

Session 3a: Post class test solutions

1. **d. Estimate expected cash flows on the asset, and discount back at a risk-adjusted rate.** If you use “conservative” estimates, you will double count risk. Using PE or liquidation valuation is pricing, not intrinsic value.
2. **c. When valuing companies, he focused only on the earnings and cash flows that are highly predictable.** Effectively, he is using certainty equivalent cash flows and can use a riskfree rate.
3. **3. Discounting cash flows to the firm at the cost of equity, and netting out debt.** The cost of equity is higher than the cost of capital, and using a higher discount rate than you should be using will result in too low a value for the firm, and too low a value for equity (after you net out debt).
4. **Both d and e.** Companies that pay out more than they can afford will be overvalued with a dividend discount model and that that pay out less than they can afford will be undervalued.
5. **b. You are discounting cash flows that equity and debt investors collectively make at a rate that reflects what it costs you to raise money from both equity and debt.**