Quiz 2: Valuation

Answer all questions and show necessary work. Please be brief. This is an open books, open notes exam.

1. You are valuing HikeMeet Inc., a social media site for people who like the outdoors (Ironic, right?). The company had revenues of $10 million in the year that just ended, but has projected revenues and pre-tax operating income (in millions) for the next three years:

	1	2	3
Expected revenues	$40	$75	$100
Pre-tax Operating Income	-$10	$10	$30

The company currently has a NOL (Net Operating Loss carried forward) of $20 million and a book value of equity of $15 million, no debt outstanding and a cash balance of $10 million. If the company maintains its current sales to invested capital ratio for the next 3 years and faces a tax rate of 25% (both marginal & effective), estimate the free cash flow to the firm each year for the next 3 years. (3 points)

2. Capri Inc. is a beverage company that holds a 75% stake in a TrueSmoke, a tobacco company. In Capri's consolidated financial statements, the company is expected to generate an after-tax operating income of $25 million next year, which it expects to grow 2% in perpetuity thereafter. The return on capital, from the consolidated statements, is 10% and the cost of capital for the consolidated company is 7%. You are also provided with the following additional information:
   - The net debt (debt minus cash) outstanding at the consolidated company is $100 million, of which $25 million is TrueSmoke's debt.
   - You don't have access to TrueSmoke's financials but the company is publicly traded and has a total market value of equity of $200 million.
   - Capri has 25 million shares outstanding and 10 million options (with an estimated value of $2.5/option).

   Estimate the value per share of equity in Capri. (4 points)

3. Domino Media is a highly levered telecomm company that is expected to generate \$30 million in free cash flow to the firm next year, growing at 3% a year in perpetuity with a cost of capital of 9%. The company has debt outstanding of \$350 million, a cash balance of \$50 million and 10 million shares outstanding. If the shares are currently trading at \$15/share and you believe that the market is correctly pricing the shares, given the risk that Domino Media will go bankrupt, estimate the probability of bankruptcy. (You can assume that the equity will be worth nothing in the event of bankruptcy). (3 points)