 2.24
 - Under / Over Valuation = Undervalued by about 40%

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.

Conventional usage...

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



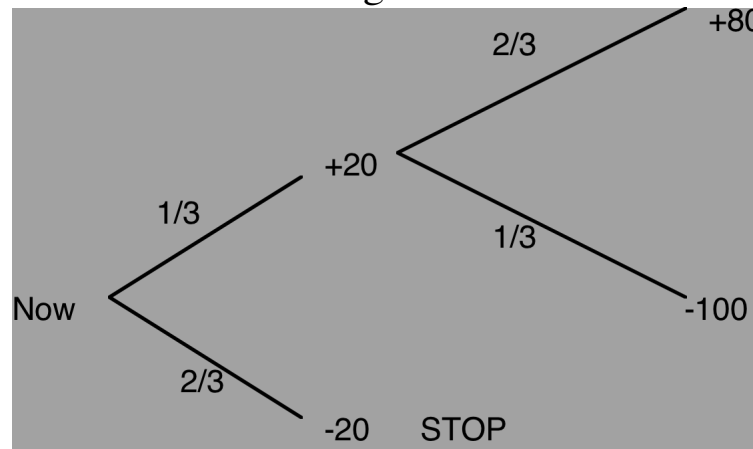
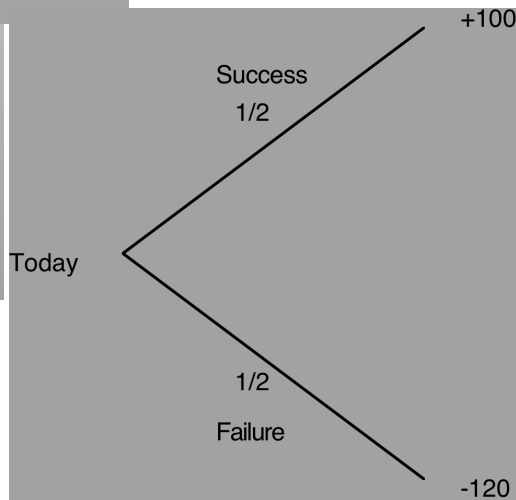
Real Options: Fact and Fantasy

Aswath Damodaran

The Basis for Real Options

- In the last few years, there are some who have argued that discounted cashflow valuations under valued some companies and that a real option premium should be tacked on to DCF valuations. To understanding its moorings, compare the two trees below:

A bad investment..... Becomes a good one..



1. Learn at relatively low cost
2. Make better decisions based on learning

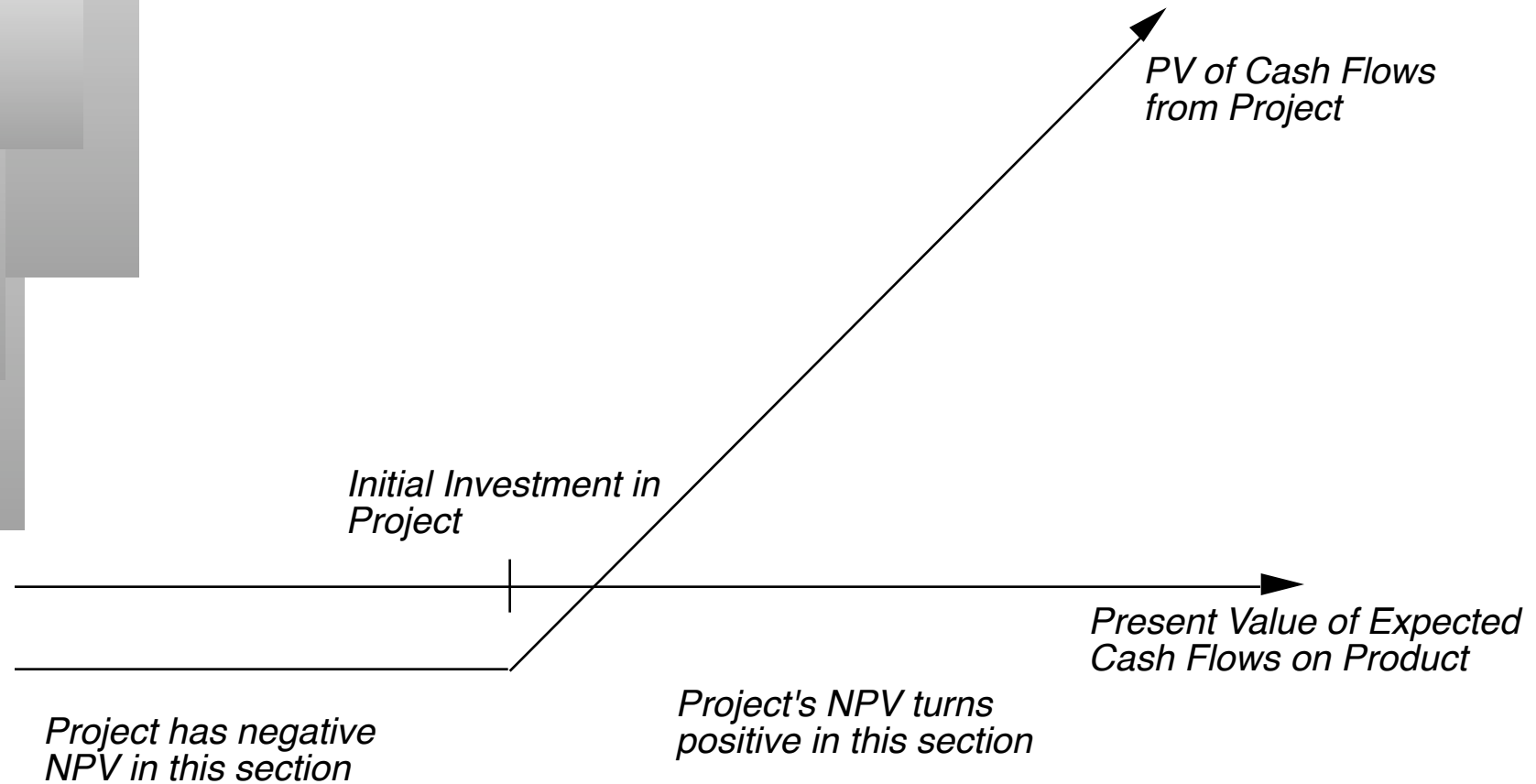
Three Basic Questions

- When is there a real option embedded in a decision or an asset?
- When does that real option have significant economic value?
- Can that value be estimated using an option pricing model?

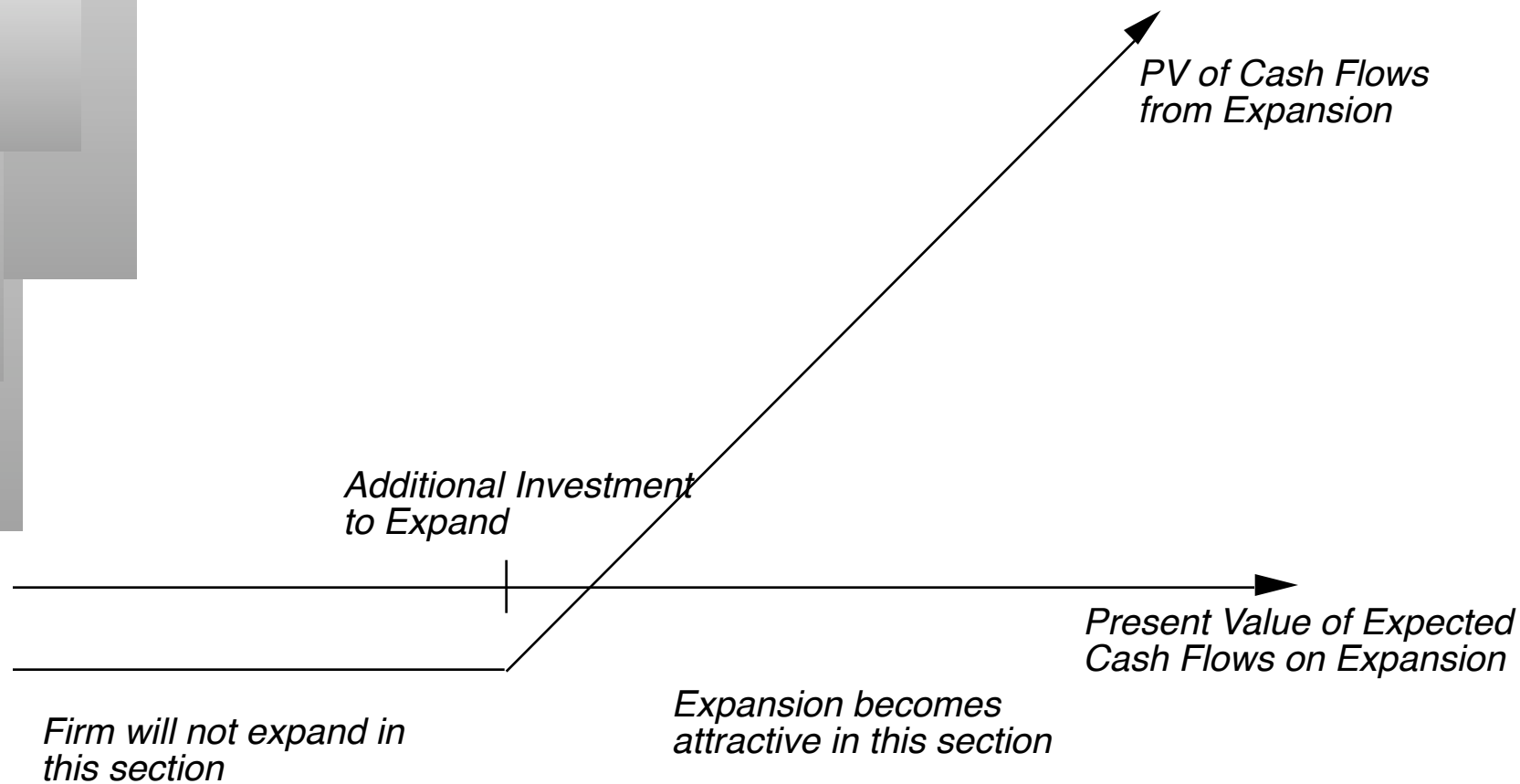
When is there an option embedded in an action?

- An option provides the holder with the **right** to buy or sell a specified quantity of an underlying asset at a fixed price (called a strike price or an exercise price) at or before the expiration date of the option.
- There has to be a clearly defined underlying asset whose value changes over time in unpredictable ways.
- The payoffs on this asset (real option) have to be contingent on an specified event occurring within a finite period.

Example 1: Product Patent as an Option



Example 2: Expansion of existing project as an option



When does the option have significant economic value?

- For an option to have significant economic value, there has to be a restriction on competition in the event of the contingency. In a perfectly competitive product market, no contingency, no matter how positive, will generate positive net present value.
- At the limit, real options are most valuable when you have exclusivity - you and only you can take advantage of the contingency. They become less valuable as the barriers to competition become less steep.

Exclusivity: Putting Real Options to the Test

- **Product Options: Patent on a drug**
 - Patents restrict competitors from developing similar products
 - Patents do not restrict competitors from developing other products to treat the same disease.
- **Growth Options: Expansion into a new product or market**
 - Barriers may range from strong (exclusive licenses granted by the government - as in telecom businesses) to weaker (brand name, knowledge of the market) to weakest (first mover).

Determinants of option value

- Variables Relating to Underlying Asset
 - Value of Underlying Asset; as this value increases, the right to buy at a fixed price (calls) will become more valuable and the right to sell at a fixed price (puts) will become less valuable.
 - Variance in that value; as the variance increases, both calls and puts will become more valuable because all options have limited downside and depend upon price volatility for upside.
 - Expected dividends on the asset, which are likely to reduce the price appreciation component of the asset, reducing the value of calls and increasing the value of puts.
- Variables Relating to Option
 - Strike Price of Options; the right to buy (sell) at a fixed price becomes more (less) valuable at a lower price.
 - Life of the Option; both calls and puts benefit from a longer life.
- Level of Interest Rates; as rates increase, the right to buy (sell) at a fixed price in the future becomes more (less) valuable.

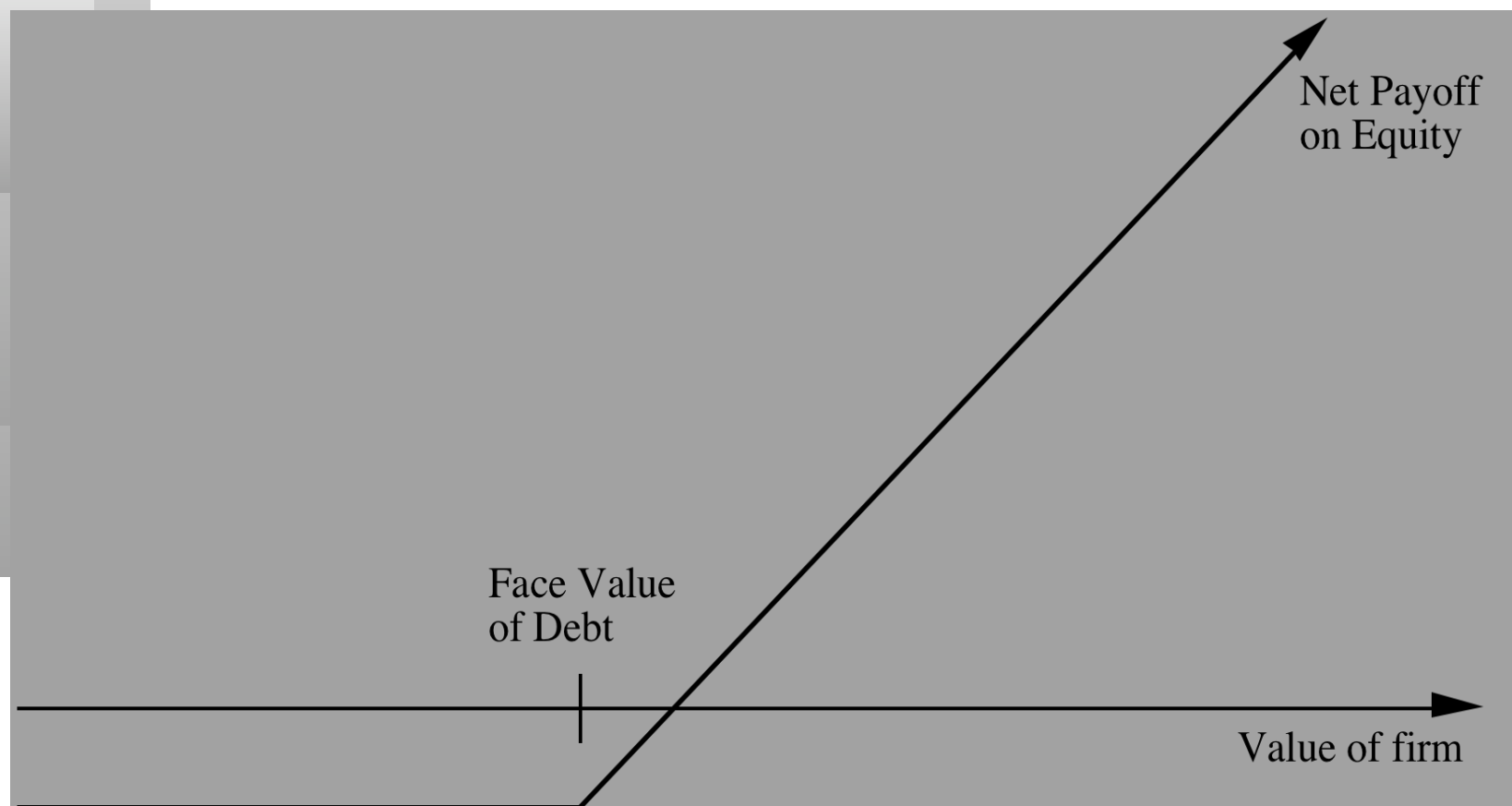
The Building Blocks for Option Pricing Models: Arbitrage and Replication

- The objective in creating a replicating portfolio is to use a combination of riskfree borrowing/lending and the underlying asset to create the same cashflows as the option being valued.
 - Call = Borrowing + Buying Δ of the Underlying Stock
 - Put = Selling Short Δ on Underlying Asset + Lending
 - The number of shares bought or sold is called the **option delta**.
- The principles of arbitrage then apply, and the value of the option has to be equal to the value of the replicating portfolio.

When can you use option pricing models to value real options?

- The notion of a replicating portfolio that drives option pricing models makes them most suited for valuing real options where
 - The underlying asset is traded - this yields not only observable prices and volatility as inputs to option pricing models but allows for the possibility of creating replicating portfolios
 - An active marketplace exists for the option itself.
 - The cost of exercising the option is known with some degree of certainty.
- When option pricing models are used to value real assets, we have to accept the fact that
 - The value estimates that emerge will be far more imprecise.
 - The value can deviate much more dramatically from market price because of the difficulty of arbitrage.

One final example: Equity as a Liquidation Option



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?

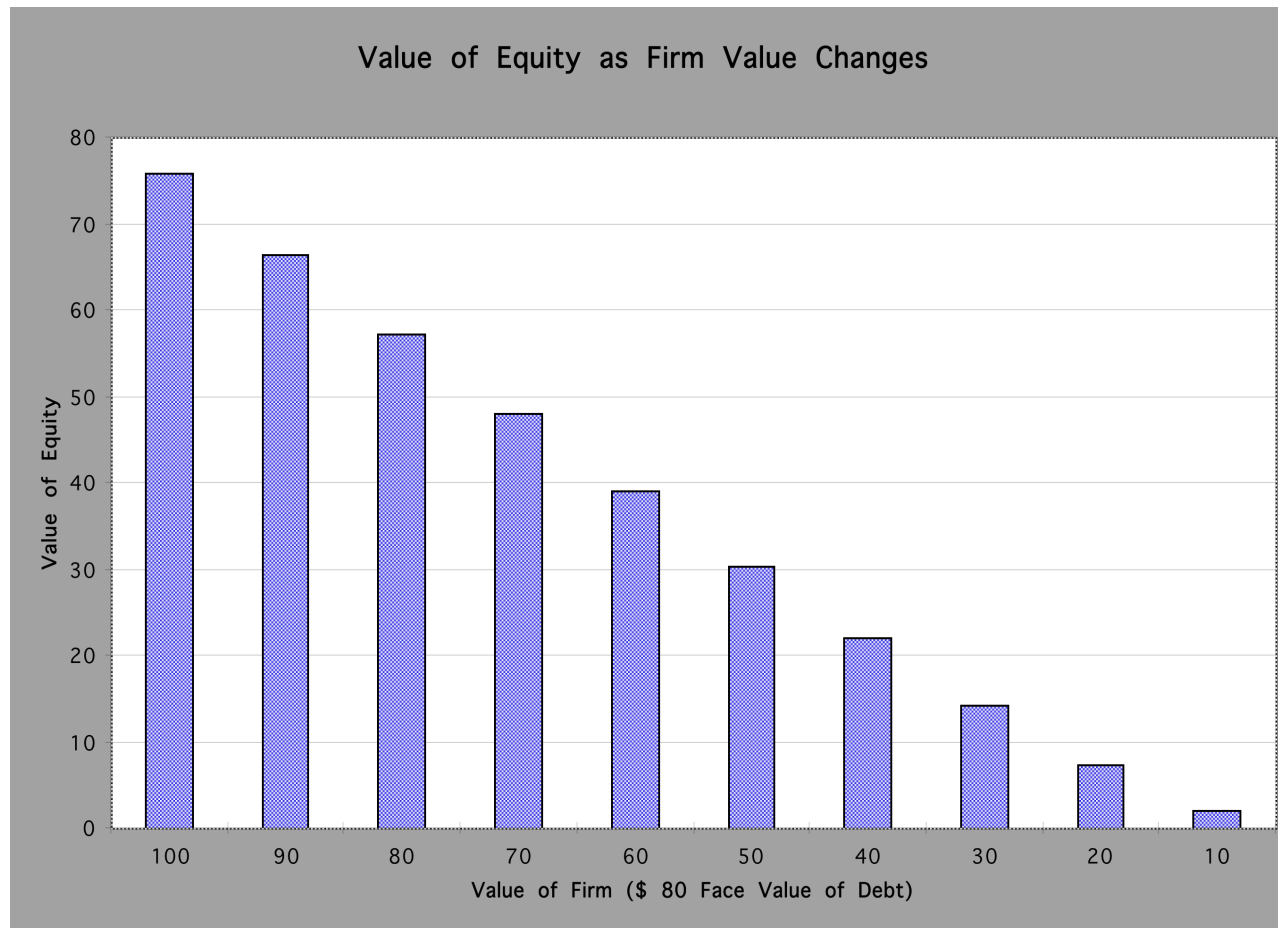
Valuing Equity as a Call Option

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

The Effect of Catastrophic Drops in Value

- 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. Consider the new inputs into the equity valuation:
 - Value of the underlying asset = S = Value of the firm = \$ 50 million
 - Exercise price = K = Face Value of outstanding debt = \$ 80 million
 - Life of the option = t = Life of zero-coupon debt = 10 years
 - Variance in the value of the underlying asset = σ^2 = Variance in firm value = 0.16
 - Riskless rate = r = Treasury bond rate corresponding to option life = 10%
- Based upon these inputs, the Black-Scholes model provides the following value for the call:
 - $d1 = 1.0515$ $N(d1) = 0.8534$
 - $d2 = -0.2135$ $N(d2) = 0.4155$
 - Value of the call (Equity) = $50 (0.8534) - 80 \exp^{(-0.10)(10)} (0.4155) = \30.44 million
 - Value of the debt = $\$50 - \$30.44 = \$19.56$ million

Equity value persists ..



Back to Lemmings...

