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VALUATION: ART, SCIENCE, CRAFT OR MAGIC?

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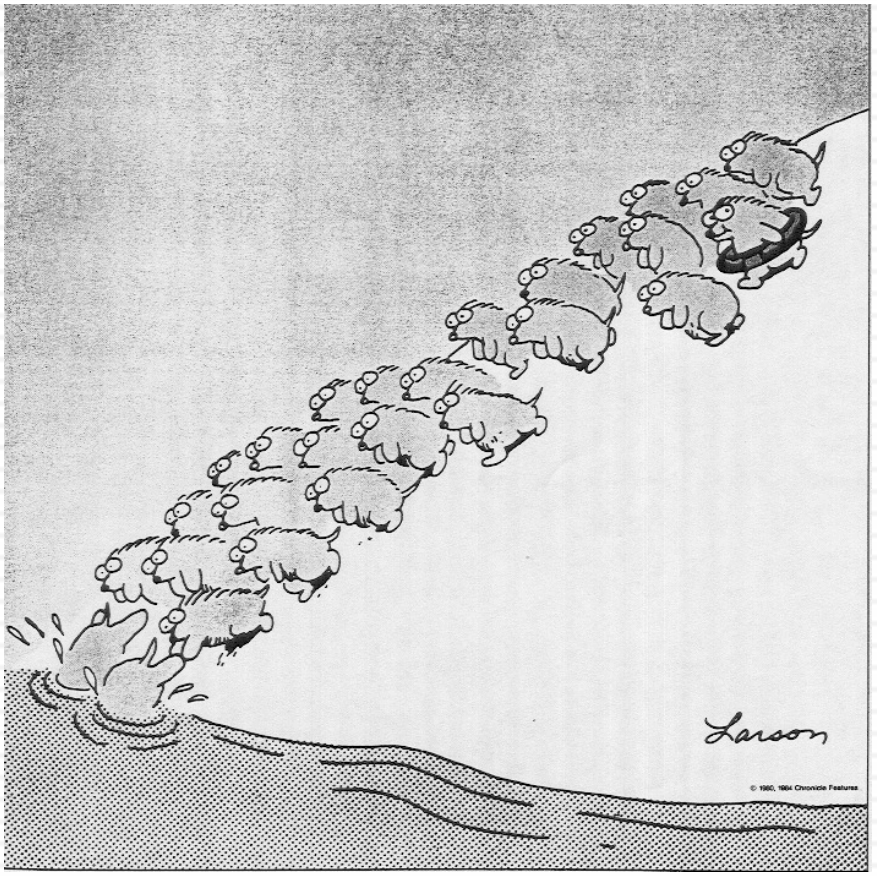
Some Initial Thoughts

" 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

- **Intrinsic valuation**, relates the value of an asset to the present value of expected future cashflows on that asset. In its most common form, this takes the form of a discounted cash flow valuation.
- **Relative valuation**, estimates the value of an asset by looking at the pricing of 'comparable' assets relative to a common variable like earnings, 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.

Intrinsic Value: Four Basic Propositions

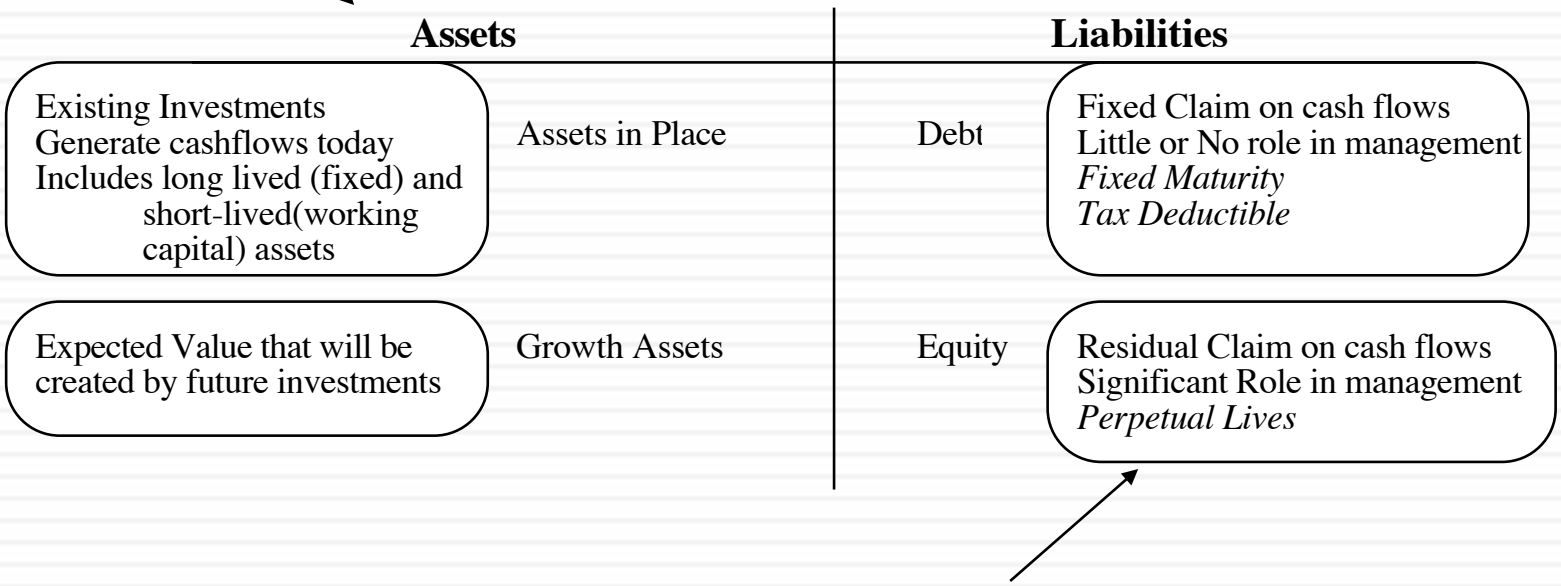
The value of an asset is the present value of the expected cash flows on that asset, over its expected life:

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

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

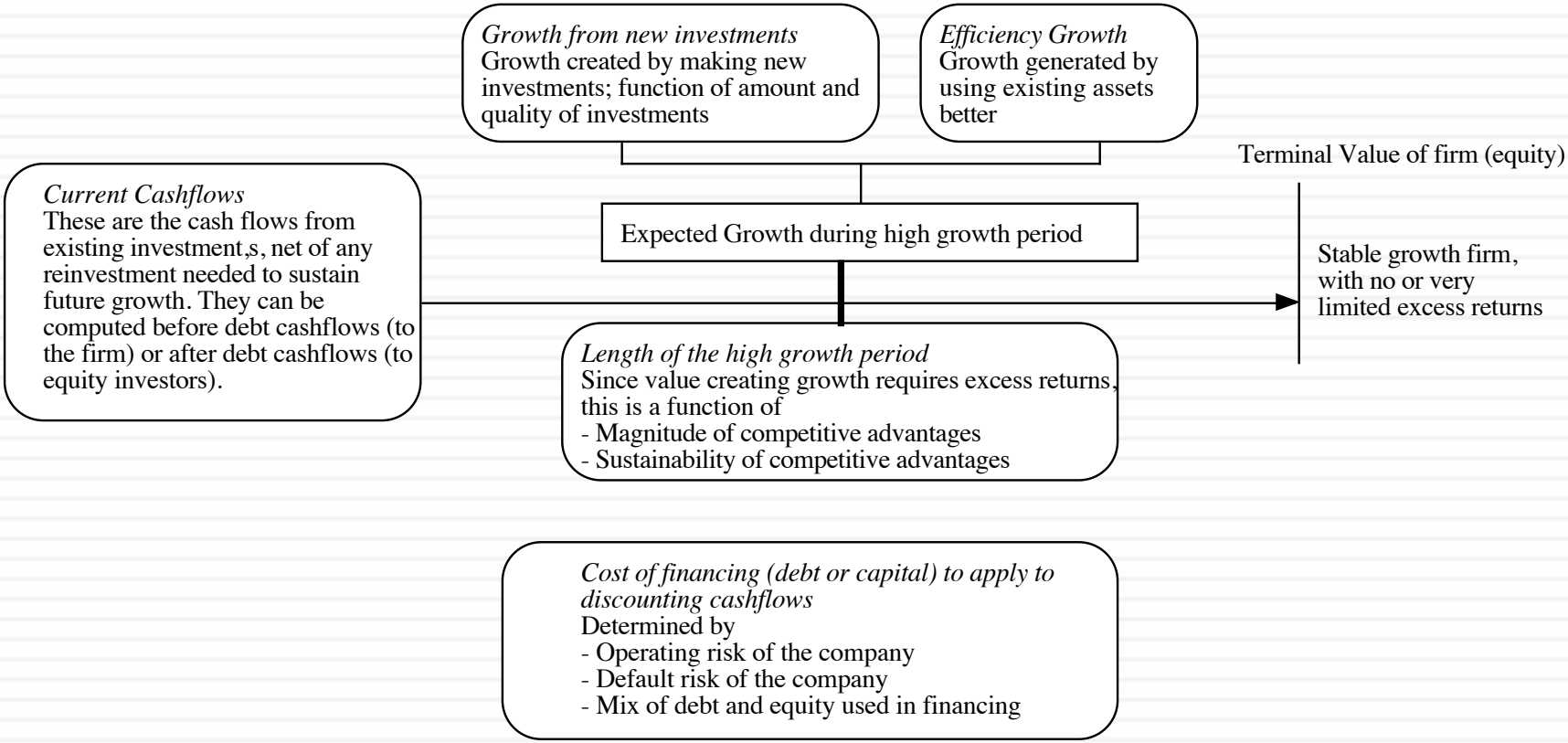
DCF Choices: Equity Valuation versus Firm Valuation

Firm Valuation: Value the entire business

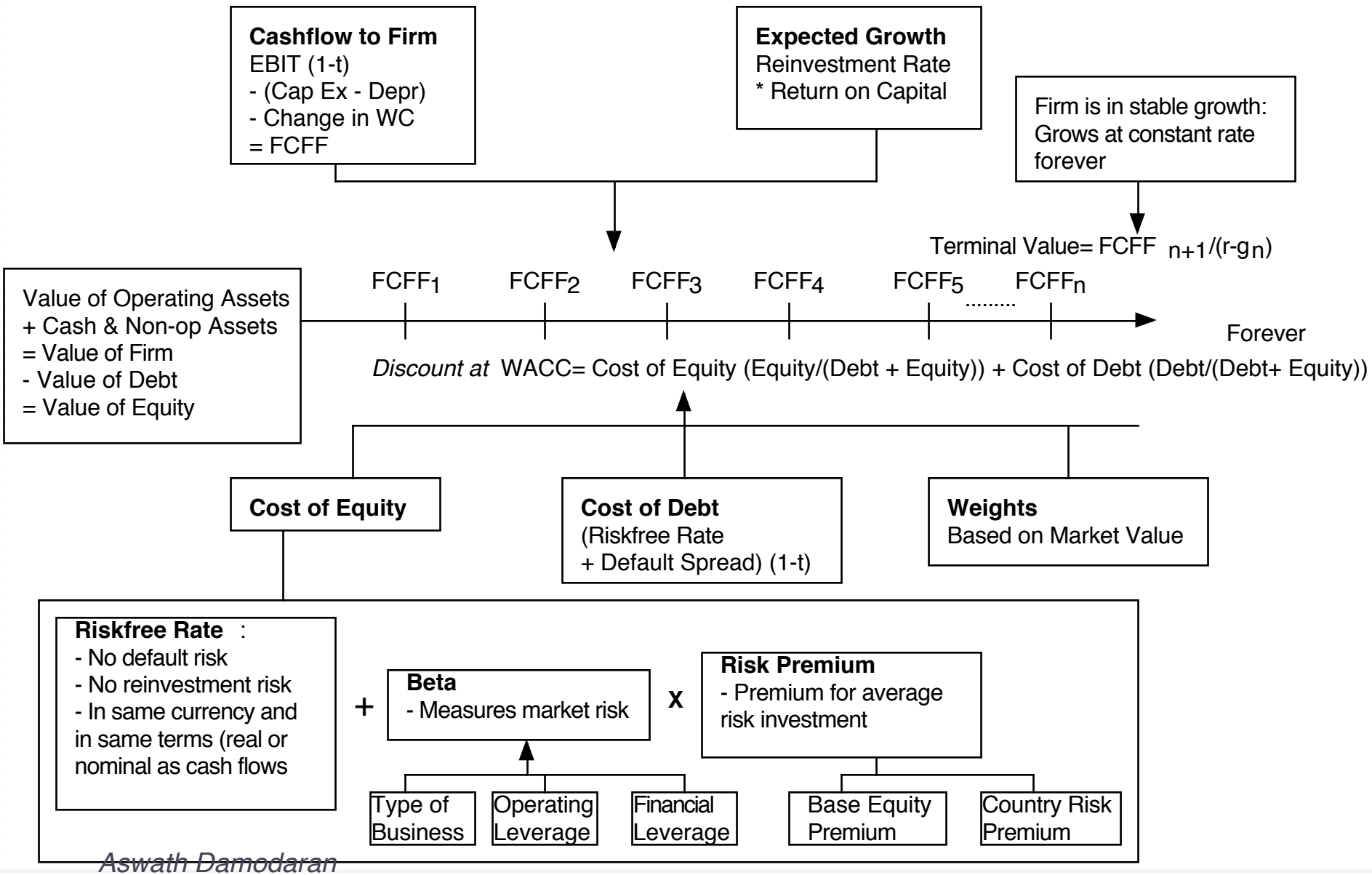


Equity valuation: Value just the equity claim in the business

The Drivers of Value…



DISCOUNTED CASHFLOW VALUATION



Amgen: Status Quo

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

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

Reinvestment Rate 60%

Return on Capital 16%

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

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

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

First 5 years

Growth decreases gradually to 4%

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

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

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

Debt ratio increases to 20%
Beta decreases to 1.10

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

Cost of Equity
11.70%

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

Weights
E = 90% D = 10%

Riskfree Rate:
Riskfree rate = 4.78%

+

Beta
1.73

x

Risk Premium
4%

Unlevered Beta for Sectors: 1.59

D/E=11.06%

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%

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

Reinvestment Rate 70%

Return on Capital 17.16%

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

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

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

Rs Cashflows

Year	1	2	3	4	5	6	7	8	9	10
EBIT (1-t)	22533	25240	28272	31668	35472	39236	42848	46192	49150	51607
- Reinvestment	15773	17668	19790	22168	24830	25242	25138	24482	23264	21503
FCFF	6760	7572	8482	9500	10642	13994	17711	21710	25886	30104

45278
21785
23493

Op. Assets Rs210,813
+ Cash: 11418
+ Other NO 140576
- Debt 109198
=Equity 253,628

Value/Share Rs 614

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

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

Cost of Equity 14.00%

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

Weights
E = 74.7% D = 25.3%

On April 1, 2010
Tata Motors price = Rs 781

Riskfree Rate:
Rs Riskfree Rate= 5%

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

Unlevered Beta for Sectors: 1.04

Firm's D/E Ratio: 33%

Country Default Spread 3% X Rel Equity Mkt Vol 1.50

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Alibaba: Pre-IPO valuation - May 8, 2014 (in US $)

	2013	2012 (Est)
Revenues	$ 7,911	$ 4,100
Operating income	$ 3,882	$ 2,000
Operating margin	49.07%	48.78%
Revenue Growth	75.80%	
Sales/Capital	1.93	

Revenue growth of **27%** a year for 5 years, tapering down to 2.63% in year 10

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

Sales to capital ratio maintained at 2.00 (current level is 1.93)

Stable Growth
g = 2.63%
Cost of capital = 8%
ROC= 8%;
Reinvestment Rate= 2.63%/8% = 32.88%

Terminal Value$_{10}$= 9,590/(.08-0263) = $178,593

	1	2	3	4	5	6	7	8	9	10
Revenue growth rate	27.00%	27.00%	27.00%	27.00%	27.00%	22.13%	17.25%	12.38%	7.50%	2.63%
Revenues	$10,047	$12,760	$16,205	$20,580	$26,137	$31,920	$37,426	$42,059	$45,215	$46,404
EBIT (Operating) margin	48.81%	47.83%	46.85%	45.87%	44.89%	43.92%	42.94%	41.96%	40.98%	40.00%
EBIT (Operating income)	$ 4,904	$ 6,103	$ 7,592	$ 9,441	$11,734	$14,018	$16,070	$17,647	$18,529	$18,562
Tax rate	11.42%	11.42%	11.42%	11.42%	11.42%	14.13%	16.85%	19.57%	22.28%	25.00%
EBIT(1-t)	$ 4,344	$ 5,406	$ 6,725	$ 8,363	$10,394	$12,036	$13,362	$14,194	$14,400	$13,921
- Reinvestment	$ 1,068	$ 1,356	$ 1,723	$ 2,188	$ 2,778	$ 2,891	$ 2,753	$ 2,316	$ 1,578	$ 595
FCFF	$ 3,276	$ 4,050	$ 5,003	$ 6,175	$ 7,616	$ 9,145	$10,608	$11,878	$12,822	$13,327

Term yr
EBIT (1-t) $14,287
- Reinv 4,697
FCFF 9,590

Operating assets	$127,484
+ Cash	7,876
- Debt	6,670
+ Equity investments	2,087
+ Alipay provision	3,000
+ IPO Proceeds (est)	15,000
- Options	3,190
Value of equity	145,587
Value per share	$61.46

Cost of capital = 9.06% (.963) + 3.00% (.037) = 8.84%

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

Cost of Equity
9.06%

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

Weights
E = 96.3% D = 3.7%

At the time of the valuation, estimates of value ranged from $120 billion (from the company) to $200 billion (from the most optimistic analysts)

Riskfree Rate:
Riskfree rate = 2.63%

+

Beta
1.074

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

D/E = 3.81%

X

ERP
5.99%

Region	% of Revenues	ERP
China	80.59%	5.90%
Global	19.41%	6.35%
Alibaba	100.00%	5.99%

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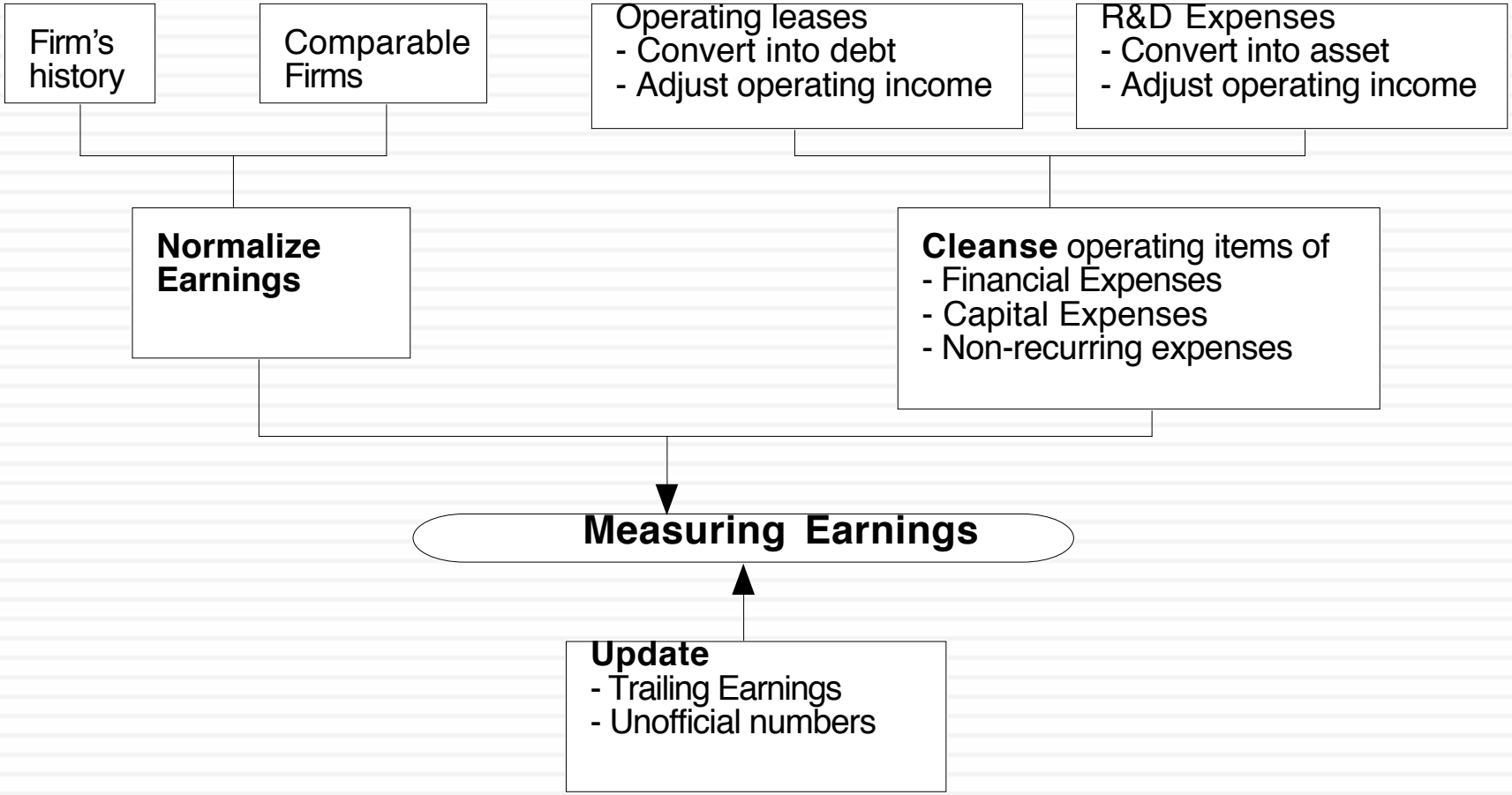
DCF INPUTS

"Garbage in, garbage out"

I. Measure earnings right..



Operating Leases at Amgen in 2007

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

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

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

Capitalizing R&D Expenses: Amgen

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

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

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

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

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

Amgen's Net Capital Expenditures

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

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

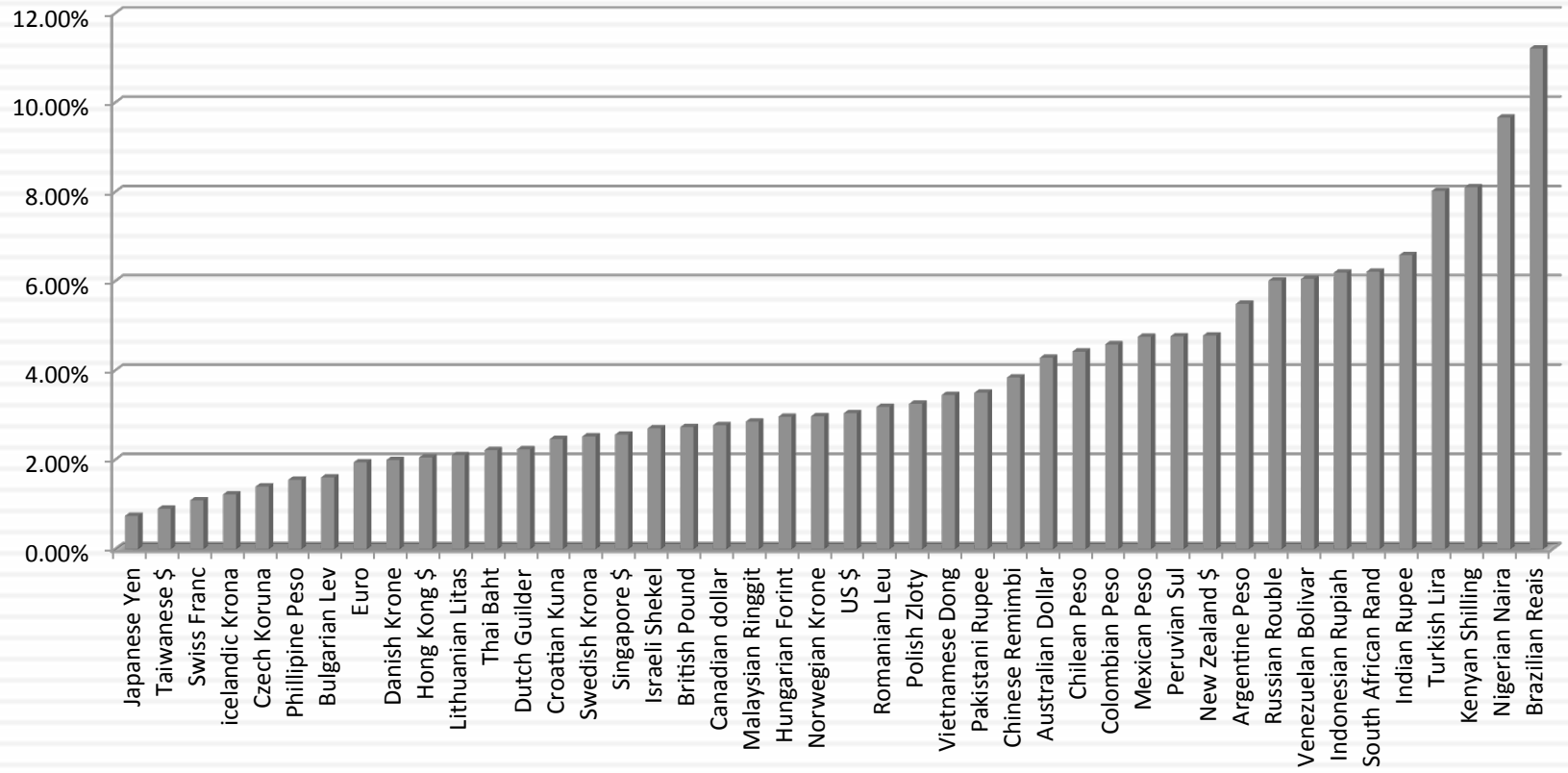
- When valuing Amgen in US dollars, the US$ ten-year bond rate of 4.78% was used as the risk free rate. We assumed that the US treasury was default free.
- When valuing Tata Motors in Indian rupees in 2010, the Indian government bond rate of 8% was not default free. Using the Indian government's local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

  Risk free rate in Indian Rupees = 8% - 3% = 5%
- To value a Brazilian company in nominal Reais, you would need a risk free rate in $R. The ten-year Brazilian government bond rate in $R was 13.18% in January 2013. Given Brazil's local currency rating of Baa2, the default spread for Brazil is 1.90%.

  Risk free rate in $R = 13.18% - 1.90% = 11.28%

Risk free rates will vary across currencies: January 2014

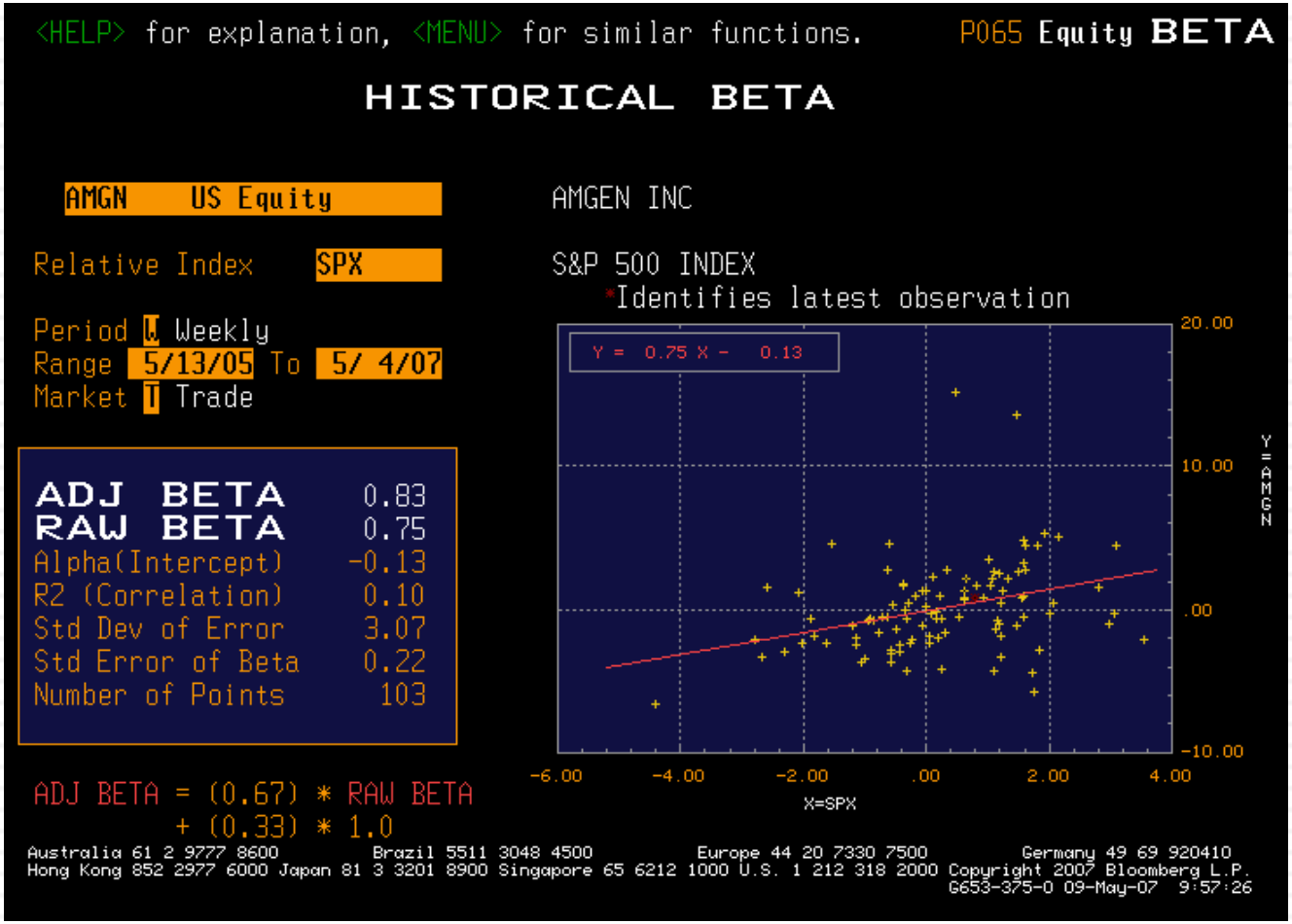
Risk free rate by Currency: January 2014



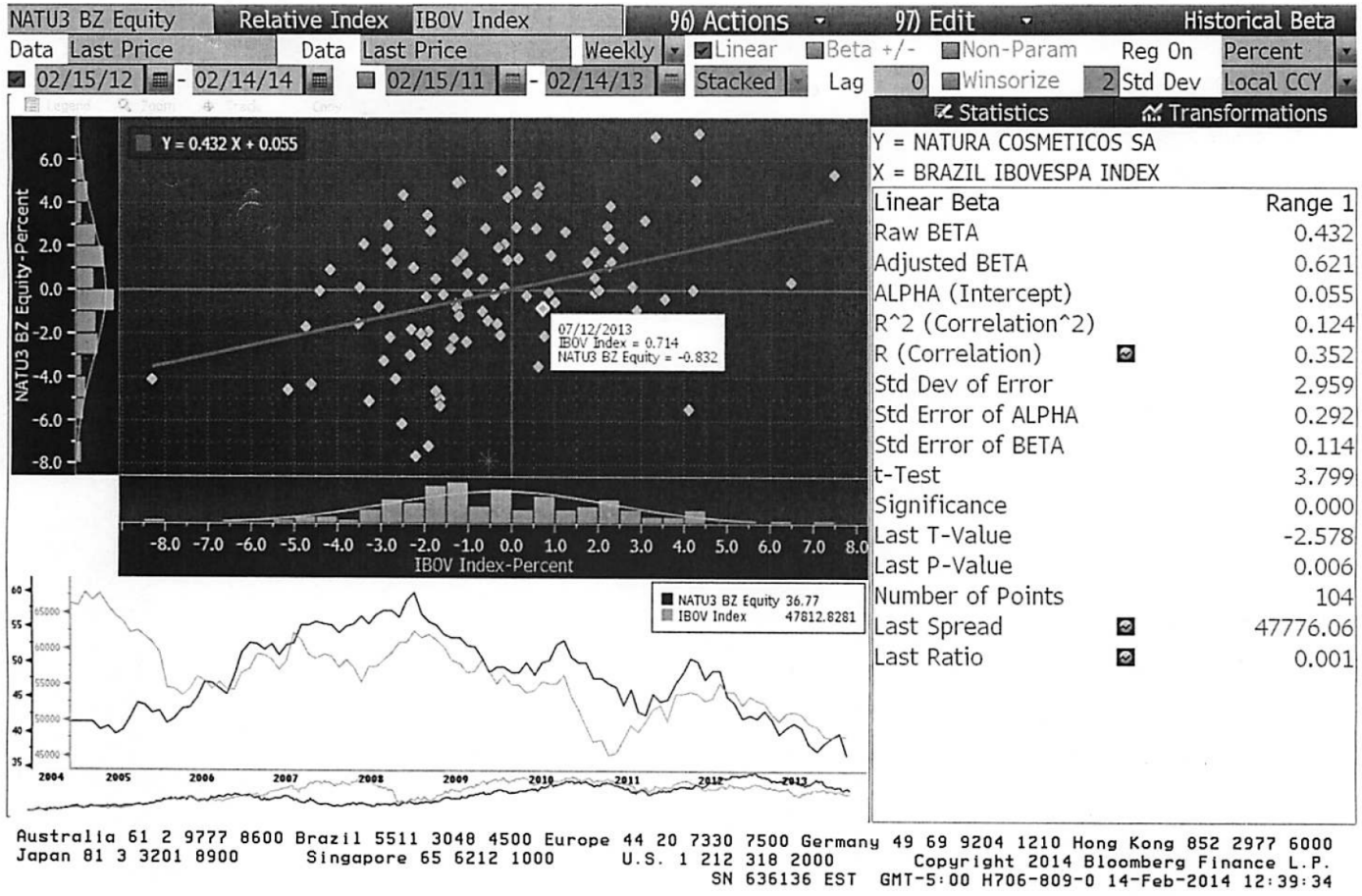
But valuations should not.. Tata Motors in US dollars

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

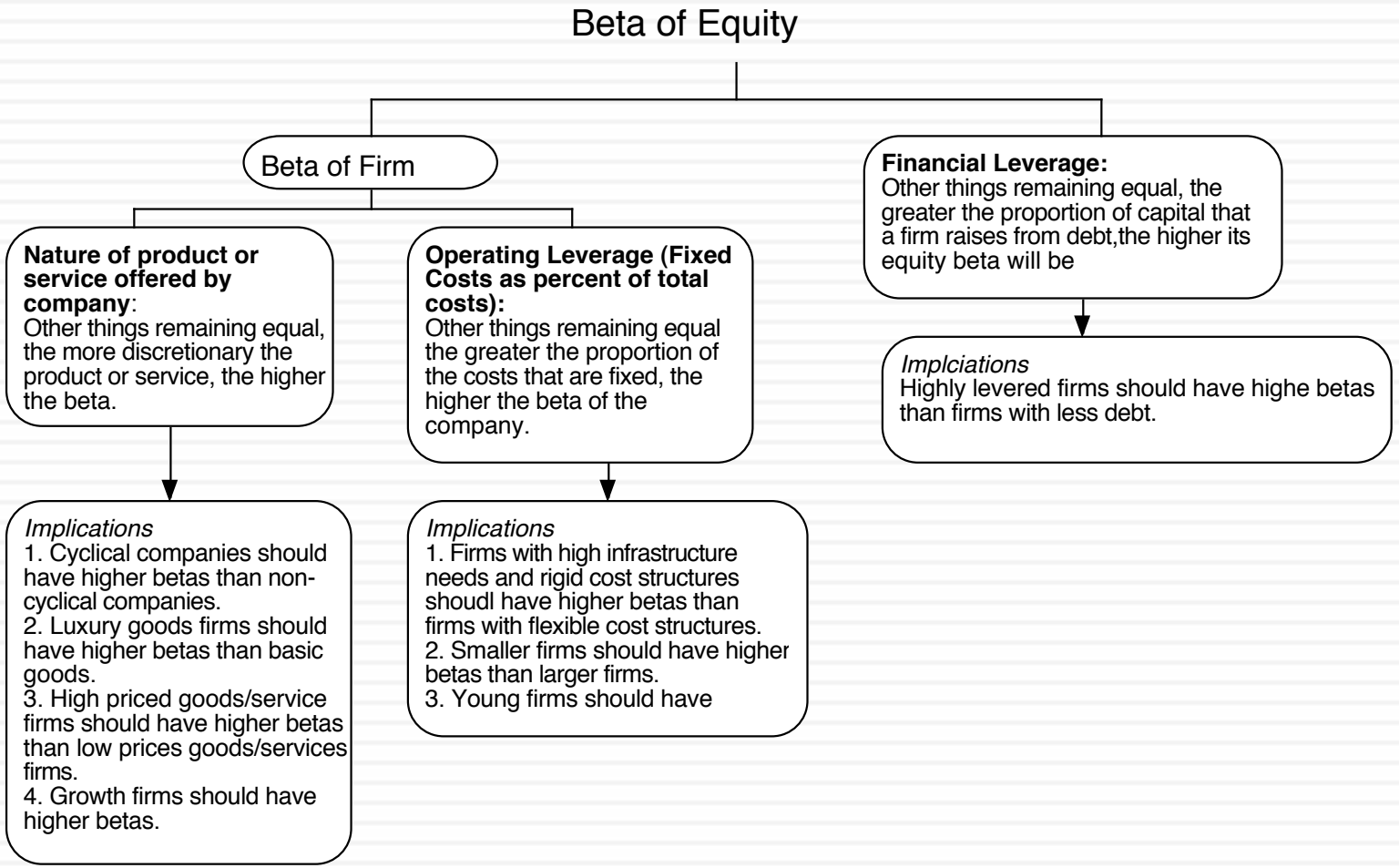
IV. Betas do not come from regressions… and are noisy…



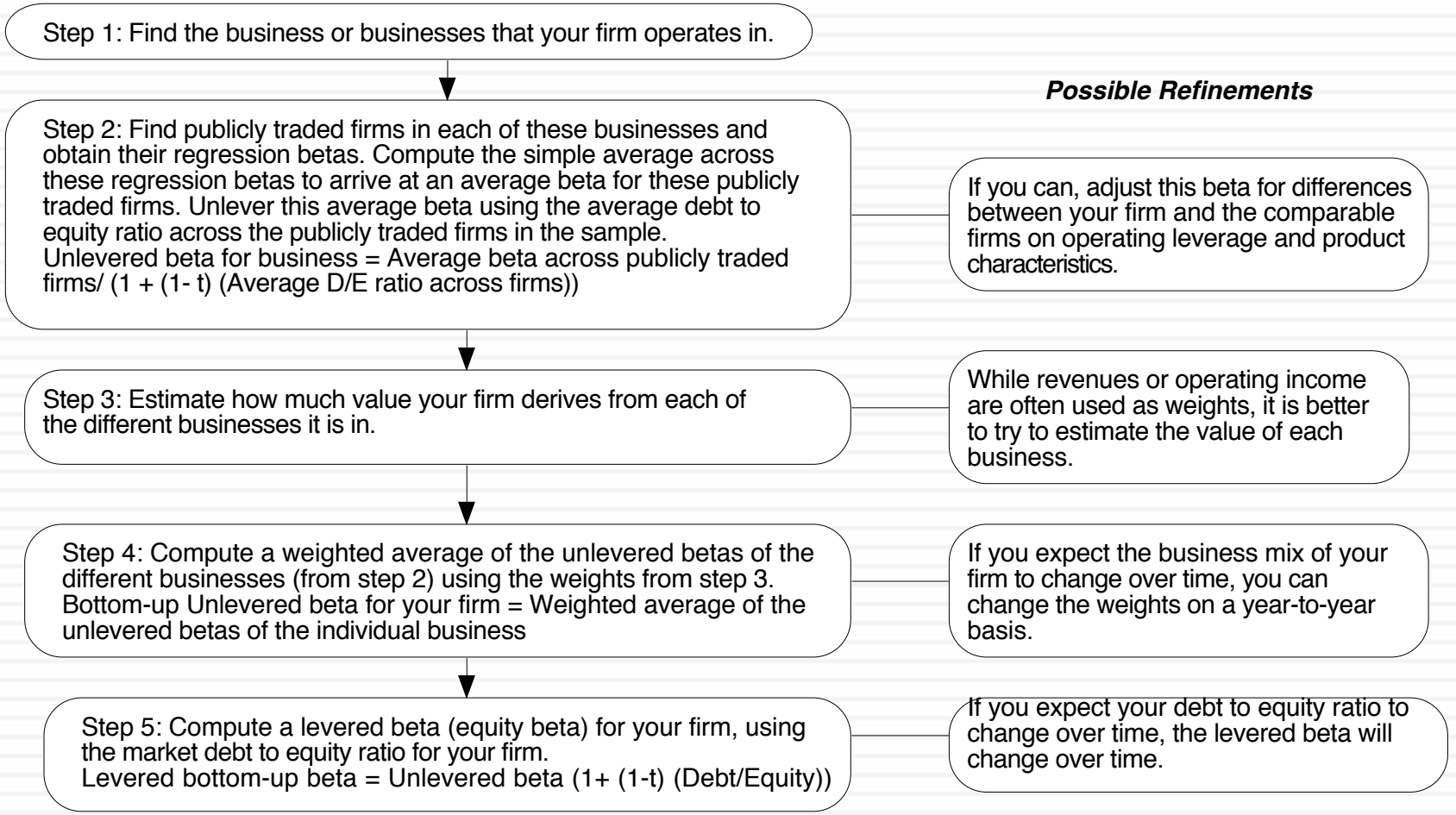
And can be a complete mess, when the market index is not a good one



Determinants of Betas



Bottom-up Betas



Working through with our companies

- Amgen in 2007
  - The unlevered beta for pharmaceutical firms is 1.59. Using Amgen's debt to equity ratio of 11% and the marginal tax for the US in 2007 of 35%, the bottom up beta for Amgen is
  - Bottom-up Beta = 1.59 (1+ (1-.35)(.11)) = 1.73
- Tata Motors in 2010
  - The unlevered beta for global automobile firms is 0.98. Using Tata Motor's debt to equity ratio of 33.87% and the marginal tax rate for India of 33.99%, the bottom up beta for Tata Motors is
  - Bottom-up Beta = 0.98 (1+ (1-.3399)(.3387)) = 1.20
- Natura in February 2014
  - The unlevered beta for cosmetics companies is 0.97.
  - The debt to equity ratio for Natura, based on market values for equity and debt, is 15.4% and the marginal tax rate for Brazil is 34.00%.
  - Bottom-up Beta = 0.97 (1+ (1-.34)(.154)) = 1.07

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. :

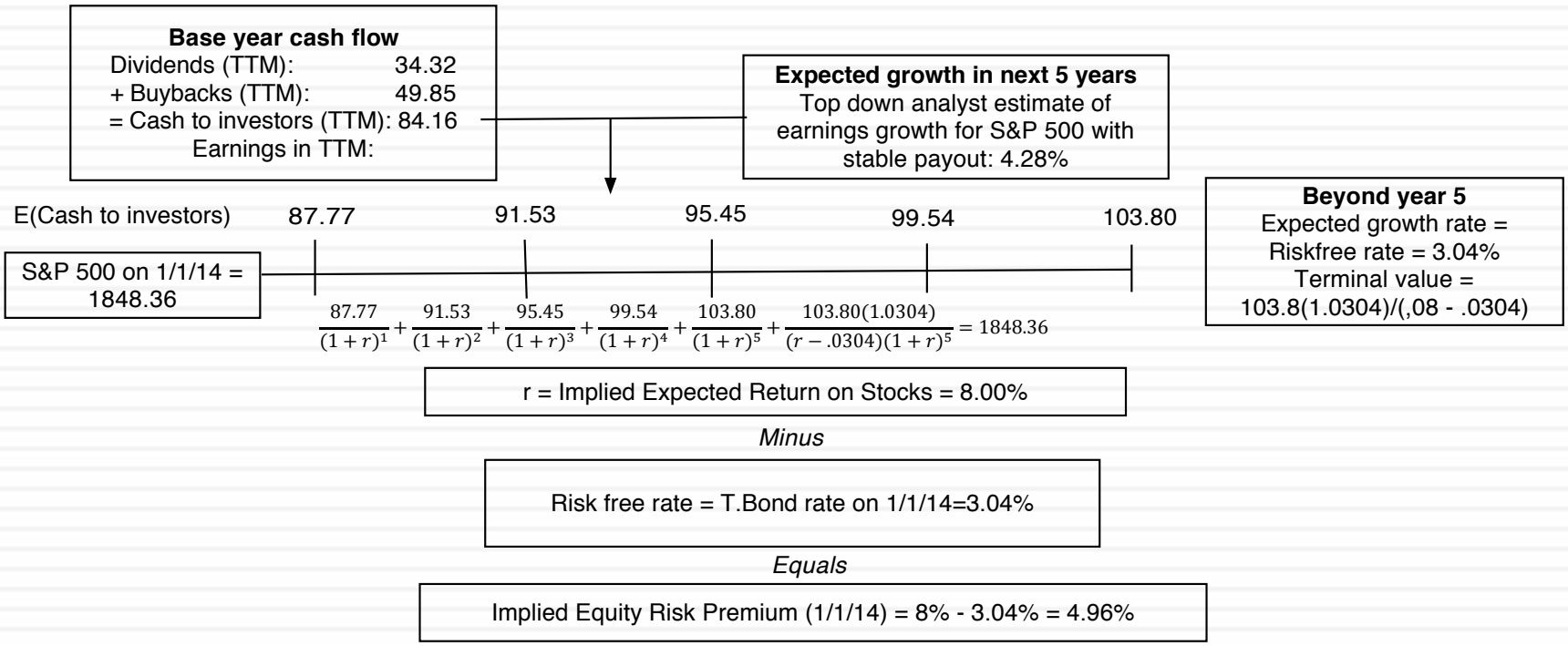
	Arithmetic Average		Geometric Average	
	Stocks - T. Bills	Stocks - T. Bonds	Stocks - T. Bills	Stocks - T. Bonds
1928-2013	7.93%	6.29%	6.02%	4.62%
Std Error	*2.19%*	*2.34%*		
1964-2013	6.18%	4.32%	4.83%	3.33%
Std Error	*2.42%*	*2.75%*		
2004-2013	7.55%	4.41%	5.80%	3.07%
Std Error	*6.02%*	*8.66%*		

- Not only is this approach backward-looking, but it yields estimates which significant noise associated with them. The standard error in a historical estimate will be the following:

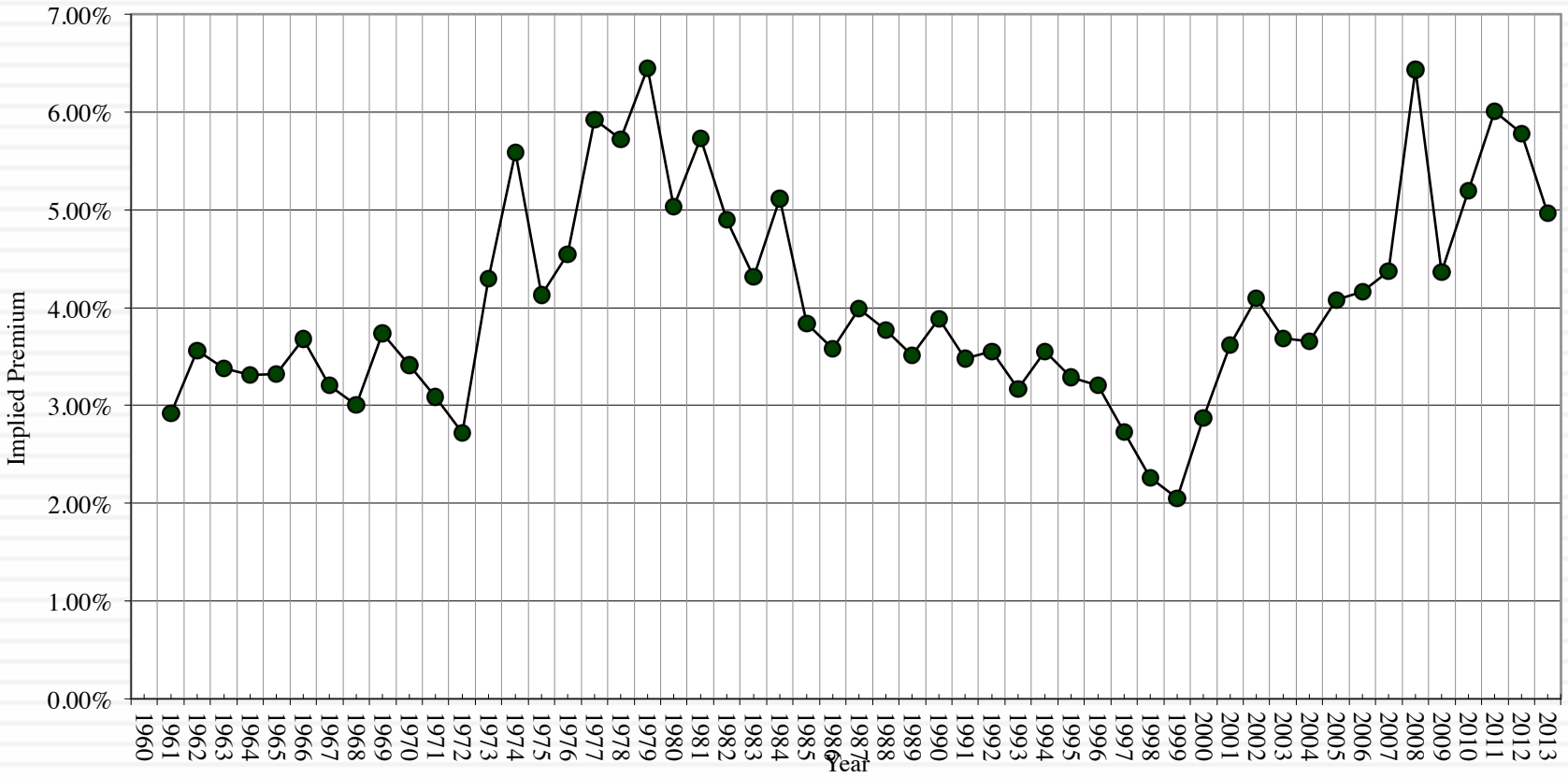
$$Standard\ Error_{Historical\ ERP} = \frac{Annual\ Standard\ Deviation_{Stocks}}{\sqrt{Number\ of\ years\ of\ data}}$$

- In most markets, you will be hard pressed to find more than a few decades of reliable stock market history, making historical risk premiums close to useless.

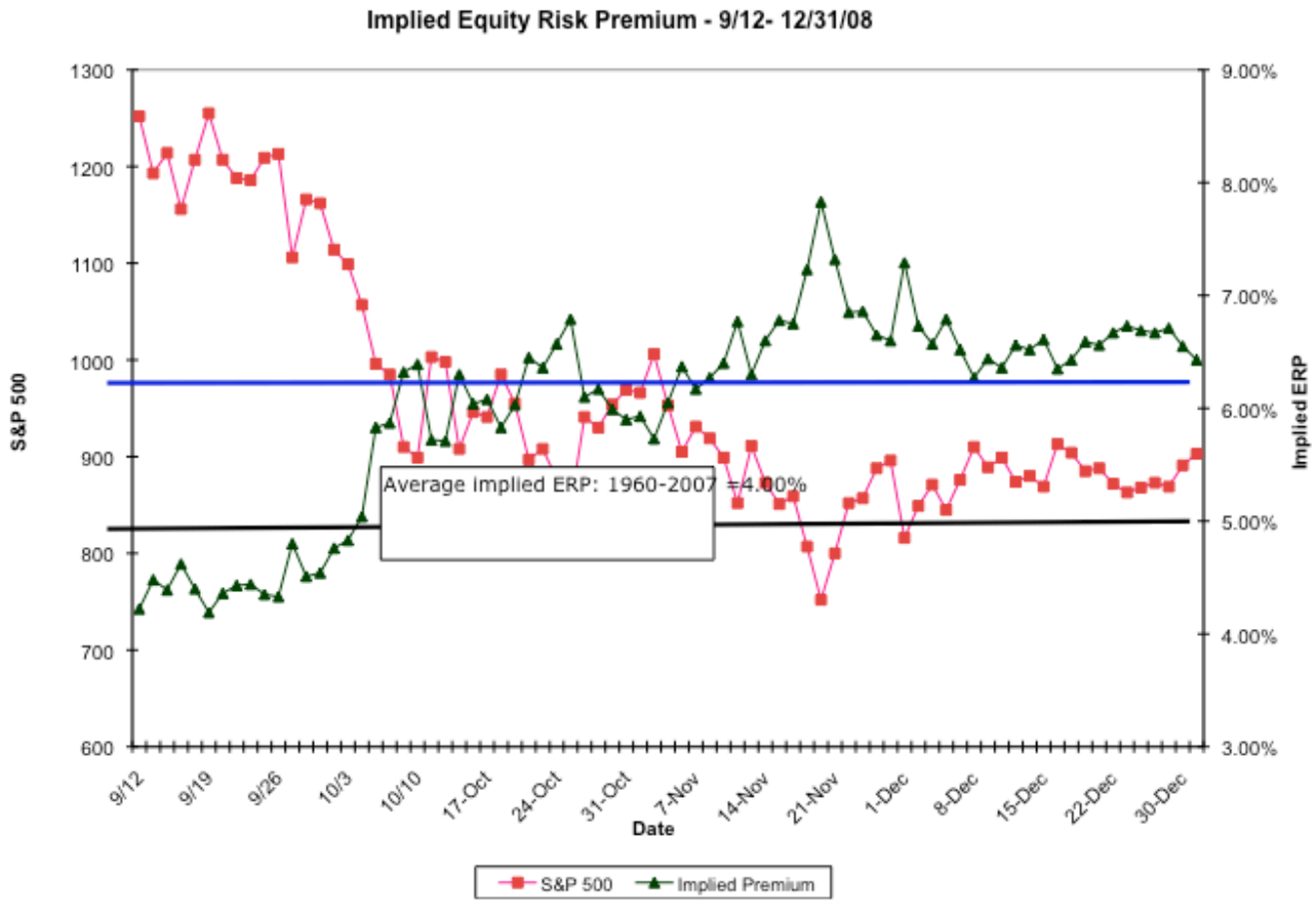
A forward-looking alternative: Back out an implied equity risk premium



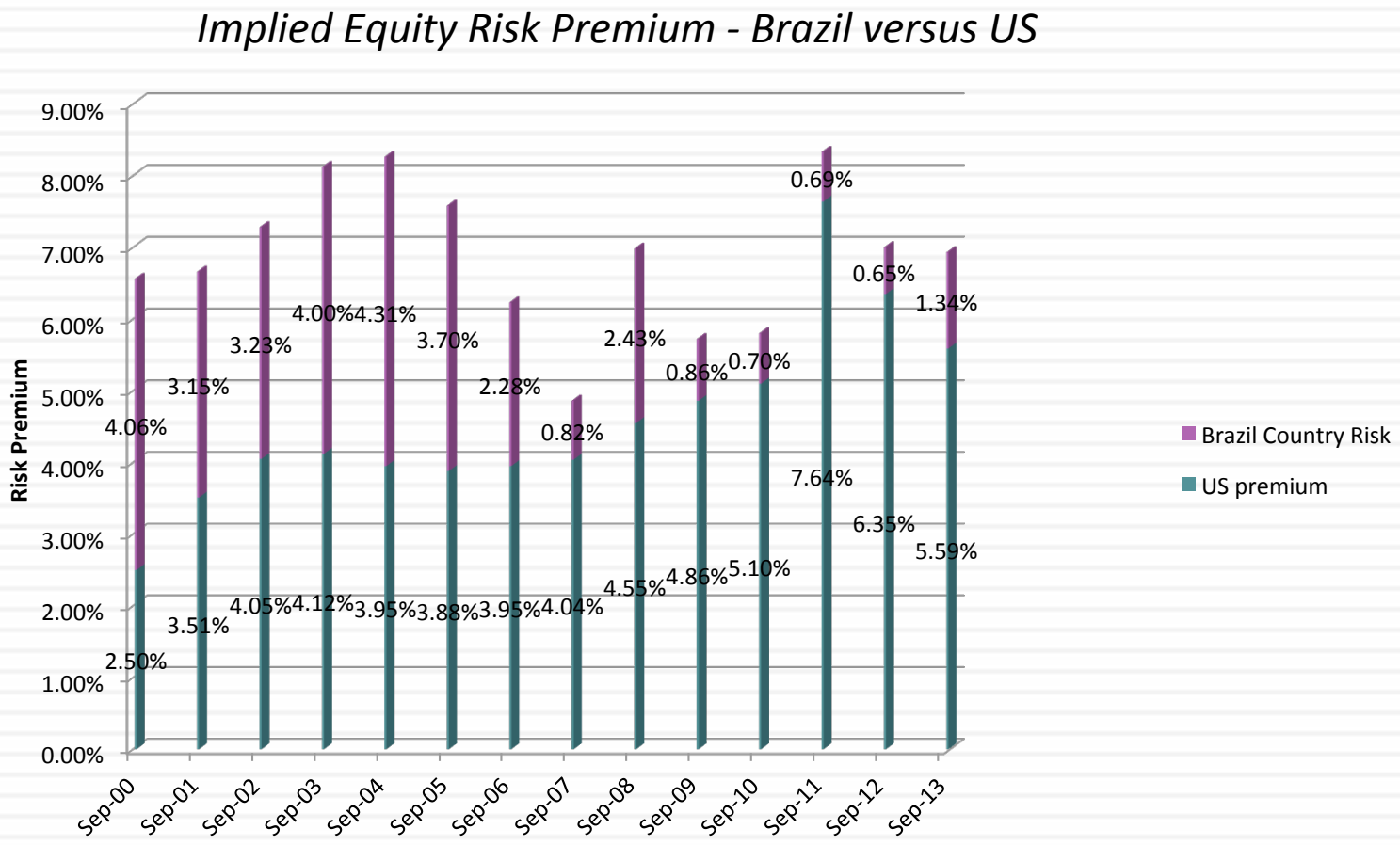
Implied Premiums in the US: 1960-2013



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



Implied ERP for Brazil versus US



VI. There is a downside to globalization…

- Emerging markets offer growth opportunities but they are also riskier. If we want to count the growth, we have to also consider the risk.
- Two ways of estimating the country risk premium:
  - Sovereign Default Spread: In this approach, the country equity risk premium is set equal to the default spread of the bond issued by the country.
    - Equity Risk Premium for mature market = 4.50%
    - Default Spread for India = 3.00% (based on rating)
    - Equity Risk Premium for India = 4.50% + 3.00%
  - Adjusted for equity risk: The country equity risk premium is based upon the volatility of the equity market relative to the government bond rate.
    - Country risk premium= Default Spread* $\text{Std Deviation}_{\text{Country Equity}} / \text{Std Deviation}_{\text{Country Bond}}$
    - Standard Deviation in Sensex = 21%
    - Standard Deviation in Indian government bond= 14%
    - Default spread on Indian Bond= 3%
    - Additional country risk premium for India = 3% (21/14) = 4.5%

ERP : Jan 2014

Andorra	6.80%	1.80%
Austria	5.00%	0.00%
Belgium	5.90%	0.90%
Cyprus	20.00%	15.00%
Denmark	5.00%	0.00%
Finland	5.00%	0.00%
France	5.60%	0.60%
Germany	5.00%	0.00%
Greece	20.00%	15.00%
Iceland	8.30%	3.30%
Ireland	8.75%	3.75%
Italy	7.85%	2.85%
Liechtenstein	5.00%	0.00%
Luxembourg	5.00%	0.00%
Malta	6.80%	1.80%
Netherlands	5.00%	0.00%
Norway	5.00%	0.00%
Portugal	10.40%	5.40%
Spain	8.30%	3.30%
Sweden	5.00%	0.00%
Switzerland	5.00%	0.00%
Turkey	8.30%	3.30%
United Kingdom	5.60%	0.60%
Western Europe	**6.29%**	**1.29%**

Canada	5.00%	0.00%
United States of America	5.00%	0.00%
North America	**5.00%**	**0.00%**

Argentina	14.75%	9.75%
Belize	18.50%	13.50%
Bolivia	10.40%	5.40%
Brazil	7.85%	2.85%
Chile	5.90%	0.90%
Colombia	8.30%	3.30%
Costa Rica	8.30%	3.30%
Ecuador	16.25%	11.25%
El Salvador	10.40%	5.40%
Guatemala	8.75%	3.75%
Honduras	13.25%	8.25%
Mexico	7.40%	2.40%
Nicaragua	14.75%	9.75%
Panama	7.85%	2.85%
Paraguay	10.40%	5.40%
Peru	7.85%	2.85%
Suriname	10.40%	5.40%
Uruguay	8.30%	3.30%
Venezuela	16.25%	11.25%
Latin America	**8.62%**	**3.62%**

Angola	10.40%	5.40%
Benin	13.25%	8.25%
Botswana	6.28%	1.28%
Burkina Faso	13.25%	8.25%
Cameroon	13.25%	8.25%
Cape Verde	13.25%	8.25%
DR Congo	14.75%	9.75%
Egypt	16.25%	11.25%
Gabon	10.40%	5.40%
Ghana	11.75%	6.75%
Kenya	11.75%	6.75%
Morocco	8.75%	3.75%
Mozambique	11.75%	6.75%
Namibia	8.30%	3.30%
Nigeria	10.40%	5.40%
Rep Congo	10.40%	5.40%
Rwanda	13.25%	8.25%
Senegal	11.75%	6.75%
South Africa	7.40%	2.40%
Tunisia	10.40%	5.40%
Uganda	11.75%	6.75%
Zambia	11.75%	6.75%
Africa	**10.04%**	**5.04%**

Albania	11.75%	6.75%
Armenia	9.50%	4.50%
Azerbaijan	8.30%	3.30%
Belarus	14.75%	9.75%
Bosnia and Herzegovina	14.75%	9.75%
Bulgaria	7.85%	2.85%
Croatia	8.75%	3.75%
Czech Republic	6.05%	1.05%
Estonia	6.05%	1.05%
Georgia	10.40%	5.40%
Hungary	8.75%	3.75%
Kazakhstan	7.85%	2.85%
Latvia	7.85%	2.85%
Lithuania	7.40%	2.40%
Macedonia	10.40%	5.40%
Moldova	14.75%	9.75%
Montenegro	10.40%	5.40%
Poland	6.28%	1.28%
Romania	8.30%	3.30%
Russia	7.40%	2.40%
Serbia	11.75%	6.75%
Slovakia	6.28%	1.28%
Slovenia	8.75%	3.75%
Ukraine	16.25%	11.25%
E. Europe & Russia	**7.96%**	**2.96%**

Bangladesh	10.40%	5.40%
Cambodia	13.25%	8.25%
China	5.90%	0.90%
Fiji	11.75%	6.75%
Hong Kong	5.60%	0.60%
India	8.30%	3.30%
Indonesia	8.30%	3.30%
Japan	5.90%	0.90%
Korea	5.90%	0.90%
Macao	5.90%	0.90%
Malaysia	6.80%	1.80%
Mauritius	7.40%	2.40%
Mongolia	11.75%	6.75%
Pakistan	16.25%	11.25%
Papua New Guinea	11.75%	6.75%
Philippines	8.30%	3.30%
Singapore	5.00%	0.00%
Sri Lanka	11.75%	6.75%
Taiwan	5.90%	0.90%
Thailand	7.40%	2.40%
Vietnam	13.25%	8.25%
Asia	**6.51%**	**1.51%**

Abu Dhabi	5.75%	0.75%
Bahrain	7.85%	2.85%
Israel	6.05%	1.05%
Jordan	11.75%	6.75%
Kuwait	5.75%	0.75%
Lebanon	11.75%	6.75%
Oman	6.05%	1.05%
Qatar	5.75%	0.75%
Saudi Arabia	5.90%	0.90%
United Arab Emirates	5.75%	0.75%
Middle East	**6.14%**	**1.14%**

Australia	5.00%	0.00%
Cook Islands	11.75%	6.75%
New Zealand	5.00%	0.00%
Australia & New Zealand	**5.00%**	**0.00%**

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

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

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

Globalization's flip side: Operation-based ERP

Coca Cola (2011)

Region	*Revenues*	*Total ERP*	*CRP*
Western Europe	19%	6.67%	0.67%
Eastern Europe & Russia	5%	8.60%	2.60%
Asia	15%	7.63%	1.63%
Latin America	15%	9.42%	3.42%
Australia	4%	6.00%	0.00%
Africa	4%	9.82%	3.82%
North America	40%	6.00%	0.00%
Coca Cola	100%	7.14%	1.14%

Natura (2013)

Brazil	88.72%	7.85%	88.72%
Argentina	2.57%	14.75%	2.57%
Chile	2.57%	5.90%	2.57%
Peru	2.57%	7.85%	2.57%
Mexico	1.79%	7.40%	1.79%
Colombia	1.79%	8.30%	1.79%
Natura	**100.00%**	**7.98%**	**100.00%**

Vale (2013)

	% Revenues	ERP
US & Canada	4.90%	5.50%
Brazil	16.90%	8.50%
Rest of Latin Ameria	1.70%	10.09%
China	37.00%	6.94%
Japan	10.30%	6.70%
Rest of Asia	8.50%	8.61%
Europe	17.20%	6.72%
Rest of World	3.50%	10.06%
Company	100.00%	7.38%

An alternate approach: Estimate a "country risk exposure factor (lambda)

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

VIII. Growth has to be earned (not endowed or estimated): Measuring Investment Quality

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

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

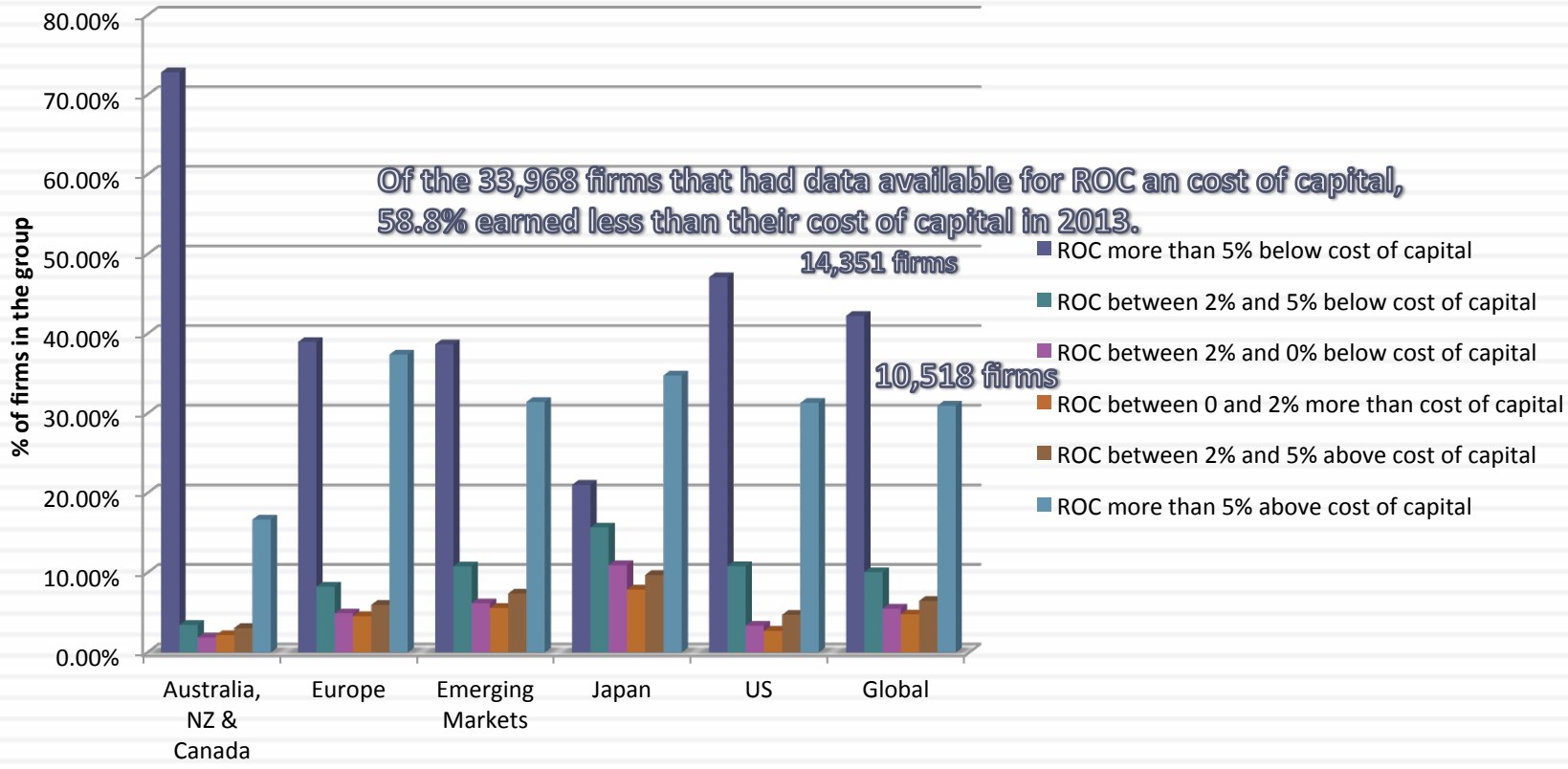
Adjust book equity for
1. Capitalized R&D
2. Acquisition Debris (Goodwill)

Adjust book value of debt for
a. Capitalized operating leases

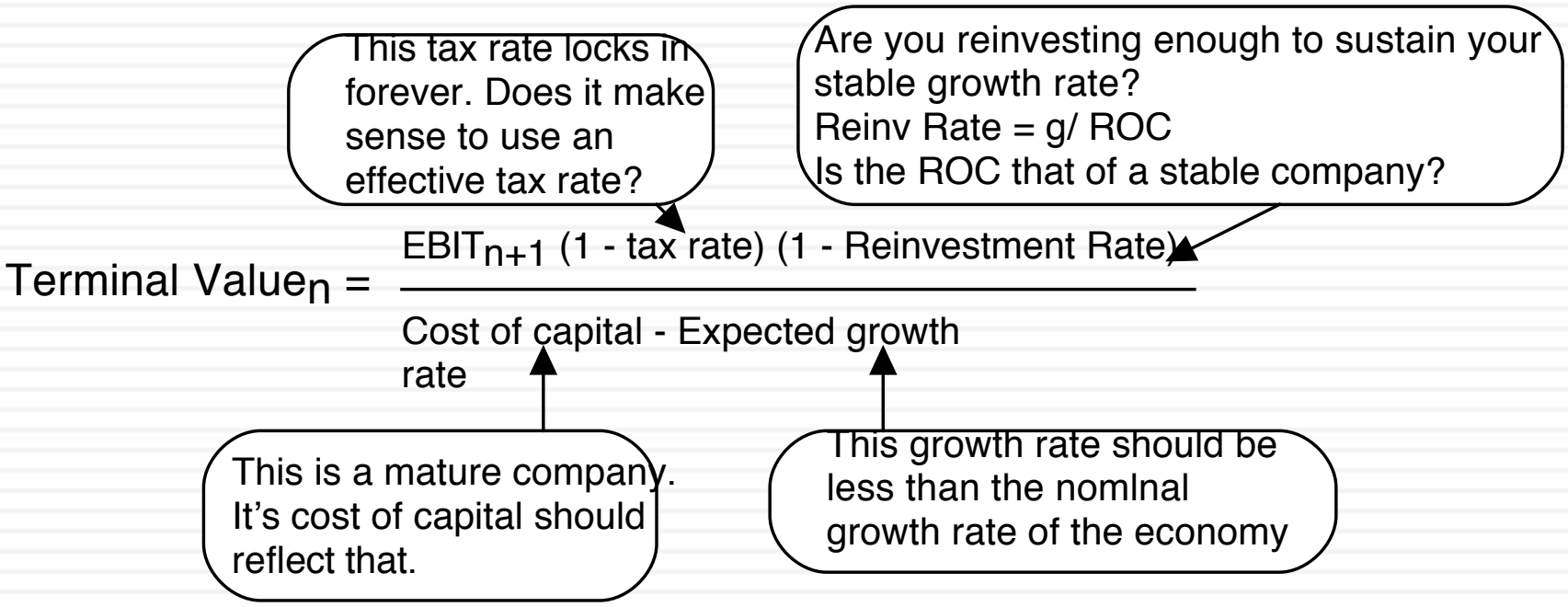
Use end of prior year numbers or average over the year but be consistent in your application

The Quality of Growth – A Global Perspective

ROIC versus Cost of Capital: A Global Assessment for 2013



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



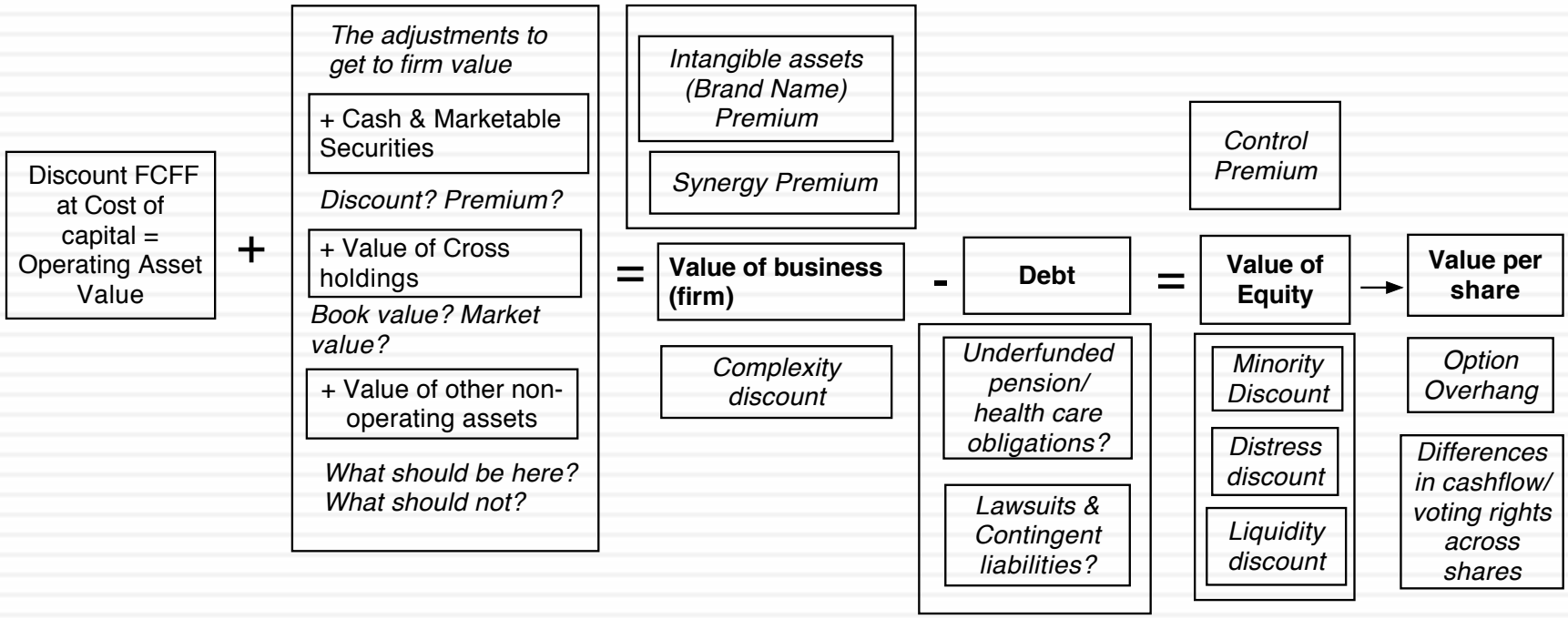
Terminal Value and Growth

Stable growth rate	*Amgen*	*Tata Motors*	*Stable growth rate*	*Natura*
0%	$150,652	435,686₹	0%	R$ 21,709
1%	$154,479	435,686₹	2%	R$ 24,473
2%	$160,194	435,686₹	4%	R$ 27,989
3%	$167,784	435,686₹	6%	R$ 32,538
4%	$179,099	435,686₹	8%	R$ 38,815
5%		435,686₹	10%	R$ 48,394
Riskfree rate	4.78%	5%		11.28%
ROIC	10%	10.39%		25.00%
Cost of capital	8.08%	10.39%		16.35%

THE LOOSE ENDS IN VALUATION…

Aswath Damodaran

Getting from DCF to value per share: The Loose Ends



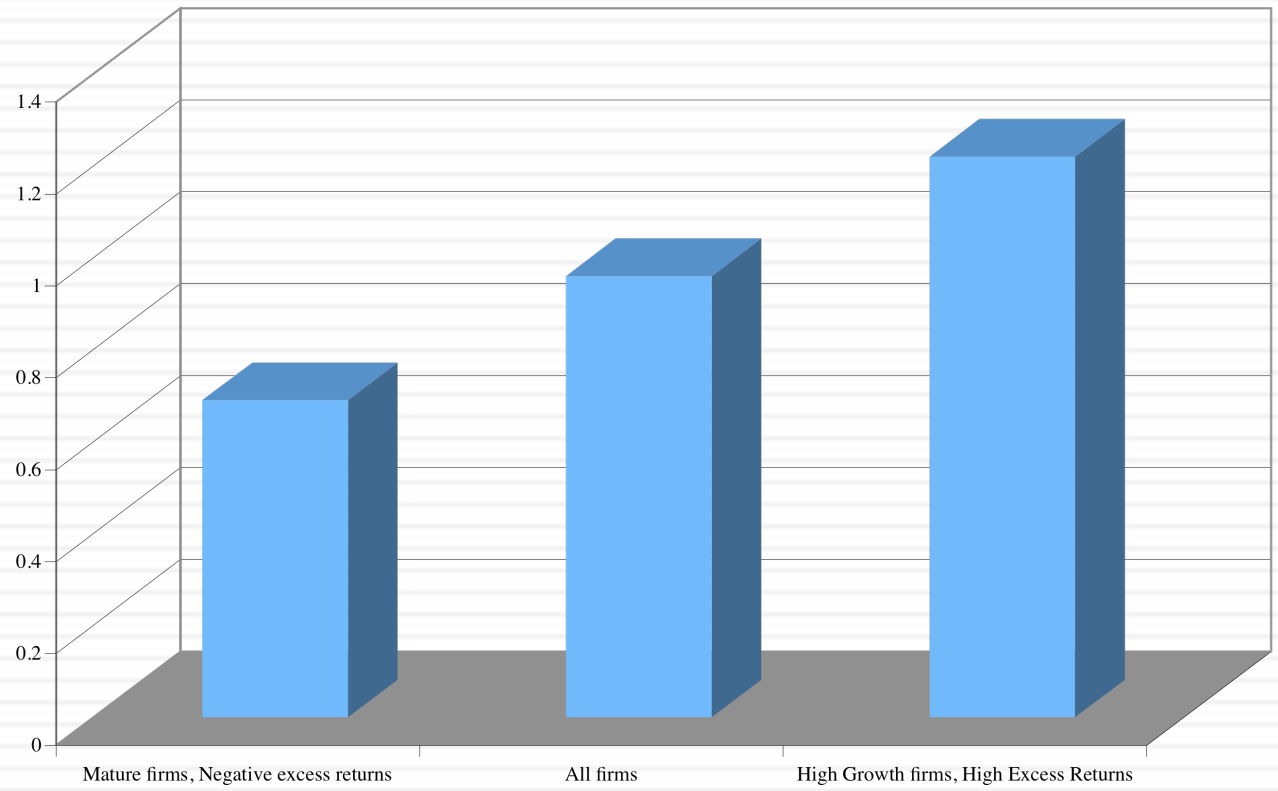
1. The Value of Cash
An Exercise in Cash Valuation

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

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

Cash: Discount or Premium?

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



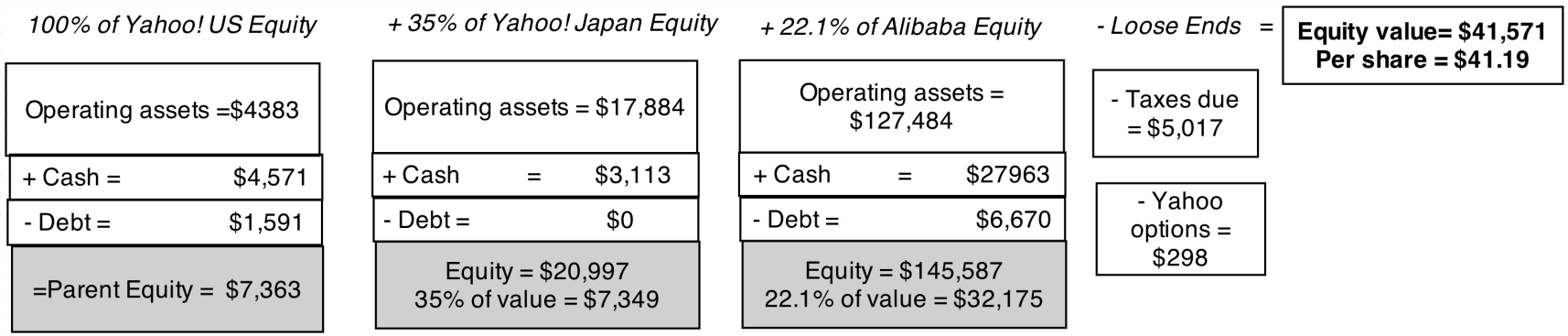
2. Dealing with Holdings in Other firms

- 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 estimate cash flows and discount rates.

Valuing Yahoo as the sum of its intrinsic pieces



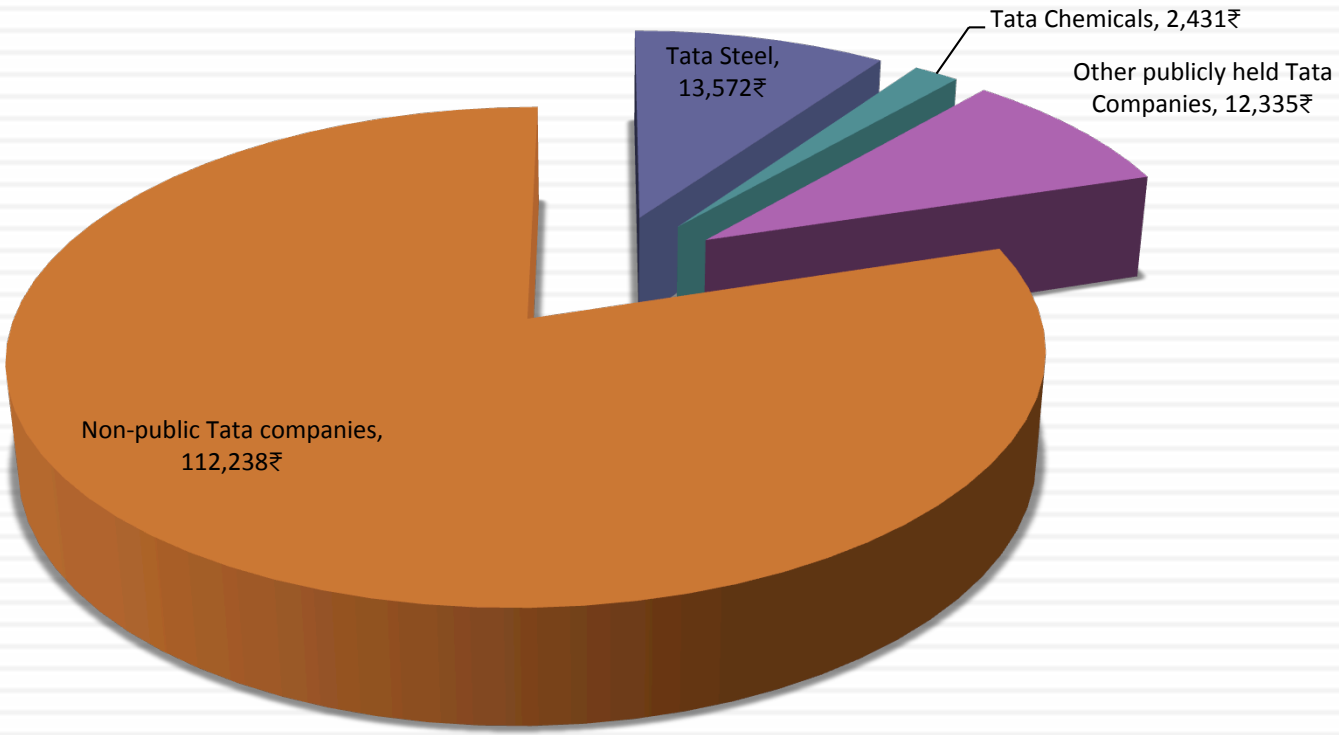
Two compromise solutions…

- 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.

Yahoo: A pricing game?

Item	*Computation details*	*Estimated value*
Market Capitalization of Yahoo!	$33.76*1009.39 million	$34,077
- 35% of Market Cap of Yahoo! Japan	.35 ($24,393 million)	$8,538
- 22.1% of Equity value in Alibaba (estimate)	.221($150,000 million)	$33,165
+ Taxes Due on Alibaba share sale	40% of capital gains	$5,232
+ Yahoo Debt	From 2013 10K	$1,228
- Yahoo Cash	From 2013 10K	$4,998
+ Yahoo equity options	From Yahoo valution	$388
Imputed value for Yahoo Parent operating assets		**-$5,776**
Intrinsic value (my estimate) of Yahoo! Parent		**$5,474**
Relative value (my estimate) of Yahoo! Parent		**$5,289**

Tata Motor's Cross Holdings



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

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

4. Brand name, great management, superb product …Don't double count!

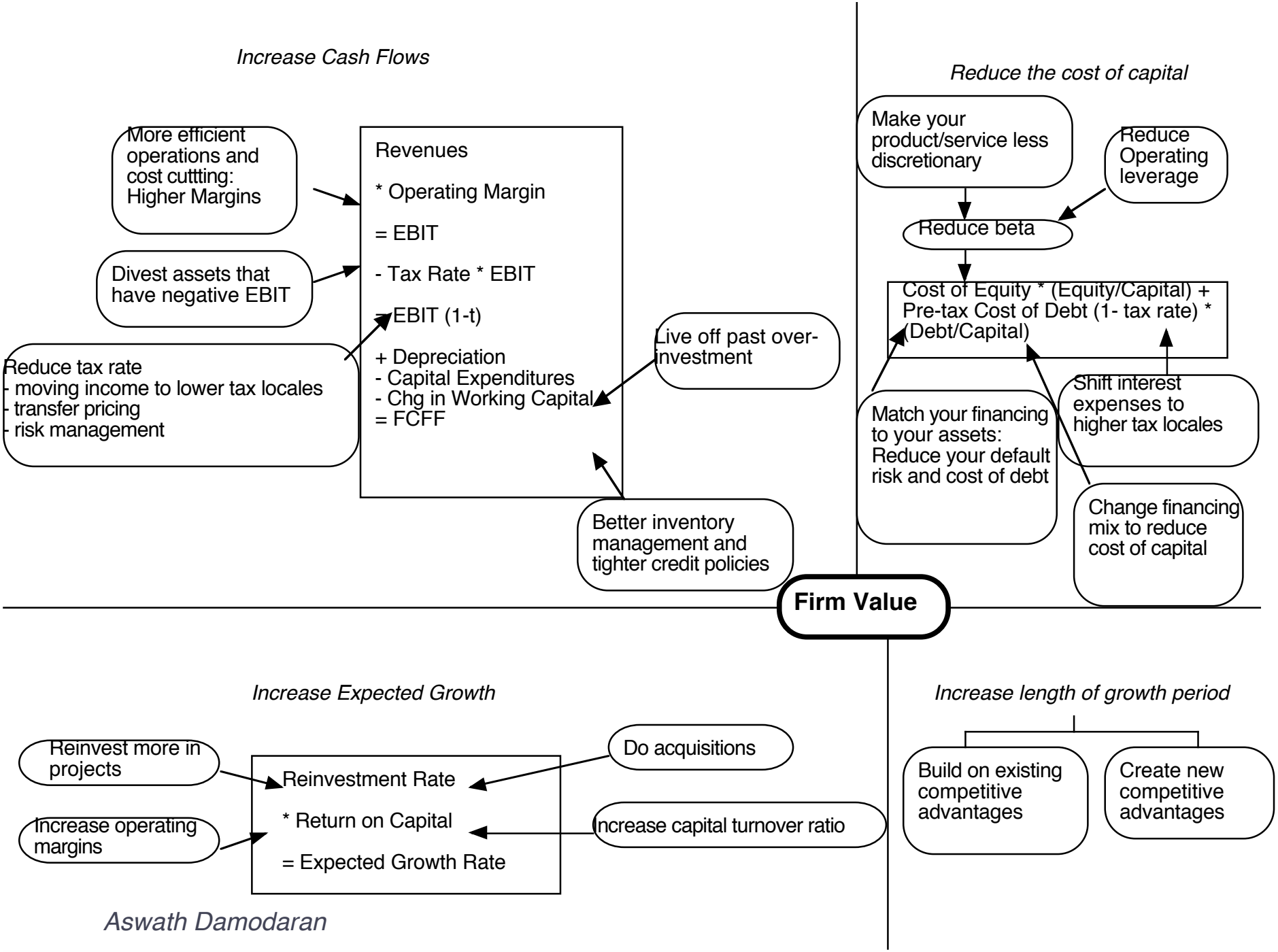
- There is often a temptation to add on premiums for intangibles. Here are a few examples.
  - Brand name
  - Great management
  - Loyal workforce
  - Technological prowess
- There are two potential dangers:
  - For some assets, the value may already be in your value and adding a premium will be double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

Valuing Brand Name

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

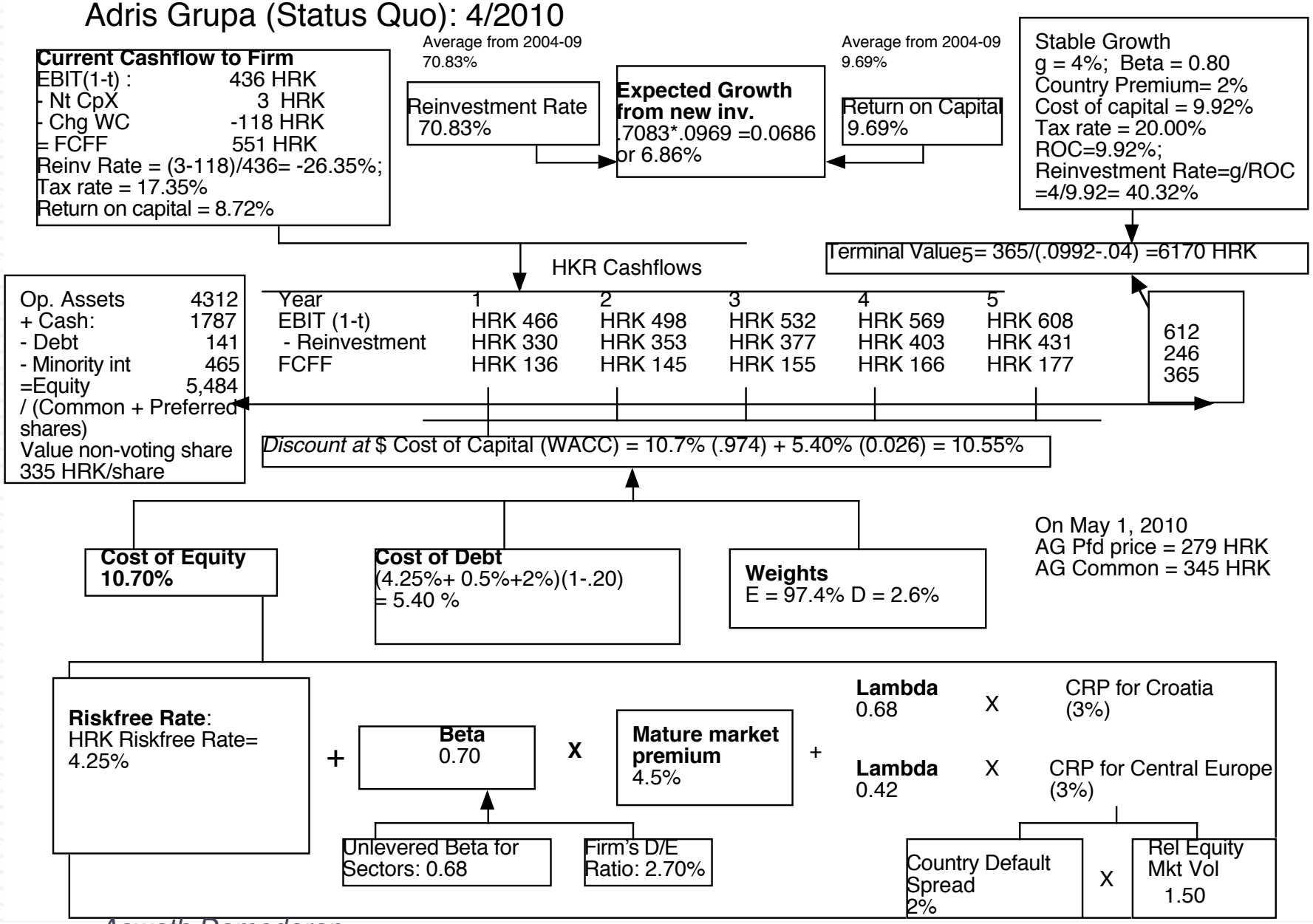
5. The Value of Control: It's not always worth 20%!!

- 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

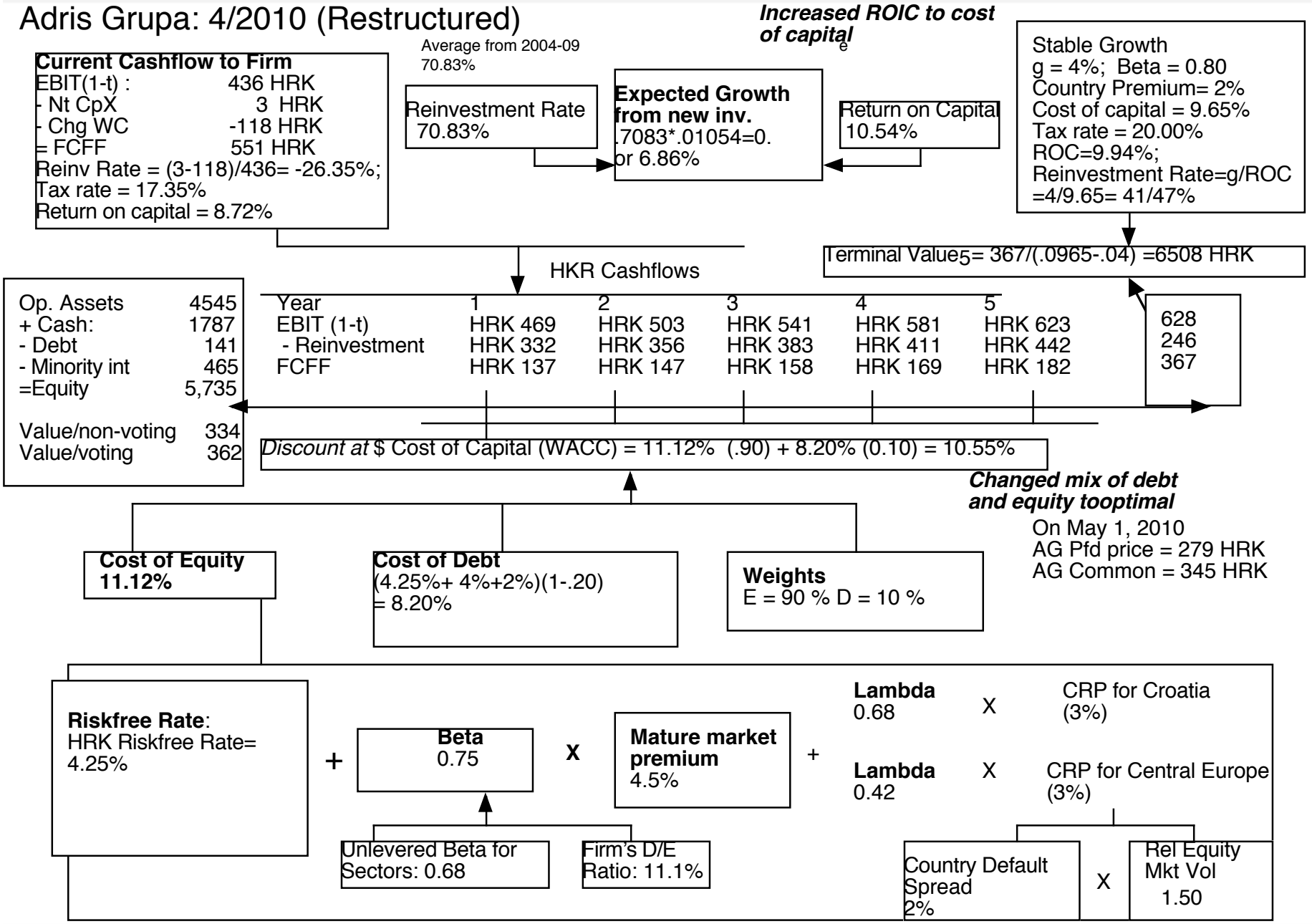


Aswath Damodaran

Adris Grupa (Status Quo): 4/2010



Adris Grupa: 4/2010 (Restructured)



Value of Control and the Value of Voting Rights

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

  Status Quo Value of Equity = 5,484 million HKR

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

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

  Value per voting share =334 HKR + 249/9.616 = 362 HKR

A closing thought…