Applied Corporate Finance

Aswath Damodaran

www.damodaran.com

For material specific to this package, go to

www.stern.nyu.edu/~adamodar/New_Home_Page/triumdesc.html
What is corporate finance?

- Every decision that a business makes has financial implications, and any decision which affects the finances of a business is a corporate finance decision.
- Defined broadly, everything that a business does fits under the rubric of corporate finance.
First Principles

- Invest in projects that yield a return greater than the minimum acceptable hurdle rate.
  - The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners’ funds (equity) or borrowed money (debt)
  - Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.

- Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.

- If there are not enough investments that earn the hurdle rate, return the cash to stockholders.
  - The form of returns - dividends and stock buybacks - will depend upon the stockholders’ characteristics.

Objective: Maximize the Value of the Firm
In traditional corporate finance, the objective in decision making is to maximize the value of the firm.

A narrower objective is to maximize stockholder wealth. When the stock is traded and markets are viewed to be efficient, the objective is to maximize the stock price.
The Classical Objective Function

**STOCKHOLDERS**
- Maximize stockholder wealth
- Hire & fire managers
  - Board
  - Annual Meeting
- Lend Money

**BONDHOLDERS**
- Protect bondholder interests
- Reveal information honestly and on time

**MANAGERS**
- No Social Costs
- Costs can be traced to firm
- Markets are efficient and assess effect on value

**FINANCIAL MARKETS**

**SOCIETY**

Aswath Damodaran
What can go wrong?

STOCKHOLDERS
- Managers put their interests above stockholders
- Have little control over managers

BONDHOLDERS
- Bondholders can get ripped off
- Lend Money

Managers
- Delay bad news or provide misleading information
- Markets make mistakes and can overreact

FINANCIAL MARKETS
- Significant Social Costs
- Some costs cannot be traced to firm

SOCIETY

Aswath Damodaran
A dysfunctional board? The Disney Experience - 1997

Revest F. Bowers 1, 5
Head of School
Center for Early Education

Roy E. Disney 3
Vice Chairman
The Walt Disney Company

Michael D. Eisner 2
Chairman and Chief Executive Officer
The Walt Disney Company

Stanley R. Gold 4, 5
President and Chief Executive Officer
Shamarck Holdings, Inc.

Sanford M. Litvack
Senior Executive Vice President and Chief of Corporate Operations
The Walt Disney Company

Ignacio E. Lozano, Jr. 1, 2, 4
Editor-in-Chief, LA OPINION

George J. Mitchell 5
Special Counsel
Verner, Liipfert, Bernhard, McPherson and Head

Thomas S. Murphy
Former Chairman
Capital Cities/ABC, Inc.

Richard A. Nunis
Chairman
Walt Disney Attractions

Leo J. O’Donovan, S.J.
President
Georgetown University

Michael S. Ovitz 3
President
The Walt Disney Company

Sidney Poitier 2, 4
Chief Executive Officer
Venon-Cedric Productions

Irwin R. Russell 2, 4
Attorney at Law

Robert A. M. Stern
Senior Partner Productions

E. Cardon Walker 1
Former Chairman and Chief Executive Officer
The Walt Disney Company

Raymond L. Watson 1, 2, 3
Vice Chairman
The Irvine Company

Gary L. Wilson 6
Co-Chairman
Northwest Airlines Corporation

1 Member of Audit Review Committee
2 Member of Compensation Committee
3 Member of Executive Committee
4 Member of Executive Performance Plan Committee
5 Member of Nominating Committee
### The Tata Board...

<table>
<thead>
<tr>
<th>Name of member</th>
<th>Category</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ratan N Tata (Chairman)</td>
<td>Promoter, non-executive</td>
</tr>
<tr>
<td>R Gopalakrishnan (Vice-Chairman)</td>
<td>Promoter, non-executive</td>
</tr>
<tr>
<td>Keshub Mahindra</td>
<td>Independent, non-executive</td>
</tr>
<tr>
<td>D M Ghia</td>
<td>-do-</td>
</tr>
<tr>
<td>Nusli N Wadia</td>
<td>-do-</td>
</tr>
<tr>
<td>R C Khanna</td>
<td>-do-</td>
</tr>
<tr>
<td>Dr D V Kapur</td>
<td>-do-</td>
</tr>
<tr>
<td>U M Rao (ICICI Bank Nominee)</td>
<td>-do-</td>
</tr>
<tr>
<td>(Nomination withdrawn w.e.f. November 4, 2004)</td>
<td></td>
</tr>
<tr>
<td>Homi Khusrokhkan (Managing Director)</td>
<td>Executive</td>
</tr>
<tr>
<td>Dr T Mukherjee</td>
<td>Non-independent, non-executive</td>
</tr>
<tr>
<td>Dr Vijay L Kelkar (Additional Director w.e.f. October 19, 2004)</td>
<td>Independent, non-executive</td>
</tr>
</tbody>
</table>
Application Test: Who owns/runs your firm?

Look at: Bloomberg printout HDS for your firm

- Who are the top stockholders in your firm?
- What are the potential conflicts of interests that you see emerging from this stockholding structure?
- If you can, take a look at the board of directors for your firm and the corporate governance structure?

Outside stockholders
- Size of holding
- Active or Passive?
- Short or Long term?

Inside stockholders
- % of stock held
- Voting and non-voting shares
- Control structure

Control of the firm

Managers
- Length of tenure
- Links to insiders

Government

Employees

Lenders
Disney’s top stockholders in 2003

<table>
<thead>
<tr>
<th>Holder Name</th>
<th>Portfolio Name</th>
<th>Source</th>
<th>Held</th>
<th>Outstanding</th>
<th>Change Date</th>
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<td>13F</td>
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<td>2CITIGROUP INC</td>
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<td>FIDELITY MANAGEMENT</td>
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<td>STATE STREET</td>
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<td>54,635M</td>
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<td>SOUTHEASTERN ASST</td>
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<td>47,333M</td>
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<td>EAST FARM MUTUAL AU</td>
<td>EAST FARM MUTUAL AU</td>
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<td>1.700</td>
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<td>INMELON BANK N A</td>
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<tr>
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<td>T ROWE PRICE ASSOCIA</td>
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Sub-totals for current page: 599,159M, 23,340M
Tata Chemical’s top stockholders in 2007

<table>
<thead>
<tr>
<th>Holder name</th>
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<th>Percent</th>
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<td>12/06</td>
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<td>UBI MASTER EQUITY PL</td>
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<td>0$SUNDARAM NEWTON</td>
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<td>1$HSBC INVESTMENT</td>
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<td>0.702</td>
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<td>1$FRANKLIN TEMPLET</td>
<td>FRANKLIN TEMPLETON B</td>
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<tr>
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<td>07/07</td>
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<tr>
<td>1$UNIT TRUST</td>
<td>UBI DIVIDEND YIELD F</td>
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<td>0.495</td>
<td>07/07</td>
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<td>1$DSP MERRILL</td>
<td>DSP MERRILL LYNCH EQ</td>
<td>MF-IN</td>
<td>685,066</td>
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<td>-817</td>
<td>06/07</td>
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Sub-totals for current page: 129,394M 60.155
When traditional corporate financial theory breaks down, the solution is:

- To choose a different mechanism for corporate governance
- To choose a different objective for the firm.
- To maximize stock price, but reduce the potential for conflict and breakdown:
  - Making managers (decision makers) and employees into stockholders
  - By providing information honestly and promptly to financial markets
An Alternative Corporate Governance System

- Germany and Japan developed a different mechanism for corporate governance, based upon corporate cross holdings.
  - In Germany, the banks form the core of this system.
  - In Japan, it is the keiretsus.
  - Other Asian countries have modeled their system after Japan, with family companies forming the core of the new corporate families.
- At their best, the most efficient firms in the group work at bringing the less efficient firms up to par. They provide a corporate welfare system that makes for a more stable corporate structure.
- At their worst, the least efficient and poorly run firms in the group pull down the most efficient and best run firms down. The nature of the cross holdings makes it very difficult for outsiders (including investors in these firms) to figure out how well or badly the group is doing.
Choose a Different Objective Function

- Firms can always focus on a different objective function. Examples would include
  - maximizing earnings
  - maximizing revenues
  - maximizing firm size
  - maximizing market share
  - maximizing EVA
- The key thing to remember is that these are intermediate objective functions.
  - To the degree that they are correlated with the long term health and value of the company, they work well.
  - To the degree that they do not, the firm can end up with a disaster
Maximize stock prices, subject to...
The self-correcting objective

STOCKHOLDERS

1. More activist investors
2. Hostile takeovers

Managers of poorly run firms are put on notice.

BONDHOLDERS

1. Covenants
2. New Types

Protect themselves

Firms are punished for misleading markets

MANAGERS

Corporate Good Citizen Constraints

1. More laws
2. Investor/Customer Backlash

SOCIETY

FINANCIAL MARKETS

Investors and analysts become more skeptical
Picking the Right Projects: Investment Analysis

“Let us watch well our beginnings, and results will manage themselves”

Alexander Clark
First Principles

- Invest in projects that yield a return greater than the **minimum acceptable hurdle rate**.
  - The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners’ funds (equity) or borrowed money (debt)
  - Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.

- Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.

- If there are not enough investments that earn the hurdle rate, return the cash to stockholders.
  - The form of returns - dividends and stock buybacks - will depend upon the stockholders’ characteristics.
What is Risk?

- Risk, in traditional terms, is viewed as a ‘negative’. Webster’s dictionary, for instance, defines risk as “exposing to danger or hazard”. The Chinese symbols for risk, reproduced below, give a much better description of risk.

危機

- The first symbol is the symbol for “danger”, while the second is the symbol for “opportunity”, making risk a mix of danger and opportunity.
Aswath Damodaran

Risk and Return Models in Finance…

<table>
<thead>
<tr>
<th>Step 1: Defining Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>The risk in an investment can be measured by the variance in actual returns around an expected return</td>
</tr>
<tr>
<td>Riskless Investment</td>
</tr>
<tr>
<td>Low Risk Investment</td>
</tr>
<tr>
<td>High Risk Investment</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>E(R)</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Riskless Investment</th>
</tr>
</thead>
</table>

| Risk that is specific to investment (Firm Specific) |
| Can be diversified away in a diversified portfolio |
| 1. each investment is a small proportion of portfolio |
| 2. risk averages out across investments in portfolio |
| The marginal investor is assumed to hold a “diversified” portfolio. Thus, only market risk will be rewarded and priced. |

<table>
<thead>
<tr>
<th>Step 2: Differentiating between Rewarded and Unrewarded Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk that affects all investments (Market Risk)</td>
</tr>
<tr>
<td>Cannot be diversified away since most assets are affected by it.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>The CAPM</th>
</tr>
</thead>
<tbody>
<tr>
<td>If there is</td>
</tr>
<tr>
<td>1. no private information</td>
</tr>
<tr>
<td>2. no transactions cost</td>
</tr>
<tr>
<td>the optimal diversified portfolio includes every traded asset. Everyone will hold this market portfolio</td>
</tr>
<tr>
<td>Market Risk = Risk added by any investment to the market portfolio:</td>
</tr>
</tbody>
</table>

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<th>The APM</th>
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<tr>
<td>If there are no arbitrage opportunities then the market risk of any asset must be captured by betas relative to factors that affect all investments.</td>
</tr>
<tr>
<td>Market Risk = Risk exposures of any asset to market factors:</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Multi-Factor Models</th>
</tr>
</thead>
<tbody>
<tr>
<td>Since market risk affects most or all investments, it must come from macro economic factors.</td>
</tr>
<tr>
<td>Market Risk = Risk exposures of any asset to macro economic factors.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Proxy Models</th>
</tr>
</thead>
<tbody>
<tr>
<td>In an efficient market, differences in returns across long periods must be due to market risk differences. Looking for variables correlated with returns should then give us proxies for this risk.</td>
</tr>
<tr>
<td>Market Risk = Captured by the Proxy Variable(s)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Beta of asset relative to Market portfolio (from a regression)</th>
</tr>
</thead>
</table>

<table>
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<tr>
<th>Betas of asset relative to unspecified market factors (from a factor analysis)</th>
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<tr>
<th>Betas of assets relative to specified macro economic factors (from a regression)</th>
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</thead>
</table>

<table>
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<tr>
<th>Equation relating returns to proxy variables (from a regression)</th>
</tr>
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</table>
Limitations of the CAPM

1. The model makes unrealistic assumptions
2. The parameters of the model cannot be estimated precisely
   - Definition of a market index
   - Firm may have changed during the 'estimation' period'
3. The model does not work well
   - If the model is right, there should be
     a linear relationship between returns and betas
     the only variable that should explain returns is betas
   - The reality is that
     the relationship between betas and returns is weak
     Other variables (size, price/book value) seem to explain differences in returns better.
Application Test: Who is the marginal investor in your firm?

You can get information on insider and institutional holdings in your firm from: http://finance.yahoo.com/
Enter your company’s symbol and choose profile.

- Looking at the breakdown of stockholders in your firm, consider whether the marginal investor is
  a) An institutional investor
  b) An individual investor
  c) An insider
- Is this investor likely to be diversified?
Who are Disney’s marginal investors?
Tata Chemical’s top stockholders in 2007

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<td>1.323</td>
<td>-90,100</td>
<td>12/06</td>
</tr>
<tr>
<td>1MENTON ASSET TEMPLON INDIA EQUI MF- IN</td>
<td>2,611M</td>
<td>1.214</td>
<td></td>
<td></td>
<td>06/07</td>
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</tr>
<tr>
<td>1UNIT TRUST</td>
<td>UTI MASTER EQUITY PL MF-IN</td>
<td>2,000M</td>
<td>0.930</td>
<td></td>
<td>07/07</td>
<td></td>
</tr>
<tr>
<td>1SUNDARAM NEWTON</td>
<td>SUNDARAM BNP PARIBAS MF-IN</td>
<td>1,510M</td>
<td>0.702</td>
<td></td>
<td>06/07</td>
<td></td>
</tr>
<tr>
<td>1HSBC INVESTMENT</td>
<td>HSBC INDIAN EQUITY MF-LX</td>
<td>1,509M</td>
<td>0.702</td>
<td></td>
<td>01/07</td>
<td></td>
</tr>
<tr>
<td>1FRANKLIN TEMPLETON</td>
<td>FRANKLIN TEMPLETON B MF-LX</td>
<td>1,502M</td>
<td>0.698</td>
<td></td>
<td>03/07</td>
<td></td>
</tr>
<tr>
<td>1UNIT TRUST</td>
<td>UTI MASTERSHARE</td>
<td>1,452M</td>
<td>0.675</td>
<td></td>
<td>07/07</td>
<td></td>
</tr>
<tr>
<td>1UNIT TRUST</td>
<td>UTI DIVIDEND YIELD F MF-IN</td>
<td>1,064M</td>
<td>0.495</td>
<td></td>
<td>07/07</td>
<td></td>
</tr>
<tr>
<td>1DSP MERRILL</td>
<td>DSP MERRILL LYNCH EQ MF-IN</td>
<td>685,066</td>
<td>0.318</td>
<td>817</td>
<td>06/07</td>
<td></td>
</tr>
</tbody>
</table>

Sub-totals for current page: 129,394M 60.155
The capital asset pricing model yields the following expected return:

\[ \text{Expected Return} = \text{Riskfree Rate} + \beta \times (\text{Expected Return on the Market Portfolio} - \text{Riskfree Rate}) \]

To use the model we need three inputs:

(a) The current risk-free rate
(b) The expected market risk premium (the premium expected for investing in risky assets (market portfolio) over the riskless asset)
(c) The beta of the asset being analyzed.
On a riskfree asset, the actual return is equal to the expected return. Therefore, there is no variance around the expected return.

For an investment to be riskfree, i.e., to have an actual return be equal to the expected return, two conditions have to be met –

- There has to be no default risk, which generally implies that the security has to be issued by the government. Note, however, that not all governments can be viewed as default free.
- There can be no uncertainty about reinvestment rates, which implies that it is a zero coupon security with the same maturity as the cash flow being analyzed.
A Purist view of riskfree rates…

- The riskfree rate is the rate on a zero coupon government bond matching the time horizon of the cash flow being analyzed.
- Theoretically, this translates into using different riskfree rates for each cash flow - the 1 year zero coupon rate for the cash flow in year 1, the 2-year zero coupon rate for the cash flow in year 2 ...
A practical approach to Riskfree Rates

- Using a long term government rate (even on a coupon bond) as the riskfree rate on all of the cash flows in a long term analysis will yield a close approximation of the true value.
- For short term analysis, it is entirely appropriate to use a short term government security rate as the riskfree rate.
- The riskfree rate that you use in an analysis should be in the same currency that your cashflows are estimated in. In other words, if your cashflows are in U.S. dollars, your riskfree rate has to be in U.S. dollars as well. If your analysis is in Indian Rupees, your riskfree rate should also be in rupees.
Riskfree Rates

- T Bond rate = 4.55%
- German Eu Rate(07) = 4.30%
- Greek Eu Rate(07) = 4.30%
- UST $: 2003
- UST $: 2007
- Currency & Security

- Indian Govt 10 yr Rs rate = 7.91%
- India country rating = Baa2
- Default spread for rating = 1.15%
- Indian Rupee: 2007
- 6.76%
- 0.26%
- 4.30%
- 4.30%
- 0%
- 4%
- 5%
- 6%
- 7%
- 8%

Aswath Damodaran 28
Measurement of the risk premium

- The risk premium is the premium that investors demand for investing in an average risk investment, relative to the riskfree rate.
- As a general proposition, this premium should be
  - increase with the riskiness of the “average” risk investment
  - increase with the risk aversion of the investors in that market
What is your risk premium?

Assume that stocks are the only risky assets and that you are offered two investment options:

- a riskless investment (say a Government Security), on which you can make 5%
- a mutual fund of all stocks, on which the returns are uncertain

How much of an expected return would you demand to shift your money from the riskless asset to the mutual fund?

a) Less than 5%
b) Between 5 - 7%
c) Between 7 - 9%
d) Between 9 - 11%
e) Between 11- 13%
f) More than 13%

Check your premium against the survey premium on my web site.
Risk Premiums do change..

Go back to the previous example. Assume now that you are making the same choice but that you are making it in the aftermath of a stock market crash (it has dropped 25% in the last month). Would you change your answer?

a) I would demand a larger premium
b) I would demand a smaller premium
c) I would demand the same premium
Estimating Risk Premiums in Practice

- **Survey investors** on their desired risk premiums and use the average premium from these surveys.
- Assume that the actual premium delivered over long time periods is equal to the expected premium - i.e., **use historical data**
- Estimate the **implied premium** in today’s asset prices.
The Survey Approach

- Surveying all investors in a market place is impractical.
- However, you can survey a few investors (especially the larger investors) and use these results. In practice, this translates into surveys of money managers’ expectations of expected returns on stocks over the next year.
- The limitations of this approach are:
  - there are no constraints on reasonability (the survey could produce negative risk premiums or risk premiums of 50%)
  - they are extremely volatile
  - they tend to be short term; even the longest surveys do not go beyond one year
The Historical Premium Approach

- This is the default approach used by most to arrive at the premium to use in the model.
- In most cases, this approach does the following:
  - it defines a time period for the estimation (1926-Present, 1962-Present,...)
  - it calculates average returns on a stock index during the period
    - it calculates average returns on a riskless security over the period
      - it calculates the difference between the two
      - and uses it as a premium looking forward
- The limitations of this approach are:
  - it assumes that the risk aversion of investors has not changed in a systematic way across time. (The risk aversion may change from year to year, but it reverts back to historical averages)
  - it assumes that the riskiness of the “risky” portfolio (stock index) has not changed in a systematic way across time.
### Historical Average Premiums for the United States

<table>
<thead>
<tr>
<th>Historical Period</th>
<th>Arithmetic Average</th>
<th>Geometric Average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Stocks -</td>
<td>T.Bills</td>
</tr>
<tr>
<td>1928-2006</td>
<td>7.87%</td>
<td>6.57%</td>
</tr>
<tr>
<td>1966-2006</td>
<td>5.57%</td>
<td>4.13%</td>
</tr>
<tr>
<td>1996-2006</td>
<td>6.91%</td>
<td>5.14%</td>
</tr>
</tbody>
</table>

**What is the right premium?**

- Go back as far as you can. Otherwise, the standard error in the estimate will be large.

\[
\text{Std Error in estimate} = \frac{\text{Annualized Std deviation in Stock prices}}{\sqrt{\text{Number of years of historical data}}}
\]

- Be consistent in your use of a riskfree rate.

- Use arithmetic premiums for one-year estimates of costs of equity and geometric premiums for estimates of long term costs of equity.

**Data Source:** Check out the returns by year and estimate your own historical premiums by going to updated data on my web site.
What about historical premiums for other markets?

- Historical data for markets outside the United States is available for much shorter time periods. The problem is even greater in emerging markets.
- The historical premiums that emerge from this data reflects this and there is much greater error associated with the estimates of the premiums.
One solution: Look at a country’s bond rating and default spreads as a start

- Ratings agencies such as S&P and Moody’s assign ratings to countries that reflect their assessment of the default risk of these countries. These ratings reflect the political and economic stability of these countries and thus provide a useful measure of country risk. In September 2007, for instance, India had a country rating of Baa2.

- If a country issues bonds denominated in a different currency (say dollars or euros), you can also see how the bond market views the risk in that country. India does not have any such bonds but the typical normalized default spread for countries with the same rating as India is 1.15%.

- Many analysts add this default spread to the US risk premium to come up with a risk premium for a country. Using this approach would yield a risk premium of 6.06% for India, if we use 4.91% as the premium for the US.
Beyond the default spread

Country ratings measure default risk. While default risk premiums and equity risk premiums are highly correlated, one would expect equity spreads to be higher than debt spreads. If we can compute how much more risky the equity market is, relative to the bond market, we could use this information. For example,

- Standard Deviation in Sensex (Equity) = 24%
- Standard Deviation in Indian government bond = 16%
- Default spread based upon rating= 1.15%
- Country Risk Premium for India = 1.15% (24%/16%) = 1.72%

Note that this is on top of the premium you estimate for a mature market. Thus, if you assume that the risk premium in the US is 4.91%, the risk premium for India would be 6.63%.
An alternate view of ERP: Watch what I pay, not what I say.

You can back out an equity risk premium from stock prices:

<table>
<thead>
<tr>
<th>Year</th>
<th>Dividends</th>
<th>Buybacks</th>
<th>Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$36.27</td>
<td>$32.75</td>
<td>2.62%</td>
</tr>
<tr>
<td>2002</td>
<td>$39.22</td>
<td>$30.62</td>
<td>3.39%</td>
</tr>
<tr>
<td>2003</td>
<td>$46.76</td>
<td>$38.53</td>
<td>2.84%</td>
</tr>
<tr>
<td>2004</td>
<td>$49.68</td>
<td>$66.42</td>
<td>3.35%</td>
</tr>
<tr>
<td>2005</td>
<td>$54.83</td>
<td>$104.28</td>
<td>4.90%</td>
</tr>
<tr>
<td>2006</td>
<td>$54.78</td>
<td>$109.81</td>
<td>5.39%</td>
</tr>
</tbody>
</table>

Average yield between 2001-2006 = 3.75%

Between 2001 and 2006, dividends and stock buybacks averaged 3.75% of the index each year.

Analysts expect earnings (53.16) to grow 6% a year for the next 5 years.

After year 5, we will assume that earnings on the index will grow at 4.7%, the same rate as the entire economy.

Jan 1, 2007
S&P 500 is at 1418.3
3.75% of 1418.3 = 53.16
Solving for the implied premium…

- If we know what investors paid for equities at the beginning of 2007 and we can estimate the expected cash flows from equities, we can solve for the rate of return that they expect to make (IRR):

\[
1418.3 = \frac{56.35}{(1 + r)} + \frac{59.73}{(1 + r)^2} + \frac{63.32}{(1 + r)^3} + \frac{67.12}{(1 + r)^4} + \frac{71.14}{(1 + r)^5} + \frac{71.14(1.047)}{(r - .047)(1 + r)^5}
\]

- Expected Return on Stocks = 8.86%
- Implied Equity Risk Premium = Expected Return on Stocks - T.Bond Rate = 8.86% - 4.70% = 4.16%
Implied Premiums in the US

![Graph showing implied premiums for US equity market over years 1960 to 2010. The graph illustrates the fluctuation of implied premiums with a peak around 1990 and a general downward trend thereafter.]
Implied premium for the Sensex (September 2007)

- Inputs for the computation
  - Sensex on 9/5/07 = 15446
  - Dividend yield on index = 3.05%
  - Expected growth rate - next 5 years = 14%
  - Growth rate beyond year 5 = 6.76% (set equal to riskfree rate)

- Solving for the expected return:

\[
15446 = \frac{537.06}{(1 + r)} + \frac{612.25}{(1 + r)^2} + \frac{697.86}{(1 + r)^3} + \frac{795.67}{(1 + r)^4} + \frac{907.07}{(1 + r)^5} + \frac{907.07(1.0676)}{(r -.0676)(1 + r)^5}
\]

- Expected return on stocks = 11.18%
- Implied equity risk premium for India = 11.18% - 6.76% = 4.42%
Application Test: A Market Risk Premium for the US

Based upon our discussion of historical risk premiums so far, the risk premium looking forward for the US should be:

a) About 7.9%, which is what the arithmetic average premium has been since 1928, for stocks over T.Bills
b) About 4.9%, which is the geometric average premium since 1928, for stocks over T.Bonds
c) About 4%, which is the implied premium in the US market today

The risk premium that you would use for India will be

• The same as the risk premium for the US
• Approximately 1.15% higher than the US premium
• About 1.72% higher than the US premium
• The implied risk premium for the Sensex (4.42%)
Estimating Beta

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

  $$R_j = a + b R_m$$

  - where $a$ is the intercept and $b$ is the slope of the regression.

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

The intercept of the regression provides a simple measure of performance during the period of the regression, relative to the capital asset pricing model.

\[ R_j = R_f + b (R_m - R_f) \]

\[ = R_f (1-b) + b R_m \]

............ Capital Asset Pricing Model

\[ R_j = a + b R_m \]

............ Regression Equation

If

\[ a > R_f (1-b) \quad \text{Stock did better than expected during regression period} \]

\[ a = R_f (1-b) \quad \text{Stock did as well as expected during regression period} \]

\[ a < R_f (1-b) \quad \text{Stock did worse than expected during regression period} \]

The difference between the intercept and \( R_f (1-b) \) is Jensen's alpha. If it is positive, your stock did perform better than expected during the period of the regression.
Breaking down risk..

- The $R^2$ of the regression provides an estimate of the proportion of the risk (variance) of a firm that can be attributed to market risk;
- The balance $(1 - R^2)$ can be attributed to firm specific risk.
Setting up for the Estimation

- Decide on an estimation period
  - Services use periods ranging from 2 to 5 years for the regression
  - Longer estimation period provides more data, but firms change.
  - Shorter periods can be affected more easily by significant firm-specific event that occurred during the period (Example: ITT for 1995-1997)

- Decide on a return interval - daily, weekly, monthly
  - Shorter intervals yield more observations, but suffer from more noise.
  - Noise is created by stocks not trading and biases all betas towards one.

- Estimate returns (including dividends) on stock
  - Return = (Price\textsubscript{End} - Price\textsubscript{Beginning} + Dividends\textsubscript{Period})/ Price\textsubscript{Beginning}
  - Included dividends only in ex-dividend month

- Choose a market index, and estimate returns (inclusive of dividends) on the index for each interval for the period.
Choosing the Parameters: Disney

- Period used: 5 years
- Return Interval = Monthly
- Market Index: S&P 500 Index.

For instance, to calculate returns on Disney in December 1999,
- Price for Disney at end of November 1999 = $ 27.88
- Price for Disney at end of December 1999 = $ 29.25
- Dividends during month = $0.21 (It was an ex-dividend month)
- Return =($29.25 - $27.88 + $ 0.21)/$27.88= 5.69%

To estimate returns on the index in the same month
- Index level (including dividends) at end of November 1999 = 1388.91
- Index level (including dividends) at end of December 1999 = 1469.25
- Return =($1469.25 - 1388.91)/ 1388.91 = 5.78%
Disney’s Historical Beta

Figure 4.3: Disney versus S&P 500: 1999 - 2003
Using monthly returns from 1999 to 2003, we ran a regression of returns on Disney stock against the S&P 500. The output is below:

\[ \text{Returns}_{\text{Disney}} = 0.0467\% + 1.01 \times \text{Returns}_{S \& P \ 500} \quad (\text{R squared}= 29\%) \]

\[ (0.20) \]
Analyzing Disney’s Performance

- **Intercept = 0.0467%**
  - This is an intercept based on monthly returns. Thus, it has to be compared to a monthly riskfree rate.
  - Between 1999 and 2003,
    - Monthly Riskfree Rate = 0.313% (based upon average T.Bill rate: 99-03)
    - Riskfree Rate (1-Beta) = 0.313% (1-1.01) = -.0032%

- The Comparison is then between
  
<table>
<thead>
<tr>
<th>Intercept</th>
<th>versus</th>
<th>Riskfree Rate (1 - Beta)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.0467%</td>
<td></td>
<td>0.313%(1-1.01)=-0.0032%</td>
</tr>
</tbody>
</table>

- Jensen’s Alpha = 0.0467% -(-0.0032%) = 0.05%

- Disney did 0.05% better than expected, per month, between 1999 and 2003.
  - Annualized, Disney’s annual excess return = (1.0005)\(^{12}\)-1= 0.60%
Estimating Disney’s Beta

- Slope of the Regression of 1.01 is the beta

- Regression parameters are always estimated with error. The error is captured in the standard error of the beta estimate, which in the case of Disney is 0.20.

- Assume that I asked you what Disney’s true beta is, after this regression.
  - What is your best point estimate?
  - What range would you give me, with 67% confidence?
  - What range would you give me, with 95% confidence?
Breaking down Disney’s Risk

- R Squared = 29%
- This implies that
  - 29% of the risk at Disney comes from market sources
  - 71%, therefore, comes from firm-specific sources
- The firm-specific risk is diversifiable and will not be rewarded. Beta captures the market risk in this investment and should be rewarded by a higher expected return.
Beta Estimation: Using a Service (Bloomberg)

HISTORICAL BETA

Number of points may be insufficient for an accurate beta.

THE WALT DISNEY CO.

S&P 500 INDEX

*Identifies latest observation

Y = 1.01 X - 0.03

ADJ BETA = (0.57) * RAW BETA + (0.33) * 1.0

ADJ BETA = (0.57) * RAW BETA + (0.33) * 1.0
Estimating Expected Returns for Disney in September 2004

- Inputs to the expected return calculation
  - Disney’s Beta = 1.01
  - Riskfree Rate = 4.00% (U.S. ten-year T.Bond rate)
  - Risk Premium = 4.82% (Approximate historical premium: 1928-2003)
- Expected Return = Riskfree Rate + Beta (Risk Premium)
  = 4.00% + 1.01(4.82%) = 8.87%
Use to a Potential Investor in Disney

As a potential investor in Disney, what does this expected return of 8.87% tell you?

a) This is the return that I can expect to make in the long term on Disney, if the stock is correctly priced and the CAPM is the right model for risk,

b) This is the return that I need to make on Disney in the long term to break even on my investment in the stock

Both

Assume now that you are an active investor and that your research suggests that an investment in Disney will yield 12.5% a year for the next 5 years. Based upon the expected return of 8.87%, you would

a) Buy the stock

b) Sell the stock
How managers use this expected return

- Managers at Disney
  - need to make at least 8.87% as a return for their equity investors to break even.
  - this is the hurdle rate for projects, when the investment is analyzed from an equity standpoint
- In other words, Disney’s cost of equity is 8.87%.
- What is the cost of not delivering this cost of equity?
Regression Diagnostics for Tata Chemicals

Jensen’s $\alpha$  
= $-0.22\% - 6.00\%/52 \times (1-0.88) = -0.23\%$  
Annualized = $(1-0.0023)^{52} - 1 = -11.46\%$

Expected Return  
= Riskfree Rate + Beta * Risk premium  
= $6.76\% + 0.88 \times (4.91\% + 1.72\%) = 12.59\%$

Beta = 0.88  
67% range  
0.77 - 0.99

37% market risk  
63% firm specific
Application Test: Analyzing the Risk Regression

Using your Bloomberg risk and return print out, answer the following questions:

- How well or badly did your stock do, relative to the market, during the period of the regression? (You can assume an annualized riskfree rate of 6% during the regression period for India)

  \[ \text{Intercept} - (6\%/52) (1 - \beta) = \text{Jensen’s Alpha} \]

  Your regressions are all weekly regressions.

- What proportion of the risk in your stock is attributable to the market? What proportion is firm-specific?

- What is the historical estimate of beta for your stock? What is the range on this estimate with 67% probability? With 95% probability?

- Based upon this beta, what is your estimate of the required return on this stock?

  \[ \text{Riskless Rate} + \beta \times \text{Risk Premium} \]
A Quick Test

You are advising a very risky software firm on the right cost of equity to use in project analysis. You estimate a beta of 3.0 for the firm and come up with a cost of equity of 27.5%. The CFO of the firm is concerned about the high cost of equity and wants to know whether there is anything he can do to lower his beta.

How do you bring your beta down?

Should you focus your attention on bringing your beta down?
   a) Yes
   b) No
## Beta: Exploring Fundamentals

<table>
<thead>
<tr>
<th>Beta Value</th>
<th>Company</th>
<th>Beta</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beta &gt; 1</td>
<td>Real Networks</td>
<td>3.24</td>
</tr>
<tr>
<td></td>
<td>Qwest Communications</td>
<td>2.60</td>
</tr>
<tr>
<td>Beta = 1</td>
<td>Microsoft</td>
<td>1.25</td>
</tr>
<tr>
<td></td>
<td>Enron</td>
<td>0.95</td>
</tr>
<tr>
<td></td>
<td>General Electric</td>
<td>1.10</td>
</tr>
<tr>
<td>Beta &lt; 1</td>
<td>Philip Morris</td>
<td>0.65</td>
</tr>
<tr>
<td></td>
<td>Exxon Mobil</td>
<td>0.40</td>
</tr>
<tr>
<td>Beta = 0</td>
<td>Harmony Gold Mining</td>
<td>-0.10</td>
</tr>
</tbody>
</table>
Determinant 1: Product Type

**Industry Effects:** The beta value for a firm depends upon the sensitivity of the demand for its products and services and of its costs to macroeconomic factors that affect the overall market.

- **Cyclical companies** have higher betas than non-cyclical firms
- Firms which sell more discretionary products will have higher betas than firms that sell less discretionary products
Determinant 2: Operating Leverage Effects

- Operating leverage refers to the proportion of the total costs of the firm that are fixed.
- Other things remaining equal, higher operating leverage results in greater earnings variability which in turn results in higher betas.
Measures of Operating Leverage

Fixed Costs Measure = Fixed Costs / Variable Costs
- This measures the relationship between fixed and variable costs. The higher the proportion, the higher the operating leverage.

EBIT Variability Measure = % Change in EBIT / % Change in Revenues
- This measures how quickly the earnings before interest and taxes changes as revenue changes. The higher this number, the greater the operating leverage.
### Disney’s Operating Leverage: 1987-2003

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Sales</th>
<th>% Change in Sales</th>
<th>EBIT</th>
<th>% Change in EBIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>2877</td>
<td></td>
<td>756</td>
<td></td>
</tr>
<tr>
<td>1988</td>
<td>3438</td>
<td>19.50%</td>
<td>848</td>
<td>12.17%</td>
</tr>
<tr>
<td>1989</td>
<td>4594</td>
<td>33.62%</td>
<td>1177</td>
<td>38.80%</td>
</tr>
<tr>
<td>1990</td>
<td>5844</td>
<td>27.21%</td>
<td>1368</td>
<td>16.23%</td>
</tr>
<tr>
<td>1991</td>
<td>6182</td>
<td>5.78%</td>
<td>1124</td>
<td>-17.84%</td>
</tr>
<tr>
<td>1992</td>
<td>7504</td>
<td>21.38%</td>
<td>1287</td>
<td>14.50%</td>
</tr>
<tr>
<td>1993</td>
<td>8529</td>
<td>13.66%</td>
<td>1560</td>
<td>21.21%</td>
</tr>
<tr>
<td>1994</td>
<td>10055</td>
<td>17.89%</td>
<td>1804</td>
<td>15.64%</td>
</tr>
<tr>
<td>1995</td>
<td>12112</td>
<td>20.46%</td>
<td>2262</td>
<td>25.39%</td>
</tr>
<tr>
<td>1996</td>
<td>18739</td>
<td>54.71%</td>
<td>3024</td>
<td>33.69%</td>
</tr>
<tr>
<td>1997</td>
<td>22473</td>
<td>19.93%</td>
<td>3945</td>
<td>30.46%</td>
</tr>
<tr>
<td>1998</td>
<td>22976</td>
<td>2.24%</td>
<td>3843</td>
<td>-2.59%</td>
</tr>
<tr>
<td>1999</td>
<td>23435</td>
<td>2.00%</td>
<td>3580</td>
<td>-6.84%</td>
</tr>
<tr>
<td>2000</td>
<td>25418</td>
<td>8.46%</td>
<td>2525</td>
<td>-29.47%</td>
</tr>
<tr>
<td>2001</td>
<td>25172</td>
<td>-0.97%</td>
<td>2832</td>
<td>12.16%</td>
</tr>
<tr>
<td>2002</td>
<td>25329</td>
<td>0.62%</td>
<td>2384</td>
<td>-15.82%</td>
</tr>
<tr>
<td>2003</td>
<td>27061</td>
<td>6.84%</td>
<td>2713</td>
<td>13.80%</td>
</tr>
<tr>
<td>1987-2003</td>
<td></td>
<td>15.83%</td>
<td></td>
<td>10.09%</td>
</tr>
<tr>
<td>1996-2003</td>
<td></td>
<td>11.73%</td>
<td></td>
<td>4.42%</td>
</tr>
</tbody>
</table>

DOL = 10.09%/15.83% = 0.64
Determinant 3: Financial Leverage

- As firms borrow, they create fixed costs (interest payments) that make their earnings to equity investors more volatile.
- This increased earnings volatility which increases the equity beta
Equity Betas and Leverage

- The beta of equity alone can be written as a function of the unlevered beta and the debt-equity ratio

\[ \beta_L = \beta_u (1+ ((1-t)D/E)) \]

where

- \( \beta_L \) = Levered or Equity Beta
- \( \beta_u \) = Unlevered Beta
- \( t \) = Corporate marginal tax rate
- \( D \) = Market Value of Debt
- \( E \) = Market Value of Equity
The regression beta for Disney is 1.01. This beta is a levered beta (because it is based on stock prices, which reflect leverage) and the leverage implicit in the beta estimate is the average market debt equity ratio during the period of the regression (1999 to 2003).

The average debt equity ratio during this period was 27.5%.

The unlevered beta for Disney can then be estimated (using a marginal tax rate of 37.3%)

\[
\text{Unlevered Beta} = \frac{\text{Current Beta}}{1 + (1 - \text{tax rate}) \times (\text{Average Debt/Equity})}
\]

\[
= \frac{1.01}{1 + (1 - 0.373) \times (0.275)} = 0.8615
\]
# Disney: Beta and Leverage

<table>
<thead>
<tr>
<th>Debt to Capital</th>
<th>Debt/Equity Ratio</th>
<th>Beta</th>
<th>Effect of Leverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.00%</td>
<td>0.00%</td>
<td>0.86</td>
<td>0.00</td>
</tr>
<tr>
<td>10.00%</td>
<td>11.11%</td>
<td>0.92</td>
<td>0.06</td>
</tr>
<tr>
<td>20.00%</td>
<td>25.00%</td>
<td>1.00</td>
<td>0.14</td>
</tr>
<tr>
<td>30.00%</td>
<td>42.86%</td>
<td>1.09</td>
<td>0.23</td>
</tr>
<tr>
<td>40.00%</td>
<td>66.67%</td>
<td>1.22</td>
<td>0.36</td>
</tr>
<tr>
<td>50.00%</td>
<td>100.00%</td>
<td>1.40</td>
<td>0.54</td>
</tr>
<tr>
<td>60.00%</td>
<td>150.00%</td>
<td>1.67</td>
<td>0.81</td>
</tr>
<tr>
<td>70.00%</td>
<td>233.33%</td>
<td>2.12</td>
<td>1.26</td>
</tr>
<tr>
<td>80.00%</td>
<td>400.00%</td>
<td>3.02</td>
<td>2.16</td>
</tr>
<tr>
<td>90.00%</td>
<td>900.00%</td>
<td>5.72</td>
<td>4.86</td>
</tr>
</tbody>
</table>
The beta of a portfolio is always the market-value weighted average of the betas of the individual investments in that portfolio.

Thus,

- The beta of a mutual fund is the weighted average of the betas of the stocks and other investments in that portfolio.
- The beta of a firm after a merger is the market-value weighted average of the betas of the companies involved in the merger.
- The beta of a firm involved in multiple businesses should be a weighted average of the betas of the individual business, with the weights reflecting the value contributed by each business.
Bottom-up versus Top-down Beta

- The top-down beta for a firm comes from a regression.
- The bottom up beta can be estimated by doing the following:
  - Find out the businesses that a firm operates in.
  - Find the unlevered betas of other firms in these businesses.
  - Take a weighted (by sales or operating income) average of these unlevered betas.
  - Lever up using the firm’s debt/equity ratio.
- The bottom up beta will give you a better estimate of the true beta when:
  - the standard error of the beta from the regression is high (and) the beta for a firm is very different from the average for the business.
  - the firm has reorganized or restructured itself substantially during the period of the regression.
  - when a firm is not traded.
## Disney’s business breakdown

<table>
<thead>
<tr>
<th>Business</th>
<th>Comparable firms</th>
<th>Number of firm</th>
<th>Average levered beta</th>
<th>Median D/E</th>
<th>Unlevered beta</th>
<th>Cash/Firm Value</th>
<th>Unlevered beta corrected for cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Media Networks</td>
<td>Radio and TV broadcasting companies</td>
<td>24</td>
<td>1.22</td>
<td>20.45%</td>
<td>1.0768</td>
<td>0.75%</td>
<td>1.0850</td>
</tr>
<tr>
<td>Parks and Resorts</td>
<td>Theme park &amp; Entertainment firms</td>
<td>9</td>
<td>1.58</td>
<td>120.76%</td>
<td>0.8853</td>
<td>2.77%</td>
<td>0.9105</td>
</tr>
<tr>
<td>Studio Entertainment</td>
<td>Movie companies</td>
<td>11</td>
<td>1.16</td>
<td>27.96%</td>
<td>0.9824</td>
<td>14.08%</td>
<td>1.1435</td>
</tr>
<tr>
<td>Consumer Products</td>
<td>Toy and apparel retailers; Entertainment software</td>
<td>77</td>
<td>1.06</td>
<td>9.18%</td>
<td>0.9981</td>
<td>12.08%</td>
<td>1.1353</td>
</tr>
</tbody>
</table>
## Disney’s bottom up beta

The beta of a company can be calculated using the formula:

$$\text{EV/Sales} = \frac{\text{(Market Value of Equity + Debt - Cash)}}{\text{Sales}}$$

This formula is derived from comparable firms. The table below shows the calculation for Disney's various businesses:

<table>
<thead>
<tr>
<th>Business</th>
<th>Disney’s Revenues</th>
<th>EV/Sales</th>
<th>Estimated Value</th>
<th>Firm Value Proportion</th>
<th>Unlevered beta</th>
</tr>
</thead>
<tbody>
<tr>
<td>Media Networks</td>
<td>$10,941</td>
<td>3.41</td>
<td>$37,278.62</td>
<td>49.25%</td>
<td>1.0850</td>
</tr>
<tr>
<td>Parks and Resorts</td>
<td>$6,412</td>
<td>2.37</td>
<td>$15,208.37</td>
<td>20.09%</td>
<td>0.9105</td>
</tr>
<tr>
<td>Studio Entertainment</td>
<td>$7,364</td>
<td>2.63</td>
<td>$19,390.14</td>
<td>25.62%</td>
<td>1.1435</td>
</tr>
<tr>
<td>Consumer Products</td>
<td>$2,344</td>
<td>1.63</td>
<td>$3,814.38</td>
<td>5.04%</td>
<td>1.1353</td>
</tr>
<tr>
<td>Disney</td>
<td>$27,061</td>
<td></td>
<td>$75,691.51</td>
<td>100.00%</td>
<td>1.0674</td>
</tr>
</tbody>
</table>
Disney’s Cost of Equity

<table>
<thead>
<tr>
<th>Business</th>
<th>Unlevered Beta</th>
<th>D/E Ratio</th>
<th>Levered Beta</th>
<th>Cost of Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Media Networks</td>
<td>1.0850</td>
<td>26.62%</td>
<td>1.2661</td>
<td>10.10%</td>
</tr>
<tr>
<td>Parks and Resorts</td>
<td>0.9105</td>
<td>26.62%</td>
<td>1.0625</td>
<td>9.12%</td>
</tr>
<tr>
<td>Studio Entertainment</td>
<td>1.1435</td>
<td>26.62%</td>
<td>1.3344</td>
<td>10.43%</td>
</tr>
<tr>
<td>Consumer Products</td>
<td>1.1353</td>
<td>26.62%</td>
<td>1.3248</td>
<td>10.39%</td>
</tr>
<tr>
<td>Disney</td>
<td>1.0674</td>
<td>26.62%</td>
<td>1.2456</td>
<td>10.00%</td>
</tr>
</tbody>
</table>
Discussion Issue

If you were the chief financial officer of Disney, what cost of equity would you use in capital budgeting in the different divisions?

a) The cost of equity for Disney as a company
b) The cost of equity for each of Disney’s divisions?
The bottom up beta for Tata Chemicals

- We estimated betas for chemical firms using three categorizations:

<table>
<thead>
<tr>
<th>Grouping</th>
<th>Average Beta</th>
<th>Unlevered beta</th>
<th>Cash-corrected Beta</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emerg Mkts (93)</td>
<td>1.14</td>
<td>0.80</td>
<td>0.88</td>
</tr>
<tr>
<td>US (36)</td>
<td>0.97</td>
<td>0.86</td>
<td>0.90</td>
</tr>
<tr>
<td>Global (152)</td>
<td>1.05</td>
<td>0.84</td>
<td>0.89</td>
</tr>
</tbody>
</table>

- Using the global average cash-corrected beta for chemical companies as the bottom-up unlevered beta for Tata Chemicals, and the current market debt to equity ratio for the company of 19.17%, we estimated a levered beta of 1.00 for the firm.

$$\text{Levered beta} = 0.89 \times (1 + (1-0.3366) \times 0.1917) = 1.00$$
Estimating Betas for Non-Traded Assets

- The conventional approaches of estimating betas from regressions do not work for assets that are not traded.
- There are two ways in which betas can be estimated for non-traded assets
  - using comparable firms
  - using accounting earnings
Using comparable firms to estimate beta for Bookscape

Assume that you are trying to estimate the beta for an independent bookstore in New York City.

<table>
<thead>
<tr>
<th>Firm</th>
<th>Beta</th>
<th>Debt</th>
<th>Equity</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Books-A-Million</td>
<td>0.532</td>
<td>$45</td>
<td>$45</td>
<td>$5</td>
</tr>
<tr>
<td>Borders Group</td>
<td>0.844</td>
<td>$182</td>
<td>$1,430</td>
<td>$269</td>
</tr>
<tr>
<td>Barnes &amp; Noble</td>
<td>0.885</td>
<td>$300</td>
<td>$1,606</td>
<td>$268</td>
</tr>
<tr>
<td>Courier Corp</td>
<td>0.815</td>
<td>$1</td>
<td>$285</td>
<td>$6</td>
</tr>
<tr>
<td>Info Holdings</td>
<td>0.883</td>
<td>$2</td>
<td>$371</td>
<td>$54</td>
</tr>
<tr>
<td>John Wiley &amp;Son</td>
<td>0.636</td>
<td>$235</td>
<td>$1,662</td>
<td>$33</td>
</tr>
<tr>
<td>Scholastic Corp</td>
<td>0.744</td>
<td>$549</td>
<td>$1,063</td>
<td>$11</td>
</tr>
<tr>
<td>Sector</td>
<td>0.7627</td>
<td>$1,314</td>
<td>$6,462</td>
<td>$645</td>
</tr>
</tbody>
</table>

Unlevered Beta = \( \frac{0.7627}{1+(1-.35)(\frac{1314}{6462})} \) = 0.6737

Corrected for Cash = \( \frac{0.6737}{1 - \frac{645}{(1314+6462)}} \) = 0.7346
Estimating Bookscape Levered Beta and Cost of Equity

- Since the debt/equity ratios used are market debt equity ratios, and the only debt equity ratio we can compute for Bookscape is a book value debt equity ratio, we have assumed that Bookscape is close to the industry average debt to equity ratio of 20.33%.

- Using a marginal tax rate of 40% (based upon personal income tax rates) for Bookscape, we get a levered beta of 0.82.
  
  \[
  \text{Levered beta for Bookscape} = 0.7346 \times (1 + (1 - 0.40) \times 0.2033) = 0.82
  \]

- Using a riskfree rate of 4% (US treasury bond rate) and a historical risk premium of 4.82%:

  \[
  \text{Cost of Equity} = 4\% + 0.82 \times (4.82\%) = 7.95\%
  \]
Is Beta an Adequate Measure of Risk for a Private Firm?

The owners of most private firms are not diversified. Beta measures the risk added on to a diversified portfolio. Therefore, using beta to arrive at a cost of equity for a private firm will

a) Under estimate the cost of equity for the private firm
b) Over estimate the cost of equity for the private firm
c) Could under or over estimate the cost of equity for the private firm
Total Risk versus Market Risk

- Adjust the beta to reflect total risk rather than market risk. This adjustment is a relatively simple one, since the R squared of the regression measures the proportion of the risk that is market risk.

  Total Beta = Market Beta / Correlation of the sector with the market

- In the Bookscape example, where the market beta is 0.82 and the average R-squared of the comparable publicly traded firms is 16%,

\[
\frac{\text{Market Beta}}{\sqrt{\text{R squared}}} = \frac{0.82}{\sqrt{0.16}} = 2.06
\]

- Total Cost of Equity = 4% + 2.06 (4.82%) = 13.93%
Application Test: Estimating a Bottom-up Beta

- Based upon the business or businesses that your firm is in right now, and its current financial leverage, estimate the bottom-up unlevered beta for your firm.

- Data Source: You can get a listing of unlevered betas by industry on my web site by going to updated data.
The cost of capital is a composite cost to the firm of raising financing to fund its projects. In addition to equity, firms can raise capital from debt.
What is debt?

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

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

- If the firm has bonds outstanding, and the bonds are traded, the *yield to maturity* on a long-term, straight (no special features) bond can be used as the interest rate.

- If the firm is rated, use the rating and a typical default spread on bonds with that rating to estimate the cost of debt.

- If the firm is not rated,
  - and it has recently borrowed long term from a bank, use the interest rate on the borrowing or
  - estimate a synthetic rating for the company, and use the synthetic rating to arrive at a default spread and a cost of debt

- The cost of debt has to be estimated in the same currency as the cost of equity and the cash flows in the valuation.
Estimating Synthetic Ratings

- The rating for a firm can be estimated using the financial characteristics of the firm. In its simplest form, the rating can be estimated from the interest coverage ratio

  \[
  \text{Interest Coverage Ratio} = \frac{\text{EBIT}}{\text{Interest Expenses}}
  \]

- In 2003, Disney had operating income of $2,805 million and interest & lease expenses of $758 million.

  \[
  \text{Interest Coverage Ratio} = \frac{2805}{758} = 3.70
  \]

- In 2007, Tata Chemicals had operating income of 5,855 million INR and interest expenses of 470 million INR.

  \[
  \text{Interest Coverage Ratio} = \frac{5855}{470} = 12.46
  \]

- In 2003, Bookscape had operating income of $2 million and interest expenses of $500,000. The resulting interest coverage ratio is 4.00.

  - Interest coverage ratio = \( \frac{2,000,000}{500,000} = 4.00 \)
## Interest Coverage Ratios, Ratings and Default Spreads: Small and Large Market Cap Companies

<table>
<thead>
<tr>
<th>Interest Coverage Ratio</th>
<th>Rating</th>
<th>Typical default spread</th>
</tr>
</thead>
<tbody>
<tr>
<td>If small cap (&gt;$5 bil)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt; 12.5</td>
<td>AAA</td>
<td>0.35%</td>
</tr>
<tr>
<td>9.50 - 12.50</td>
<td>AA</td>
<td>0.50%</td>
</tr>
<tr>
<td>7.50 – 9.50</td>
<td>A+</td>
<td>0.70%</td>
</tr>
<tr>
<td>6.00 – 7.50</td>
<td>A</td>
<td>0.85%</td>
</tr>
<tr>
<td>4.50 – 6.00</td>
<td>A-</td>
<td>1.00%</td>
</tr>
<tr>
<td>4.00 – 4.50</td>
<td>BBB</td>
<td>1.50%</td>
</tr>
<tr>
<td>3.50 - 4.00</td>
<td>BB+</td>
<td>2.00%</td>
</tr>
<tr>
<td>3.00 – 3.50</td>
<td>BB</td>
<td>2.50%</td>
</tr>
<tr>
<td>2.50 – 3.00</td>
<td>B+</td>
<td>3.25%</td>
</tr>
<tr>
<td>2.00 - 2.50</td>
<td>B</td>
<td>4.00%</td>
</tr>
<tr>
<td>1.50 – 2.00</td>
<td>B-</td>
<td>6.00%</td>
</tr>
<tr>
<td>1.25 – 1.50</td>
<td>CCC</td>
<td>8.00%</td>
</tr>
<tr>
<td>0.80 – 1.25</td>
<td>CC</td>
<td>10.00%</td>
</tr>
<tr>
<td>0.50 – 0.80</td>
<td>C</td>
<td>12.00%</td>
</tr>
<tr>
<td>&lt; 0.65</td>
<td>D</td>
<td>20.00%</td>
</tr>
</tbody>
</table>

*Source: Aswath Damodaran*
Synthetic Ratings and Costs of Debt

Disney (2003)
- Synthetic rating = A-; Actual rating = BBB+
- Pre-tax Cost of debt based on actual rating = 4% + 1.25% = 5.25%
- After-tax Cost of debt = 5.25% (1-.373) = 3.29%

Bookscape (2003)
- Synthetic Rating = BBB
- Pre-tax cost of debt = Riskfree Rate + Default Spread = 4% + 1.50% = 5.50%
- After-tax cost of debt = Pre-tax cost of debt (1- tax rate) = 5.50% (1-.40) = 3.30%

Tata Chemicals (2007)
- Synthetic Rating = AA
- Pre-tax cost of debt = Riskfree Rate + Country Spread + Company spread
  = 6.76% + 1.15% + 0.50% = 8.41%
- After-tax cost of debt = Pre-tax cost of debt (1- tax rate) = 8.41% (1-.3366) = 5.58%
Application Test: Estimating a Cost of Debt

Based upon your firm’s current earnings before interest and taxes, its interest expenses, estimate:

- An interest coverage ratio for your firm
- A synthetic rating for your firm (use the interest coverage table)
- A pre-tax cost of debt for your firm
- An after-tax cost of debt for your firm
Weights for cost of capital calculation: Market values…

- Market Value of Equity should include the following
  - Market Value of Shares outstanding
  - Market Value of Warrants outstanding
  - Market Value of Conversion Option in Convertible Bonds

- Market Value of Debt is more difficult to estimate because few firms have only publicly traded debt. There are two solutions:
  - Assume book value of debt is equal to market value
  - Estimate the market value of debt from the book value
  - For Disney, with book value of 13,100 million, interest expenses of $666 million, a current cost of borrowing of 5.25% and an weighted average maturity of 11.53 years.

Estimated MV of Disney Debt =

\[
\frac{1}{(1.0525)^{11.53}} \left[ \frac{1}{\left(\frac{1.0525}{.0525}\right)^{11.53}} \right] + \frac{13,100}{(1.0525)^{11.53}} = $12,915 million
\]
Converting Operating Leases to Debt

- The “debt value” of operating leases is the present value of the lease payments, at a rate that reflects their risk.
- In general, this rate will be close to or equal to the rate at which the company can borrow.
Operating Leases at Disney

- The pre-tax cost of debt at Disney is 5.25%

<table>
<thead>
<tr>
<th>Year</th>
<th>Commitment</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$271.00</td>
<td>$257.48</td>
</tr>
<tr>
<td>2</td>
<td>$242.00</td>
<td>$218.46</td>
</tr>
<tr>
<td>3</td>
<td>$221.00</td>
<td>$189.55</td>
</tr>
<tr>
<td>4</td>
<td>$208.00</td>
<td>$169.50</td>
</tr>
<tr>
<td>5</td>
<td>$275.00</td>
<td>$212.92</td>
</tr>
<tr>
<td>6–9</td>
<td>$258.25</td>
<td>$704.93</td>
</tr>
</tbody>
</table>

Debt Value of leases = $1,752.85

- Debt outstanding at Disney = $12,915 + $1,753 = $14,668 million
Application Test: Estimating Market Value

Estimate the
- Market value of equity at your firm and Book Value of equity
- Market value of debt and book value of debt (If you cannot find the average maturity of your debt, use 3 years): Remember to capitalize the value of operating leases and add them on to both the book value and the market value of debt.

Estimate the
- Weights for equity and debt based upon market value
- Weights for equity and debt based upon book value
Current Cost of Capital: Disney

- **Equity**
  - Cost of Equity = Riskfree rate + Beta * Risk Premium
    \[ = 4\% + 1.25 \times (4.82\%) = 10.00\% \]
  - Market Value of Equity = $55.101 Billion
  - Equity/(Debt+Equity) = 79\%

- **Debt**
  - After-tax Cost of debt = (Riskfree rate + Default Spread) (1-t)
    \[ = (4\%+1.25\%) \times (1-.373) = 3.29\% \]
  - Market Value of Debt = $14.668 Billion
  - Debt/(Debt+Equity) = 21\%

- **Cost of Capital** = 10.00\%(.79)+3.29\%(.21) = 8.59\%

\[
\frac{55.101}{55.101+14.668}
\]
## Disney’s Divisional Costs of Capital

<table>
<thead>
<tr>
<th>Business</th>
<th>Cost of Equity</th>
<th>After-tax cost of debt</th>
<th>E/(D+E)</th>
<th>D/(D+E)</th>
<th>Cost of capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Media Networks</td>
<td>10.10%</td>
<td>3.29%</td>
<td>78.98%</td>
<td>21.02%</td>
<td>8.67%</td>
</tr>
<tr>
<td>Parks and Resorts</td>
<td>9.12%</td>
<td>3.29%</td>
<td>78.98%</td>
<td>21.02%</td>
<td>7.90%</td>
</tr>
<tr>
<td>Studio Entertainment</td>
<td>10.43%</td>
<td>3.29%</td>
<td>78.98%</td>
<td>21.02%</td>
<td>8.93%</td>
</tr>
<tr>
<td>Consumer Products</td>
<td>10.39%</td>
<td>3.29%</td>
<td>78.98%</td>
<td>21.02%</td>
<td>8.89%</td>
</tr>
<tr>
<td>Disney</td>
<td><strong>10.00%</strong></td>
<td><strong>3.29%</strong></td>
<td><strong>78.98%</strong></td>
<td><strong>21.02%</strong></td>
<td><strong>8.59%</strong></td>
</tr>
</tbody>
</table>
Tata Chemical’s Current Cost of Capital

**Equity**
- Cost of Equity = Riskfree rate + Beta * Risk Premium
  \[ = 6.76\% + 1.00(6.63\%) = 13.39\% \]
- Market Value of Equity = Rs 54.21 Billion
- Equity/(Debt+Equity ) = 84%

**Debt**
- After-tax Cost of debt = (Riskfree rate + Default Spread) (1-t)
  \[ = (6.76\%+1.15\%+0.5\%) (1-.33366) = 5.58\% \]
- Market Value of Debt = $ 10.39 Billion
- Debt/(Debt +Equity ) = 16%

**Cost of Capital** = 13.39\%(0.84)+ 5.58\%(0.16) = 12.13%

Market value of debt = Rs 470 m (PV of annuity, 4.25 years, 8.41%)
\[ + Rs 12,356 m/ 1.0841^{4.25} = Rs 10,390 million \]
Application Test: Estimating Cost of Capital

- Using the bottom-up unlevered beta that you computed for your firm, and the values of debt and equity you have estimated for your firm, estimate a bottom-up levered beta and cost of equity for your firm.

- Based upon the costs of equity and debt that you have estimated, and the weights for each, estimate the cost of capital for your firm.

- How different would your cost of capital have been, if you used book value weights?
Choosing a Hurdle Rate

- Either the cost of equity or the cost of capital can be used as a hurdle rate, depending upon whether the returns measured are to equity investors or to all claimholders on the firm (capital).
- If returns are measured to equity investors, the appropriate hurdle rate is the cost of equity.
- If returns are measured to capital (or the firm), the appropriate hurdle rate is the cost of capital.
Back to First Principles

- Invest in projects that yield a return greater than the minimum acceptable hurdle rate.
  - The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners’ funds (equity) or borrowed money (debt)
  - Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.
- Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.
- If there are not enough investments that earn the hurdle rate, return the cash to stockholders.
  - The form of returns - dividends and stock buybacks - will depend upon the stockholders’ characteristics.
Measuring Investment Returns

“Show me the money”

Jerry Maguire
First Principles

- Invest in projects that yield a **return** greater than the minimum acceptable hurdle rate.
  - The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners’ funds (equity) or borrowed money (debt)
  - **Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.**
- Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.
- If there are not enough investments that earn the hurdle rate, return the cash to stockholders.
  - The form of returns - dividends and stock buybacks - will depend upon the stockholders’ characteristics.
Measures of return: earnings versus cash flows

Principles Governing Accounting Earnings Measurement

- **Accrual Accounting**: Show revenues when products and services are sold or provided, not when they are paid for. Show expenses associated with these revenues rather than cash expenses.

- **Operating versus Capital Expenditures**: Only expenses associated with creating revenues in the current period should be treated as operating expenses. Expenses that create benefits over several periods are written off over multiple periods (as depreciation or amortization).

To get from accounting earnings to cash flows:

- you have to add back non-cash expenses (like depreciation)
- you have to subtract out cash outflows which are not expensed (such as capital expenditures)
- you have to make accrual revenues and expenses into cash revenues and expenses (by considering changes in working capital).
Measuring Returns Right: The Basic Principles

- Use cash flows rather than earnings. You cannot spend earnings.
- Use “incremental” cash flows relating to the investment decision, i.e., cashflows that occur as a consequence of the decision, rather than total cash flows.
- Use “time weighted” returns, i.e., value cash flows that occur earlier more than cash flows that occur later.

Earnings versus Cash Flows: A Disney Theme Park

- The theme parks to be built near Bangkok, modeled on Euro Disney in Paris, will include a “Magic Kingdom” to be constructed, beginning immediately, and becoming operational at the beginning of the second year, and a second theme park modeled on Epcot Center at Orlando to be constructed in the second and third year and becoming operational at the beginning of the fifth year.
- The earnings and cash flows are estimated in nominal U.S. Dollars.
# Earnings on Project

<table>
<thead>
<tr>
<th></th>
<th>Now (0)</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Magic Kingdom</td>
<td>$0</td>
<td>$1,000</td>
<td>$1,400</td>
<td>$1,700</td>
<td>$2,000</td>
<td>$2,200</td>
<td>$2,420</td>
<td>$2,662</td>
<td>$2,928</td>
<td>$2,987</td>
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</tr>
<tr>
<td>Second Theme Park</td>
<td>$0</td>
<td>$0</td>
<td>$300</td>
<td>$500</td>
<td>$550</td>
<td>$605</td>
<td>$666</td>
<td>$732</td>
<td>$747</td>
<td></td>
<td></td>
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<tr>
<td>Resort &amp; Properties</td>
<td>$0</td>
<td>$250</td>
<td>$350</td>
<td>$500</td>
<td>$625</td>
<td>$688</td>
<td>$756</td>
<td>$832</td>
<td>$915</td>
<td>$933</td>
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<tr>
<td>Total Revenues</td>
<td>$1,250</td>
<td>$1,750</td>
<td>$2,500</td>
<td>$3,125</td>
<td>$3,438</td>
<td>$3,781</td>
<td>$4,159</td>
<td>$4,575</td>
<td>$4,667</td>
<td></td>
<td></td>
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<tr>
<td>Magic Kingdom: Operating Expenses</td>
<td>$0</td>
<td>$600</td>
<td>$840</td>
<td>$1,020</td>
<td>$1,200</td>
<td>$1,320</td>
<td>$1,452</td>
<td>$1,597</td>
<td>$1,757</td>
<td>$1,792</td>
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<tr>
<td>Epcot II: Operating Expenses</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$180</td>
<td>$300</td>
<td>$330</td>
<td>$363</td>
<td>$399</td>
<td>$439</td>
<td>$448</td>
<td></td>
</tr>
<tr>
<td>Resort &amp; Property: Operating Expenses</td>
<td>$0</td>
<td>$188</td>
<td>$263</td>
<td>$375</td>
<td>$469</td>
<td>$516</td>
<td>$567</td>
<td>$624</td>
<td>$686</td>
<td>$700</td>
<td></td>
</tr>
<tr>
<td>Depreciation &amp; Amortization</td>
<td>$0</td>
<td>$537</td>
<td>$508</td>
<td>$430</td>
<td>$359</td>
<td>$357</td>
<td>$358</td>
<td>$361</td>
<td>$366</td>
<td>$369</td>
<td></td>
</tr>
<tr>
<td>Allocated G&amp;A Costs</td>
<td>$0</td>
<td>$188</td>
<td>$263</td>
<td>$375</td>
<td>$469</td>
<td>$516</td>
<td>$567</td>
<td>$624</td>
<td>$686</td>
<td>$700</td>
<td></td>
</tr>
<tr>
<td>Operating Income</td>
<td>$0</td>
<td>-$262</td>
<td>-$123</td>
<td>$120</td>
<td>$329</td>
<td>$399</td>
<td>$473</td>
<td>$554</td>
<td>$641</td>
<td>$657</td>
<td></td>
</tr>
<tr>
<td>Taxes</td>
<td>$0</td>
<td>-$98</td>
<td>-$46</td>
<td>$45</td>
<td>$123</td>
<td>$149</td>
<td>$177</td>
<td>$206</td>
<td>$239</td>
<td>$245</td>
<td></td>
</tr>
<tr>
<td>Operating Income after Taxes</td>
<td>-$164</td>
<td>-$77</td>
<td>$75</td>
<td>$206</td>
<td>$250</td>
<td>$297</td>
<td>$347</td>
<td>$402</td>
<td>$412</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## And the Accounting View of Return

<table>
<thead>
<tr>
<th>Year</th>
<th>After-tax Operating Income</th>
<th>BV of Capital: Beginning</th>
<th>BV of Capital: Ending</th>
<th>Average BV of Capital</th>
<th>ROC</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$0</td>
<td>$2,500</td>
<td>$3,500</td>
<td>$3,000</td>
<td>NA</td>
</tr>
<tr>
<td>2</td>
<td>-$165</td>
<td>$3,500</td>
<td>$4,294</td>
<td>$3,897</td>
<td>-4.22%</td>
</tr>
<tr>
<td>3</td>
<td>-$77</td>
<td>$4,294</td>
<td>$4,616</td>
<td>$4,455</td>
<td>-1.73%</td>
</tr>
<tr>
<td>4</td>
<td>$75</td>
<td>$4,616</td>
<td>$4,524</td>
<td>$4,570</td>
<td>1.65%</td>
</tr>
<tr>
<td>5</td>
<td>$206</td>
<td>$4,524</td>
<td>$4,484</td>
<td>$4,504</td>
<td>4.58%</td>
</tr>
<tr>
<td>6</td>
<td>$251</td>
<td>$4,484</td>
<td>$4,464</td>
<td>$4,474</td>
<td>5.60%</td>
</tr>
<tr>
<td>7</td>
<td>$297</td>
<td>$4,464</td>
<td>$4,481</td>
<td>$4,472</td>
<td>6.64%</td>
</tr>
<tr>
<td>8</td>
<td>$347</td>
<td>$4,481</td>
<td>$4,518</td>
<td>$4,499</td>
<td>7.72%</td>
</tr>
<tr>
<td>9</td>
<td>$402</td>
<td>$4,518</td>
<td>$4,575</td>
<td>$4,547</td>
<td>8.83%</td>
</tr>
<tr>
<td>10</td>
<td>$412</td>
<td>$4,575</td>
<td>$4,617</td>
<td>$4,596</td>
<td>8.97%</td>
</tr>
<tr>
<td></td>
<td>$175</td>
<td></td>
<td></td>
<td>$4,301</td>
<td>4.23%</td>
</tr>
</tbody>
</table>
Should there be a risk premium for foreign projects?

- The exchange rate risk should be diversifiable risk (and hence should not command a premium) if
  - the company has projects in a large number of countries (or)
  - the investors in the company are globally diversified.

  For Disney, this risk should not affect the cost of capital used. Consequently, we would not adjust the cost of capital for Disney’s investments in other mature markets (Germany, UK, France).

- The same diversification argument can also be applied against political risk, which would mean that it too should not affect the discount rate. It may, however, affect the cash flows, by reducing the expected life or cash flows on the project.

  For Disney, this is the risk that we are incorporating into the cost of capital when it invests in Thailand (or any other emerging market).
Estimating a hurdle rate for the theme park

- We did estimate a cost of equity of 9.12% for the Disney theme park business in the last chapter, using a bottom-up levered beta of 1.0625 for the business.
- This cost of equity may not adequately reflect the additional risk associated with the theme park being in an emerging market.
- To counter this risk, we compute the cost of equity for the theme park using a risk premium that includes a country risk premium for Thailand:
  - The rating for Thailand is Baa1 and the default spread for the country bond is 1.50%. Multiplying this by the relative volatility of 2.2 of the equity market in Thailand (standard deviation of equity/standard deviation of country bond) yields a country risk premium of 3.3%.
    - Cost of Equity in US $ = 4% + 1.0625 (4.82% + 3.30%) = 12.63%
    - Cost of Capital in US $ = 12.63% (.7898) + 3.29% (.2102) = 10.66%
Do not invest in this park. The **return on capital of 4.23%** is lower than the **cost of capital for theme parks of 10.66%**; This would suggest that the project should not be taken.

Given that we have computed the average over an arbitrary period of 10 years, while the theme park itself would have a life greater than 10 years, would you feel comfortable with this conclusion?

a) Yes  
b) No
Just as a comparison of project return on capital to the cost of capital yields a measure of whether the project is acceptable, a comparison can be made at the firm level, to judge whether the existing projects of the firm are adding or destroying value.

Disney, in 2003, had earnings before interest and taxes of $2,713 million, had a book value of equity of $23,879 million and a book value of debt of 14,130 million. With a tax rate of 37.3%, we get

Return on Capital = \[
\frac{2,713(1-0.373)}{23,879+14,130} = 4.48\%
\]

Cost of Capital for Disney= 8.59%

Excess Return = 4.48%-8.59% = -4.11%

This can be converted into a dollar figure by multiplying by the capital invested, in which case it is called economic value added

\[
EVA = (0.0448 - 0.0859)(23,879+14,130) = -1,562 \text{ million}
\]
Application Test: Assessing Investment Quality

- For the most recent period for which you have data, compute the after-tax return on capital earned by your firm, where after-tax return on capital is computed to be:
  \[
  \text{After-tax ROC} = \frac{\text{EBIT} \times (1-\text{tax rate})}{(\text{BV of debt} + \text{BV of Equity})_{\text{previous year}}}
  \]

- For the most recent period for which you have data, compute the return spread earned by your firm:
  \[
  \text{Return Spread} = \text{After-tax ROC} - \text{Cost of Capital}
  \]

- For the most recent period, compute the EVA earned by your firm:
  \[
  \text{EVA} = \text{Return Spread} \times ((\text{BV of debt} + \text{BV of Equity})_{\text{previous year}})
  \]
The cash flow view of this project..

<table>
<thead>
<tr>
<th></th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Income after Taxes</td>
<td>-$165</td>
<td>-$77</td>
<td>$75</td>
<td>$206</td>
<td>$251</td>
<td></td>
<td></td>
</tr>
<tr>
<td>+ Depreciation &amp; Amortization</td>
<td>$537</td>
<td>$508</td>
<td>$430</td>
<td>$359</td>
<td>$357</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Capital Expenditures</td>
<td>$2,500</td>
<td>$1,000</td>
<td>$1,269</td>
<td>$805</td>
<td>$301</td>
<td>$287</td>
<td>$321</td>
</tr>
<tr>
<td>- Change in Working Capital</td>
<td>$0</td>
<td>$0</td>
<td>$63</td>
<td>$25</td>
<td>$38</td>
<td>$31</td>
<td>$16</td>
</tr>
<tr>
<td>Cashflow to Firm</td>
<td>-$2,500</td>
<td>-$1,000</td>
<td>-$960</td>
<td>-$399</td>
<td>$166</td>
<td>$247</td>
<td>$271</td>
</tr>
</tbody>
</table>

To get from income to cash flow, we

- added back all non-cash charges such as depreciation
- subtracted out the capital expenditures
- subtracted out the change in non-cash working capital
The incremental cash flows on the project

$500 million has already been spent

<table>
<thead>
<tr>
<th></th>
<th>Now (0)</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
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<td>$412</td>
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<td>$358</td>
<td>$361</td>
<td>$366</td>
<td>$369</td>
<td></td>
</tr>
<tr>
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<td>$1,000</td>
<td>$1,269</td>
<td>$805</td>
<td>$301</td>
<td>$287</td>
<td>$321</td>
<td>$358</td>
<td>$379</td>
<td>$403</td>
<td>$406</td>
</tr>
<tr>
<td>- Change in Working Capital</td>
<td></td>
<td>$0</td>
<td>$0</td>
<td>$63</td>
<td>$25</td>
<td>$38</td>
<td>$31</td>
<td>$16</td>
<td>$17</td>
<td>$19</td>
<td>$21</td>
</tr>
<tr>
<td>+ Non-incremental Allocated Expense (1-t)</td>
<td>$0</td>
<td>$78</td>
<td>$110</td>
<td>$157</td>
<td>$196</td>
<td>$216</td>
<td>$237</td>
<td>$261</td>
<td>$287</td>
<td>$293</td>
<td></td>
</tr>
<tr>
<td>+ Sunk Costs</td>
<td></td>
<td>500</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cashflow to Firm</td>
<td>-$2,000</td>
<td>-$1,000</td>
<td>-$880</td>
<td>-$289</td>
<td>$324</td>
<td>$443</td>
<td>$486</td>
<td>$517</td>
<td>$571</td>
<td>$631</td>
<td>$663</td>
</tr>
</tbody>
</table>

2/3rd of allocated G&A is fixed. Add back this amount (1-t)

To get from cash flow to incremental cash flows, we
- Taken out of the sunk costs from the initial investment
- Added back the non-incremental allocated costs (in after-tax terms)
# To Time-Weighted Cash Flows

<table>
<thead>
<tr>
<th>Cash Flow Type</th>
<th>Discounting Formula</th>
<th>Compounding Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Simple CF</td>
<td>$CF_n / (1+r)^n$</td>
<td>$CF_0 (1+r)^n$</td>
</tr>
<tr>
<td>2. Annuity</td>
<td>$A \left[ \frac{1 - \frac{1}{(1+r)^n}}{r} \right]$</td>
<td>$A \left[ \frac{(1+r)^n - 1}{r} \right]$</td>
</tr>
<tr>
<td>3. Growing Annuity</td>
<td>$A(1+g) \left[ \frac{1 - (1+g)^n}{(1+r)^n} \right]$</td>
<td></td>
</tr>
<tr>
<td>4. Perpetuity</td>
<td>$A/r$</td>
<td></td>
</tr>
<tr>
<td>5. Growing Perpetuity</td>
<td>Expected Cashflow next year/(r-g)</td>
<td></td>
</tr>
</tbody>
</table>
Discounted cash flow measures of return

- **Net Present Value (NPV):** The net present value is the sum of the present values of all cash flows from the project (including initial investment).

  \[
  \text{NPV} = \text{Sum of the present values of all cash flows on the project, including the initial investment, with the cash flows being discounted at the appropriate hurdle rate (cost of capital, if cash flow is cash flow to the firm, and cost of equity, if cash flow is to equity investors)}
  \]

  • Decision Rule: Accept if NPV > 0

- **Internal Rate of Return (IRR):** The internal rate of return is the discount rate that sets the net present value equal to zero. It is the percentage rate of return, based upon incremental time-weighted cash flows.

  • Decision Rule: Accept if IRR > hurdle rate
Closure on Cash Flows

- In a project with a finite and short life, you would need to compute a **salvage value**, which is the expected proceeds from selling all of the investment in the project at the end of the project life. It is usually set equal to book value of fixed assets and working capital.

- In a project with an infinite or very long life, we compute cash flows for a reasonable period, and then compute a **terminal value** for this project, which is the present value of all cash flows that occur after the estimation period ends.

- Assuming the project lasts forever, and that cash flows after year 10 grow 2% (the inflation rate) forever, the present value at the end of year 10 of cash flows after that can be written as:
  - Terminal Value in year 10 = \( \frac{CF \text{ in year 11}}{\text{Cost of Capital} - \text{Growth Rate}} \)
    \[
    = 663 \times (1.02) / (0.1066 - 0.02) = \$7,810 \text{ million}
    \]
Which yields a NPV of..

<table>
<thead>
<tr>
<th>Year</th>
<th>Annual Cashflow</th>
<th>Terminal Value</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>-$2,000</td>
<td>-$2,000</td>
<td>-$2,000</td>
</tr>
<tr>
<td>1</td>
<td>-$1,000</td>
<td></td>
<td>-$904</td>
</tr>
<tr>
<td>2</td>
<td>-$880</td>
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<td>-$719</td>
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<tr>
<td>3</td>
<td>-$289</td>
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<td>-$213</td>
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<td>$216</td>
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<td>5</td>
<td>$443</td>
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<td>$267</td>
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<td>6</td>
<td>$486</td>
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<td>$265</td>
</tr>
<tr>
<td>7</td>
<td>$517</td>
<td></td>
<td>$254</td>
</tr>
<tr>
<td>8</td>
<td>$571</td>
<td></td>
<td>$254</td>
</tr>
<tr>
<td>9</td>
<td>$631</td>
<td></td>
<td>$254</td>
</tr>
<tr>
<td>10</td>
<td>$663</td>
<td>$7,810</td>
<td>$3,076</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$749</td>
</tr>
</tbody>
</table>
Which makes the argument that..

- **The project should be accepted.** The positive net present value suggests that the project will add value to the firm, and earn a return in excess of the cost of capital.
- By taking the project, Disney will increase its value as a firm by $749 million.
The IRR of this project

Figure 5.5: NPV Profile for Disney Theme Park

Discount Rate
NPV
Internal Rate of Return
The IRR suggests..

- **The project is a good one.** Using time-weighted, incremental cash flows, this project provides a return of 11.97%. This is greater than the cost of capital of 10.66%.
- The IRR and the NPV will yield **similar results** most of the time, though there are differences between the two approaches that may cause project rankings to vary depending upon the approach used.
Currency Choices and NPV

The analysis was done in dollars. Would the conclusions have been any different if we had done the analysis in Thai Baht?

a) Yes
b) No
Disney Theme Park: Thai Baht NPV

Inflation rate in Thailand = 10%
Inflation rate in US = 2%

Bt/$ in year 1 = 42.09 \times \left(\frac{1.1}{1.02}\right) = 45.39

<table>
<thead>
<tr>
<th>Year</th>
<th>Cashflow ($)</th>
<th>Bt/$</th>
<th>Cashflow (Bt)</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>-2000</td>
<td>42.09</td>
<td>-84180</td>
<td>-84180</td>
</tr>
<tr>
<td>1</td>
<td>-1000</td>
<td>45.39</td>
<td>-45391</td>
<td>-38034</td>
</tr>
<tr>
<td>2</td>
<td>-880</td>
<td>48.95</td>
<td>-43075</td>
<td>-30243</td>
</tr>
<tr>
<td>3</td>
<td>-289</td>
<td>52.79</td>
<td>-15262</td>
<td>-8979</td>
</tr>
<tr>
<td>4</td>
<td>324</td>
<td>56.93</td>
<td>18420</td>
<td>9080</td>
</tr>
<tr>
<td>5</td>
<td>443</td>
<td>61.40</td>
<td>27172</td>
<td>11223</td>
</tr>
<tr>
<td>6</td>
<td>486</td>
<td>66.21</td>
<td>32187</td>
<td>11140</td>
</tr>
<tr>
<td>7</td>
<td>517</td>
<td>71.40</td>
<td>36920</td>
<td>10707</td>
</tr>
<tr>
<td>8</td>
<td>571</td>
<td>77.01</td>
<td>43979</td>
<td>10687</td>
</tr>
<tr>
<td>9</td>
<td>631</td>
<td>83.04</td>
<td>52412</td>
<td>10671</td>
</tr>
<tr>
<td>10</td>
<td>8474</td>
<td>89.56</td>
<td>758886</td>
<td>129470</td>
</tr>
</tbody>
</table>

NPV = 31,542 Bt/42.09 Bt = $ 749 Million
NPV is equal to NPV in dollar terms
The Role of Sensitivity Analysis

- Our conclusions on a project are clearly conditioned on a large number of assumptions about revenues, costs and other variables over very long time periods.
- To the degree that these assumptions are wrong, our conclusions can also be wrong.
- One way to gain confidence in the conclusions is to check to see how sensitive the decision measure (NPV, IRR..) is to changes in key assumptions.
Side Costs and Benefits

- Most projects considered by any business create side costs and benefits for that business.
- The side costs include the costs created by the use of resources that the business already owns (opportunity costs) and lost revenues for other projects that the firm may have.
- The benefits that may not be captured in the traditional capital budgeting analysis include project synergies (where cash flow benefits may accrue to other projects) and options embedded in projects (including the options to delay, expand or abandon a project).
- The returns on a project should incorporate these costs and benefits.
First Principles

- Invest in projects that yield a **return** greater than the minimum acceptable hurdle rate.
  - The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners’ funds (equity) or borrowed money (debt)
  - **Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.**
- Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.
- If there are not enough investments that earn the hurdle rate, return the cash to stockholders.
  - The form of returns - dividends and stock buybacks - will depend upon the stockholders’ characteristics.
Finding the Right Financing Mix: The Capital Structure Decision
First Principles

- Invest in projects that yield a return greater than the minimum acceptable hurdle rate.
  - The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners’ funds (equity) or borrowed money (debt)
  - Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.

- Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.

- If there are not enough investments that earn the hurdle rate, return the cash to stockholders.
  - The form of returns - dividends and stock buybacks - will depend upon the stockholders’ characteristics.

Objective: Maximize the Value of the Firm
Financing Choices across the life cycle

- **Revenues**
- **Earnings**

<table>
<thead>
<tr>
<th>Stage</th>
<th>External funding needs</th>
<th>Internal financing</th>
<th>External Financing</th>
<th>Growth stage</th>
<th>Financing Transitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stage 1</td>
<td>High, but constrained by infrastructure</td>
<td>Negative or low</td>
<td>Owner’s Equity Bank Debt</td>
<td>Stage 1 Start-up</td>
<td>Accessing private equity</td>
</tr>
<tr>
<td>Stage 2</td>
<td>High, relative to firm value.</td>
<td>Negative or low</td>
<td>Venture Capital Common Stock</td>
<td>Stage 2 Rapid Expansion</td>
<td>Initial Public offering</td>
</tr>
<tr>
<td>Stage 4</td>
<td>Moderate, relative to firm value.</td>
<td>Low, relative to funding needs</td>
<td>Common stock Warrants Convertibles</td>
<td>Stage 3 High Growth</td>
<td>Seasoned equity issue</td>
</tr>
<tr>
<td>Stage 5</td>
<td>Declining, as a percent of firm value</td>
<td>High, relative to funding needs</td>
<td>Debt</td>
<td>Stage 4 Mature Growth</td>
<td>Bond issues</td>
</tr>
<tr>
<td></td>
<td>Low, as projects dry up.</td>
<td>More than funding needs</td>
<td>Retire debt Repurchase stock</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Accessing private equity
- Initial Public offering
- Seasoned equity issue
- Bond issues
## Debt: Summarizing the Trade Off

<table>
<thead>
<tr>
<th>Advantages of Borrowing</th>
<th>Disadvantages of Borrowing</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Tax Benefit:</strong></td>
<td><strong>1. Bankruptcy Cost:</strong></td>
</tr>
<tr>
<td>Higher tax rates --&gt; Higher tax benefit</td>
<td>Higher business risk --&gt; Higher Cost</td>
</tr>
<tr>
<td><strong>2. Added Discipline:</strong></td>
<td><strong>2. Agency Cost:</strong></td>
</tr>
<tr>
<td>Greater the separation between managers and stockholders --&gt; Greater the separation between stockholders &amp; lenders --&gt; Higher Cost</td>
<td></td>
</tr>
<tr>
<td>Greater the benefit</td>
<td>Greater the uncertainty about future financing needs --&gt; Higher Cost</td>
</tr>
<tr>
<td><strong>3. Loss of Future Financing Flexibility:</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>
A Hypothetical Scenario

(a) There are no taxes
(b) Managers have stockholder interests at heart and do what’s best for stockholders.
(c) No firm ever goes bankrupt
(d) Equity investors are honest with lenders; there is no subterfuge or attempt to find loopholes in loan agreements.
(e) Firms know their future financing needs with certainty

What happens to the trade off between debt and equity? How much should a firm borrow?
The Miller-Modigliani Theorem

- In an environment, where there are no taxes, default risk or agency costs, capital structure is irrelevant.
- The value of a firm is independent of its debt ratio. Leverage is irrelevant. A firm's value will be determined by its cash flows.
- The cost of capital of the firm will not change with leverage. As a firm increases its leverage, the cost of equity will increase just enough to offset any gains to the leverage
Pathways to the Optimal

- The Cost of Capital Approach: The optimal debt ratio is the one that minimizes the cost of capital for a firm.
- The Sector Approach: The optimal debt ratio is the one that brings the firm closest to its peer group in terms of financing mix.
I. The Cost of Capital Approach

- Value of a Firm = Present Value of Cash Flows to the Firm, discounted back at the cost of capital.
- If the cash flows to the firm are held constant, and the cost of capital is minimized, the value of the firm will be maximized.
## Applying Cost of Capital Approach: The Textbook Example

<table>
<thead>
<tr>
<th>Debt Ratio</th>
<th>Cost of equity</th>
<th>Cost of Debt</th>
<th>After-tax Cost of Debt</th>
<th>Cost of Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.00%</td>
<td>9.00%</td>
<td>6.00%</td>
<td>3.60%</td>
<td>9.00%</td>
</tr>
<tr>
<td>10.00%</td>
<td>9.50%</td>
<td>6.50%</td>
<td>3.90%</td>
<td>8.94%</td>
</tr>
<tr>
<td>20.00%</td>
<td>10.10%</td>
<td>6.75%</td>
<td>4.05%</td>
<td>8.89%</td>
</tr>
<tr>
<td>30.00%</td>
<td>10.80%</td>
<td>6.90%</td>
<td>4.14%</td>
<td>8.80%</td>
</tr>
<tr>
<td>40.00%</td>
<td>11.60%</td>
<td>7.90%</td>
<td>4.74%</td>
<td>8.86%</td>
</tr>
<tr>
<td>50.00%</td>
<td>12.50%</td>
<td>8.90%</td>
<td>5.34%</td>
<td>8.92%</td>
</tr>
<tr>
<td>60.00%</td>
<td>13.50%</td>
<td>9.90%</td>
<td>5.94%</td>
<td>8.96%</td>
</tr>
<tr>
<td>70.00%</td>
<td>14.60%</td>
<td>11.00%</td>
<td>6.60%</td>
<td>9.00%</td>
</tr>
<tr>
<td>80.00%</td>
<td>15.80%</td>
<td>12.25%</td>
<td>7.35%</td>
<td>9.04%</td>
</tr>
<tr>
<td>90.00%</td>
<td>17.10%</td>
<td>13.75%</td>
<td>8.25%</td>
<td>9.14%</td>
</tr>
<tr>
<td>100.00%</td>
<td>18.50%</td>
<td>15.25%</td>
<td>9.15%</td>
<td>9.15%</td>
</tr>
</tbody>
</table>
The U-shaped Cost of Capital Graph…
Current Cost of Capital: Disney

- **Equity**
  - Cost of Equity = Riskfree rate + Beta * Risk Premium
    \[\text{Cost of Equity} = 4\% + 1.25 \times (4.82\%) = 10.00\%\]
  - Market Value of Equity = $55.101 Billion
  - Equity/(Debt+Equity) = 79%

- **Debt**
  - After-tax Cost of debt = (Riskfree rate + Default Spread) (1-t)
    \[\text{After-tax Cost of debt} = (4\%+1.25\%) \times (1-.373) = 3.29\%\]
  - Market Value of Debt = $14.668 Billion
  - Debt/(Debt+Equity) = 21%

- **Cost of Capital**
  \[\text{Cost of Capital} = 10.00\% \times 0.79 + 3.29\% \times 0.21 = 8.59\%\]
  
  \[
  \frac{55.101}{(55.101+14.668)}
  \]
Mechanics of Cost of Capital Estimation

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

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

3. Estimate the Cost of Capital at different levels of debt
4. Calculate the effect on Firm Value and Stock Price.
Estimating Cost of Equity

Unlevered Beta = 1.0674 (Bottom up beta based upon Disney’s businesses)
Market premium = 4.82% T.Bond Rate = 4.00% Tax rate=37.3%

<table>
<thead>
<tr>
<th>Debt Ratio</th>
<th>D/E Ratio</th>
<th>Levered Beta</th>
<th>Cost of Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.00%</td>
<td>0.00%</td>
<td>1.0674</td>
<td>9.15%</td>
</tr>
<tr>
<td>10.00%</td>
<td>11.11%</td>
<td>1.1418</td>
<td>9.50%</td>
</tr>
<tr>
<td>20.00%</td>
<td>25.00%</td>
<td>1.2348</td>
<td>9.95%</td>
</tr>
<tr>
<td>30.00%</td>
<td>42.86%</td>
<td>1.3543</td>
<td>10.53%</td>
</tr>
<tr>
<td>40.00%</td>
<td>66.67%</td>
<td>1.5136</td>
<td>11.30%</td>
</tr>
<tr>
<td>50.00%</td>
<td>100.00%</td>
<td>1.7367</td>
<td>12.37%</td>
</tr>
<tr>
<td>60.00%</td>
<td>150.00%</td>
<td>2.0714</td>
<td>13.98%</td>
</tr>
<tr>
<td>70.00%</td>
<td>233.33%</td>
<td>2.6291</td>
<td>16.67%</td>
</tr>
<tr>
<td>80.00%</td>
<td>400.00%</td>
<td>3.7446</td>
<td>22.05%</td>
</tr>
<tr>
<td>90.00%</td>
<td>900.00%</td>
<td>7.0911</td>
<td>38.18%</td>
</tr>
</tbody>
</table>
## Estimating Cost of Debt

Start with the current market value of the firm = 55,101 + 14668 = $69,769 mil

<table>
<thead>
<tr>
<th></th>
<th>D/(D+E)</th>
<th>D/E</th>
<th>Debt to capital</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>0.00%</td>
<td>10.00%</td>
<td></td>
</tr>
<tr>
<td>D/E</td>
<td>0.00%</td>
<td>11.11%</td>
<td>D/E = 10/90 = .1111</td>
</tr>
<tr>
<td>$ Debt</td>
<td>$0</td>
<td>$6,977</td>
<td>10% of $69,769</td>
</tr>
</tbody>
</table>

|                      |          |         |                 |
| EBITDA               | $3,882   | $3,882  | Same as 0% debt |
| Depreciation         | $1,077   | $1,077  | Same as 0% debt |
| EBIT                 | $2,805   | $2,805  | Same as 0% debt |
| Interest             | $0       | $303    | Pre-tax cost of debt * $ Debt |

|                      |          |         |                 |
| Pre-tax Int. cov     | ∞        | 9.24    | EBIT/ Interest Expenses |
| Likely Rating        | AAA      | AAA     | From Ratings table |
| Pre-tax cost of debt | 4.35%    | 4.35%   | Riskless Rate + Spread |
# The Ratings Table

<table>
<thead>
<tr>
<th>Interest Coverage Ratio</th>
<th>Rating</th>
<th>Typical Default Spread</th>
<th>Market Interest Rate on Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt; 8.5</td>
<td>AAA</td>
<td>0.35%</td>
<td>4.35%</td>
</tr>
<tr>
<td>6.50 - 6.50</td>
<td>AA</td>
<td>0.50%</td>
<td>4.50%</td>
</tr>
<tr>
<td>5.50 – 6.50</td>
<td>A+</td>
<td>0.70%</td>
<td>4.70%</td>
</tr>
<tr>
<td>4.25 – 5.50</td>
<td>A</td>
<td>0.85%</td>
<td>4.85%</td>
</tr>
<tr>
<td>3.00 – 4.25</td>
<td>A-</td>
<td>1.00%</td>
<td>5.00%</td>
</tr>
<tr>
<td>2.50 – 3.00</td>
<td>BBB</td>
<td>1.50%</td>
<td>5.50%</td>
</tr>
<tr>
<td>2.05 - 2.50</td>
<td>BB+</td>
<td>2.00%</td>
<td>6.00%</td>
</tr>
<tr>
<td>1.90 – 2.00</td>
<td>BB</td>
<td>2.50%</td>
<td>6.50%</td>
</tr>
<tr>
<td>1.75 – 1.90</td>
<td>B+</td>
<td>3.25%</td>
<td>7.25%</td>
</tr>
<tr>
<td>1.50 - 1.75</td>
<td>B</td>
<td>4.00%</td>
<td>8.00%</td>
</tr>
<tr>
<td>1.25 – 1.50</td>
<td>B-</td>
<td>6.00%</td>
<td>10.00%</td>
</tr>
<tr>
<td>0.80 – 1.25</td>
<td>CCC</td>
<td>8.00%</td>
<td>12.00%</td>
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<td>0.65 – 0.80</td>
<td>CC</td>
<td>10.00%</td>
<td>14.00%</td>
</tr>
<tr>
<td>0.20 – 0.65</td>
<td>C</td>
<td>12.00%</td>
<td>16.00%</td>
</tr>
<tr>
<td>&lt; 0.20</td>
<td>D</td>
<td>20.00%</td>
<td>24.00%</td>
</tr>
</tbody>
</table>
A Test: Can you do the 20% level?

<table>
<thead>
<tr>
<th></th>
<th>0.00%</th>
<th>10.00%</th>
<th>20.00%</th>
<th>2nd Iteration</th>
<th>3rd?</th>
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</thead>
<tbody>
<tr>
<td>$D/(D+E)$</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$D/E$</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$\text{ Debt}$</td>
<td>$0$</td>
<td>$6,977$</td>
<td>$13,954$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$\text{ EBITDA}$</td>
<td>$3,882$</td>
<td>$3,882$</td>
<td>$3,882$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$\text{ Depreciation}$</td>
<td>$1,077$</td>
<td>$1,077$</td>
<td>$1,077$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$\text{ EBIT}$</td>
<td>$2,805$</td>
<td>$2,805$</td>
<td>$2,805$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>$0$</td>
<td>$303$</td>
<td>$606$</td>
<td>$0.0485 \times 13954 = 676$</td>
<td></td>
</tr>
<tr>
<td>Pre-tax Int. cov</td>
<td>$\infty$</td>
<td>9.24</td>
<td>4.62</td>
<td>2805/676 = 4.15</td>
<td></td>
</tr>
<tr>
<td>Likely Rating</td>
<td>AAA</td>
<td>AAA</td>
<td>A</td>
<td>A-</td>
<td></td>
</tr>
<tr>
<td>Cost of debt</td>
<td>4.35%</td>
<td>4.35%</td>
<td>4.85%</td>
<td>5.00%</td>
<td></td>
</tr>
</tbody>
</table>
## Bond Ratings, Cost of Debt and Debt Ratios

<table>
<thead>
<tr>
<th>Debt Ratio</th>
<th>Debt</th>
<th>Interest expense</th>
<th>Interest Coverage Ratio</th>
<th>Bond Rating</th>
<th>Interest rate on debt</th>
<th>Tax Rate</th>
<th>Cost of Debt (after-tax)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>$0</td>
<td>$0</td>
<td>?</td>
<td>AAA</td>
<td>4.35%</td>
<td>37.30%</td>
<td>2.73%</td>
</tr>
<tr>
<td>10%</td>
<td>$6,977</td>
<td>$303</td>
<td>9.24</td>
<td>AAA</td>
<td>4.35%</td>
<td>37.30%</td>
<td>2.73%</td>
</tr>
<tr>
<td>20%</td>
<td>$13,954</td>
<td>$698</td>
<td>4.02</td>
<td>A-</td>
<td>5.00%</td>
<td>37.30%</td>
<td>3.14%</td>
</tr>
<tr>
<td>30%</td>
<td>$20,931</td>
<td>$1,256</td>
<td>2.23</td>
<td>BB+</td>
<td>6.00%</td>
<td>37.30%</td>
<td>3.76%</td>
</tr>
<tr>
<td>40%</td>
<td>$27,908</td>
<td>$3,349</td>
<td>0.84</td>
<td>CCC</td>
<td>12.00%</td>
<td>31.24%</td>
<td>8.25%</td>
</tr>
<tr>
<td>50%</td>
<td>$34,885</td>
<td>$5,582</td>
<td>0.50</td>
<td>C</td>
<td>16.00%</td>
<td>18.75%</td>
<td>13.00%</td>
</tr>
<tr>
<td>60%</td>
<td>$41,861</td>
<td>$6,698</td>
<td>0.42</td>
<td>C</td>
<td>16.00%</td>
<td>15.62%</td>
<td>13.50%</td>
</tr>
<tr>
<td>70%</td>
<td>$48,838</td>
<td>$7,814</td>
<td>0.36</td>
<td>C</td>
<td>16.00%</td>
<td>13.39%</td>
<td>13.86%</td>
</tr>
<tr>
<td>80%</td>
<td>$55,815</td>
<td>$8,930</td>
<td>0.31</td>
<td>C</td>
<td>16.00%</td>
<td>11.72%</td>
<td>14.13%</td>
</tr>
<tr>
<td>90%</td>
<td>$62,792</td>
<td>$10,047</td>
<td>0.28</td>
<td>C</td>
<td>16.00%</td>
<td>10.41%</td>
<td>14.33%</td>
</tr>
</tbody>
</table>
You need taxable income for interest to provide a tax savings.

In the Disney case, consider the interest expense at 30% and 40%:

<table>
<thead>
<tr>
<th></th>
<th>30% Debt Ratio</th>
<th>40% Debt Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBIT</td>
<td>$ 2,805 m</td>
<td>$ 2,805 m</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>$ 1,256 m</td>
<td>$ 3,349 m</td>
</tr>
<tr>
<td>Tax Savings</td>
<td>$ 1,256*.373=468</td>
<td>2,805*.373 = $ 1,046</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>37.30%</td>
<td>1,046/3,349= 31.2%</td>
</tr>
<tr>
<td>Pre-tax interest rate</td>
<td>6.00%</td>
<td>12.00%</td>
</tr>
<tr>
<td>After-tax Interest Rate</td>
<td>3.76%</td>
<td>8.25%</td>
</tr>
</tbody>
</table>

You can deduct only $2,805 million of the $3,349 million of the interest expense at 40%. Therefore, only 37.3% of $ 2,805 million is considered as the tax savings.
**Disney’s Cost of Capital Schedule**

<table>
<thead>
<tr>
<th>Debt Ratio</th>
<th>Cost of Equity</th>
<th>Cost of Debt (after-tax)</th>
<th>Cost of Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>9.15%</td>
<td>2.73%</td>
<td>9.15%</td>
</tr>
<tr>
<td>10%</td>
<td>9.50%</td>
<td>2.73%</td>
<td>8.83%</td>
</tr>
<tr>
<td>20%</td>
<td>9.95%</td>
<td>3.14%</td>
<td>8.59%</td>
</tr>
<tr>
<td>30%</td>
<td>10.53%</td>
<td>3.76%</td>
<td>8.50%</td>
</tr>
<tr>
<td>40%</td>
<td>11.50%</td>
<td>8.25%</td>
<td>10.20%</td>
</tr>
<tr>
<td>50%</td>
<td>13.33%</td>
<td>13.00%</td>
<td>13.16%</td>
</tr>
<tr>
<td>60%</td>
<td>15.66%</td>
<td>13.50%</td>
<td>14.36%</td>
</tr>
<tr>
<td>70%</td>
<td>19.54%</td>
<td>13.86%</td>
<td>15.56%</td>
</tr>
<tr>
<td>80%</td>
<td>27.31%</td>
<td>14.13%</td>
<td>16.76%</td>
</tr>
<tr>
<td>90%</td>
<td>50.63%</td>
<td>14.33%</td>
<td>17.96%</td>
</tr>
</tbody>
</table>
Disney: Cost of Capital Chart

Figure 8.3: Disney Cost of Capital at different Debt Ratios

Optimal Debt ratio is at this point

Cost of equity climbs as levered beta increases

After-tax cost of debt increases as interest coverage ratio deteriorates and with it the synthetic rating.
Disney: Cost of Capital Chart: 1997
Effect on Firm Value

- Firm Value before the change = 55,101 + 14,668 = $69,769
  - WACC\(_b\) = 8.59%  
    - Annual Cost = $69,769 * 8.59% = $5,993 million
  - WACC\(_a\) = 8.50%  
    - Annual Cost = $69,769 * 8.50% = $5,930 million
  - Δ WACC = 0.09%  
    - Change in Annual Cost = $63 million

- If there is no growth in the firm value, (Conservative Estimate)
  - Increase in firm value = $63 / 0.0850 = $741 million
  - Change in Stock Price = $741 / 2047.6 = $0.36 per share

- If we assume a perpetual growth of 4% in firm value over time,
  - Increase in firm value = $63 / (0.0850 - 0.04) = $1,400 million
  - Change in Stock Price = $1,400 / 2,047.6 = $0.68 per share

*Implied Growth Rate obtained by*

*Firm value Today = FCFF(1+g)/(WACC-g): Perpetual growth formula*

$69,769 = $1,722(1+g)/(0.0859-g): Solve for g -> Implied growth = 5.98%
A Test: The Repurchase Price

Let us suppose that the CFO of Disney approached you about buying back stock. He wants to know the maximum price that he should be willing to pay on the stock buyback. (The current price is $26.91) Assuming that firm value will grow by 4% a year, estimate the maximum price.

What would happen to the stock price after the buyback if you were able to buy stock back at $26.91?
The Downside Risk

- Doing What-if analysis on Operating Income
  - A. Standard Deviation Approach
    - Standard Deviation In Past Operating Income
    - Standard Deviation In Earnings (If Operating Income Is Unavailable)
    - Reduce Base Case By One Standard Deviation (Or More)
  - B. Past Recession Approach
    - Look At What Happened To Operating Income During The Last Recession. (How Much Did It Drop In % Terms?)
    - Reduce Current Operating Income By Same Magnitude

- Constraint on Bond Ratings
## Disney’s Operating Income: History

<table>
<thead>
<tr>
<th>Year</th>
<th>EBIT</th>
<th>% Change in EBIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>756</td>
<td></td>
</tr>
<tr>
<td>1988</td>
<td>848</td>
<td>12.17%</td>
</tr>
<tr>
<td>1989</td>
<td>1177</td>
<td>38.80%</td>
</tr>
<tr>
<td>1990</td>
<td>1368</td>
<td>16.23%</td>
</tr>
<tr>
<td>1991</td>
<td>1124</td>
<td>-17.84%</td>
</tr>
<tr>
<td>1992</td>
<td>1287</td>
<td>14.50%</td>
</tr>
<tr>
<td>1993</td>
<td>1560</td>
<td>21.21%</td>
</tr>
<tr>
<td>1994</td>
<td>1804</td>
<td>15.64%</td>
</tr>
<tr>
<td>1995</td>
<td>2262</td>
<td>25.39%</td>
</tr>
<tr>
<td>1996</td>
<td>3024</td>
<td>33.69%</td>
</tr>
<tr>
<td>1997</td>
<td>3945</td>
<td>30.46%</td>
</tr>
<tr>
<td>1998</td>
<td>3843</td>
<td>-2.59%</td>
</tr>
<tr>
<td>1999</td>
<td>3580</td>
<td>-6.84%</td>
</tr>
<tr>
<td>2000</td>
<td>2525</td>
<td>-29.47%</td>
</tr>
<tr>
<td>2001</td>
<td>2832</td>
<td>12.16%</td>
</tr>
<tr>
<td>2002</td>
<td>2384</td>
<td>-15.82%</td>
</tr>
<tr>
<td>2003</td>
<td>2713</td>
<td>13.80%</td>
</tr>
</tbody>
</table>
Disney: The Downside Scenario

<table>
<thead>
<tr>
<th>% Drop in EBITDA</th>
<th>EBIT</th>
<th>Optimal Debt Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>$ 2,805</td>
<td>30%</td>
</tr>
<tr>
<td>5%</td>
<td>$ 2,665</td>
<td>20%</td>
</tr>
<tr>
<td>10%</td>
<td>$ 2,524</td>
<td>20%</td>
</tr>
<tr>
<td>15%</td>
<td>$ 2,385</td>
<td>20%</td>
</tr>
<tr>
<td>20%</td>
<td>$ 2,245</td>
<td>20%</td>
</tr>
</tbody>
</table>
Constraints on Ratings

- Management often specifies a 'desired Rating' below which they do not want to fall.
- The rating constraint is driven by three factors
  - it is one way of protecting against downside risk in operating income (so do not do both)
  - a drop in ratings might affect operating income
  - there is an ego factor associated with high ratings
- Caveat: Every Rating Constraint Has A Cost.
  - Provide Management With A Clear Estimate Of How Much The Rating Constraint Costs By Calculating The Value Of The Firm Without The Rating Constraint And Comparing To The Value Of The Firm With The Rating Constraint.
Ratings Constraints for Disney

- At its optimal debt ratio of 30%, Disney has an estimated rating of BB+.
- Assume that Disney imposes a rating constraint of BBB or greater.
- The optimal debt ratio for Disney is then 25% (see next page)
- The cost of imposing this rating constraint can then be calculated as follows:

  Value at 30% Debt = $71,239 million
  - Value at 25% Debt = $70,300 million
  Cost of Rating Constraint = $999 million
### Effect of Ratings Constraints: Disney

<table>
<thead>
<tr>
<th>Debt Ratio</th>
<th>Rating</th>
<th>Firm Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>AAA</td>
<td>$62,279</td>
</tr>
<tr>
<td>10%</td>
<td>AAA</td>
<td>$66,397</td>
</tr>
<tr>
<td>20%</td>
<td>A-</td>
<td>$69,837</td>
</tr>
<tr>
<td>30%</td>
<td>BB+</td>
<td>$71,239</td>
</tr>
<tr>
<td>40%</td>
<td>CCC</td>
<td>$51,661</td>
</tr>
<tr>
<td>50%</td>
<td>C</td>
<td>$34,969</td>
</tr>
<tr>
<td>60%</td>
<td>C</td>
<td>$30,920</td>
</tr>
<tr>
<td>70%</td>
<td>C</td>
<td>$27,711</td>
</tr>
<tr>
<td>80%</td>
<td>C</td>
<td>$25,105</td>
</tr>
<tr>
<td>90%</td>
<td>C</td>
<td>$22,948</td>
</tr>
</tbody>
</table>
What if you do not buy back stock..

- The optimal debt ratio is ultimately a function of the underlying riskiness of the business in which you operate and your tax rate.
- Will the optimal be different if you invested in projects instead of buying back stock?
  - No. As long as the projects financed are in the same business mix that the company has always been in and your tax rate does not change significantly.
  - Yes, if the projects are in entirely different types of businesses or if the tax rate is significantly different.
## Tata Chemical’s Optimal Capital Structure

<table>
<thead>
<tr>
<th>Debt Ratio</th>
<th>Beta</th>
<th>Cost of Equity</th>
<th>Bond Rating</th>
<th>Interest rate on debt</th>
<th>Tax Rate</th>
<th>Cost of Debt (after-tax)</th>
<th>WACC</th>
<th>Firm Value (G)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>0.89</td>
<td>12.64%</td>
<td>AAA</td>
<td>8.26%</td>
<td>33.66%</td>
<td>5.48%</td>
<td>12.64%</td>
<td>INR 59,885</td>
</tr>
<tr>
<td>10%</td>
<td>0.95</td>
<td>13.08%</td>
<td>AA</td>
<td>8.41%</td>
<td>33.66%</td>
<td>5.58%</td>
<td>12.33%</td>
<td>INR 62,734</td>
</tr>
<tr>
<td>20%</td>
<td>1.03</td>
<td>13.62%</td>
<td>A-</td>
<td>8.91%</td>
<td>33.66%</td>
<td>5.91%</td>
<td>12.08%</td>
<td>INR 65,172</td>
</tr>
<tr>
<td>30%</td>
<td>1.14</td>
<td>14.31%</td>
<td>B+</td>
<td>11.16%</td>
<td>33.66%</td>
<td>7.40%</td>
<td>12.24%</td>
<td>INR 63,542</td>
</tr>
<tr>
<td>40%</td>
<td>1.28</td>
<td>15.24%</td>
<td>B-</td>
<td>13.91%</td>
<td>33.66%</td>
<td>9.23%</td>
<td>12.84%</td>
<td>INR 58,245</td>
</tr>
<tr>
<td>50%</td>
<td>1.48</td>
<td>16.54%</td>
<td>CC</td>
<td>17.91%</td>
<td>33.66%</td>
<td>11.88%</td>
<td>14.21%</td>
<td>INR 48,725</td>
</tr>
<tr>
<td>60%</td>
<td>1.84</td>
<td>18.96%</td>
<td>CC</td>
<td>17.91%</td>
<td>28.39%</td>
<td>12.83%</td>
<td>15.28%</td>
<td>INR 43,151</td>
</tr>
<tr>
<td>70%</td>
<td>2.50</td>
<td>23.36%</td>
<td>C</td>
<td>19.91%</td>
<td>21.89%</td>
<td>15.55%</td>
<td>17.90%</td>
<td>INR 33,477</td>
</tr>
<tr>
<td>80%</td>
<td>3.76</td>
<td>31.66%</td>
<td>C</td>
<td>19.91%</td>
<td>19.15%</td>
<td>16.10%</td>
<td>19.21%</td>
<td>INR 29,988</td>
</tr>
<tr>
<td>90%</td>
<td>7.51</td>
<td>56.57%</td>
<td>C</td>
<td>19.91%</td>
<td>17.03%</td>
<td>16.52%</td>
<td>20.53%</td>
<td>INR 27,102</td>
</tr>
</tbody>
</table>
Determinants of Optimal Debt Ratios

- Firm Specific Factors
  1. Tax Rate
     - Higher tax rates → Higher Optimal Debt Ratio
     - Lower tax rates → Lower Optimal Debt Ratio
  2. Pre-Tax CF on Firm = \( \frac{EBITDA}{MV \text{ of Firm}} \)
     - Higher Pre-tax CF → Higher Optimal Debt Ratio
     - Lower Pre-tax CF → Lower Optimal Debt Ratio
  3. Variance in Earnings [Shows up when you do 'what if' analysis]
     - Higher Variance → Lower Optimal Debt Ratio
     - Lower Variance → Higher Optimal Debt Ratio

- Macro-Economic Factors
  1. Default Spreads
     - Higher → Lower Optimal Debt Ratio
     - Lower → Higher Optimal Debt Ratio
Application Test: Your firm’s optimal financing mix

- Using the optimal capital structure spreadsheet provided:
  - Estimate the optimal debt ratio for your firm
  - Estimate the new cost of capital at the optimal
  - Estimate the effect of the change in the cost of capital on firm value
  - Estimate the effect on the stock price

- In terms of the mechanics, what would you need to do to get to the optimal immediately?
II. Relative Analysis

I. Industry Average with Subjective Adjustments

- The “safest” place for any firm to be is close to the industry average
- Subjective adjustments can be made to these averages to arrive at the right debt ratio.
  - Higher tax rates -> Higher debt ratios (Tax benefits)
  - Lower insider ownership -> Higher debt ratios (Greater discipline)
  - More stable income -> Higher debt ratios (Lower bankruptcy costs)
  - More intangible assets -> Lower debt ratios (More agency problems)
Sector Comparisons

Company versus Sector

<table>
<thead>
<tr>
<th></th>
<th>Company</th>
<th>Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disney</td>
<td>25.00%</td>
<td>30.00%</td>
</tr>
<tr>
<td>Tata Chemicals</td>
<td>20.00%</td>
<td>35.00%</td>
</tr>
</tbody>
</table>
A Framework for Getting to the Optimal Debt Ratio

Is the actual debt ratio greater than or lesser than the optimal debt ratio?

- Actual > Optimal
  - Overlevered
    - Is the firm under bankruptcy threat?
      - Yes
        - Reduce Debt quickly
          1. Equity for Debt swap
          2. Sell Assets; use cash to pay off debt
          3. Renegotiate with lenders
      - No
        - Does the firm have good projects?
          1. Pay off debt with retained earnings.
          2. Reduce or eliminate dividends.
          3. Issue new equity and pay off debt.

- Actual < Optimal
  - Underlevered
    - Is the firm a takeover target?
      - Yes
        - Increase leverage quickly
          1. Debt/Equity swaps
          2. Borrow money & buy shares.
      - No
        - Does the firm have good projects?
          1. Pay off debt with retained earnings.
          2. Reduce or eliminate dividends.
          3. Issue new equity and pay off debt.

Do your stockholders like dividends?

- Yes
  - Pay Dividends
- No
  - Buy back stock
Disney: Applying the Framework

Is the actual debt ratio greater than or lesser than the optimal debt ratio?

Actual > Optimal
Overlevered

Is the firm under bankruptcy threat?

Yes
Reduce Debt quickly
1. Equity for Debt swap
2. Sell Assets; use cash to pay off debt
3. Renegotiate with lenders

No
Does the firm have good projects?
ROE > Cost of Equity
ROC > Cost of Capital

Yes
Take good projects with new equity or with retained earnings.

No
1. Pay off debt with retained earnings.
2. Reduce or eliminate dividends
3. Issue new equity and pay off debt.

Actual < Optimal
Underlevered

Is the firm a takeover target?

Yes
Increase leverage quickly
1. Debt/Equity swaps
2. Borrow money & buy shares.

No
Does the firm have good projects?
ROE > Cost of Equity
ROC > Cost of Capital

Yes
Take good projects with debt.

No
Do your stockholders like dividends?

Yes
Pay Dividends

No
Buy back stock
Application Test: Getting to the Optimal

Based upon your analysis of both the firm’s capital structure and investment record, what path would you map out for the firm?

- Immediate change in leverage
- Gradual change in leverage
- No change in leverage

Would you recommend that the firm change its financing mix by

- Paying off debt/Buying back equity
- Take projects with equity/debt
The objective in designing debt is to make the cash flows on debt match up as closely as possible with the cash flows that the firm makes on its assets. By doing so, we reduce our risk of default, increase debt capacity and increase firm value.
The perfect financing instrument will

- Have all of the tax advantages of debt
- While preserving the flexibility offered by equity

Design debt to have cash flows that match up to cash flows on the assets financed
Ensuring that you have not crossed the line drawn by the tax code

- All of this design work is lost, however, if the security that you have designed does not deliver the tax benefits.
- In addition, there may be a trade off between mismatching debt and getting greater tax benefits.
While keeping equity research analysts, ratings agencies and regulators applauding

Ratings agencies want companies to issue equity, since it makes them safer. Equity research analysts want them not to issue equity because it dilutes earnings per share. Regulatory authorities want to ensure that you meet their requirements in terms of capital ratios (usually book value). Financing that leaves all three groups happy is nirvana.

Consider ratings agency & analyst concerns

Analyst Concerns
- Effect on EPS
- Value relative to comparables

Ratings Agency
- Effect on Ratios
- Ratios relative to comparables

Regulatory Concerns
- Measures used

Can securities be designed that can make these different entities happy?

Consider ratings agency & analyst concerns

Operating Leases
MIPs
Surplus Notes
Debt or Equity: The Strange Case of Trust Preferred

- Trust preferred stock has
  - A fixed dividend payment, specified at the time of the issue
  - That is tax deductible
  - And failing to make the payment can cause ? (Can it cause default?)
- When trust preferred was first created, ratings agencies treated it as equity. As they have become more savvy, ratings agencies have started giving firms only partial equity credit for trust preferred.
Debt, Equity and Quasi Equity

- Assuming that trust preferred stock gets treated as equity by ratings agencies, which of the following firms is the most appropriate firm to be issuing it?
  - A firm that is under levered, but has a rating constraint that would be violated if it moved to its optimal
  - A firm that is over levered that is unable to issue debt because of the rating agency concerns.
There are some firms that face skepticism from bondholders when they go out to raise debt, because
- Of their past history of defaults or other actions
- They are small firms without any borrowing history

Bondholders tend to demand much higher interest rates from these firms to reflect these concerns.

If agency problems are substantial, consider issuing convertible bonds.
And do not lock in market mistakes that work against you

- Ratings agencies can sometimes under rate a firm, and markets can under price a firm’s stock or bonds. If this occurs, firms should not lock in these mistakes by issuing securities for the long term. In particular,
  - Issuing equity or equity based products (including convertibles), when equity is under priced transfers wealth from existing stockholders to the new stockholders
  - Issuing long term debt when a firm is under rated locks in rates at levels that are far too high, given the firm’s default risk.

- What is the solution
  - If you need to use equity?
  - If you need to use debt?
The Right Debt for Disney

<table>
<thead>
<tr>
<th>Business</th>
<th>Project Cash Flow Characteristics</th>
<th>Type of Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Movies</td>
<td>Projects are likely to</td>
<td>Debt should be</td>
</tr>
<tr>
<td></td>
<td>1. Be short term</td>
<td>1. Short term</td>
</tr>
<tr>
<td></td>
<td>2. Have cash outflows primarily in dollars (since Disney makes most of its movies in the U.S.) but cash inflows could have a substantial foreign currency component (because of overseas sales)</td>
<td>2. Primarily dollar debt.</td>
</tr>
<tr>
<td></td>
<td>3. Have net cash flows that are heavily driven by whether the movie is a “hit”, which is often difficult to predict.</td>
<td>3. If possible, tied to the success of movies. (Lion King or Nemo Bonds)</td>
</tr>
<tr>
<td>Broadcasting</td>
<td>Projects are likely to be</td>
<td>Debt should be</td>
</tr>
<tr>
<td></td>
<td>1. Short term</td>
<td>1. Short term</td>
</tr>
<tr>
<td></td>
<td>2. Primarily in dollars, though foreign component is growing</td>
<td>2. Primarily dollar debt</td>
</tr>
<tr>
<td></td>
<td>3. Driven by advertising revenues and show success</td>
<td>3. If possible, linked to network ratings.</td>
</tr>
<tr>
<td>Theme Parks</td>
<td>Projects are likely to be</td>
<td>Debt should be</td>
</tr>
<tr>
<td></td>
<td>1. Very long term</td>
<td>1. Long term</td>
</tr>
<tr>
<td></td>
<td>2. Primarily in dollars, but a significant proportion of revenues come from foreign tourists, who are likely to stay away if the dollar strengthens</td>
<td>2. Mix of currencies, based upon tourist make up.</td>
</tr>
<tr>
<td></td>
<td>3. Affected by success of movie and broadcasting divisions.</td>
<td></td>
</tr>
<tr>
<td>Consumer Products</td>
<td>Projects are likely to be short to medium term and linked to the success of the movie division. Most of Disney’s product offerings are derived from their movie productions.</td>
<td>Debt should be</td>
</tr>
<tr>
<td></td>
<td></td>
<td>a. Medium term</td>
</tr>
<tr>
<td></td>
<td></td>
<td>b. Dollar debt.</td>
</tr>
</tbody>
</table>
Analyzing Disney’s Current Debt

- Disney has $13.1 billion in debt with an average maturity of 11.53 years. Even allowing for the fact that the maturity of debt is higher than the duration, this would indicate that Disney’s debt is far too long term for its existing business mix.
- Of the debt, about 12% is Euro debt and no yen denominated debt. Based upon our analysis, a larger portion of Disney’s debt should be in foreign currencies.
- Disney has about $1.3 billion in convertible debt and some floating rate debt, though no information is provided on its magnitude. If floating rate debt is a relatively small portion of existing debt, our analysis would indicate that Disney should be using more of it.
Returning Cash to the Owners: Dividend Policy
First Principles

- Invest in projects that yield a return greater than the minimum acceptable hurdle rate.
  - The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners’ funds (equity) or borrowed money (debt)
  - Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.

- Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.

- If there are not enough investments that earn the hurdle rate, return the cash to stockholders.
  - The form of returns - dividends and stock buybacks - will depend upon the stockholders’ characteristics.

Objective: Maximize the Value of the Firm
I. Dividends are sticky
II. Dividends tend to follow earnings
III. More and more firms are buying back stock, rather than pay dividends...
Measures of Dividend Policy

- **Dividend Payout:**
  - measures the percentage of earnings that the company pays in dividends
  - \( \text{Dividends} \div \text{Earnings} \)

- **Dividend Yield:**
  - measures the return that an investor can make from dividends alone
  - \( \text{Dividends} \div \text{Stock Price} \)
Dividend Payout Ratios: January 2007

Firms not paying dividends = 2699
Firms paying dividends = 1664
Payout ratio not meaningful = 2935
Dividend Yields in the United States: January 2007

![Dividend Yield: January 2007]

Firms not paying dividends = 5347
Firms paying dividends = 1710
Three Schools Of Thought On Dividends

1. If
   - (a) there are no tax disadvantages associated with dividends
   - (b) companies can issue stock, at no cost, to raise equity, whenever needed
   - \textbf{Dividends do not matter, and dividend policy does not affect value.}

2. If dividends have a tax disadvantage,
   - \textbf{Dividends are bad, and increasing dividends will reduce value}

3. If stockholders like dividends, or dividends operate as a signal of future prospects,
   - \textbf{Dividends are good, and increasing dividends will increase value}
The balanced viewpoint

- If a company has excess cash, and few good investment opportunities \((NPV>0)\), returning money to stockholders (dividends or stock repurchases) is good.
- If a company does not have excess cash, and/or has several good investment opportunities \((NPV>0)\), returning money to stockholders (dividends or stock repurchases) is bad.
Assessing Dividend Policy

- Step 1: How much could the company have paid out during the period under question?
- Step 2: How much did the company actually pay out during the period in question?
- Step 3: How much do I trust the management of this company with excess cash?
  - How well did they make investments during the period in question?
  - How well has my stock performed during the period in question?
A Measure of How Much a Company Could have Afforded to Pay out: FCFE

The Free Cashflow to Equity (FCFE) is a measure of how much cash is left in the business after non-equity claimholders (debt and preferred stock) have been paid, and after any reinvestment needed to sustain the firm’s assets and future growth.

Net Income
+ Depreciation & Amortization
= Cash flows from Operations to Equity Investors
- Preferred Dividends
- Capital Expenditures
- Working Capital Needs
- Principal Repayments
+ Proceeds from New Debt Issues
= Free Cash flow to Equity
Estimating FCFE when Leverage is Stable

Net Income
- \((1 - \delta)\) (Capital Expenditures - Depreciation)
- \((1 - \delta)\) Working Capital Needs
= Free Cash flow to Equity

\(\delta = \text{Debt/Capital Ratio}\)

For this firm,
- Proceeds from new debt issues = Principal Repayments + \(\delta\) (Capital Expenditures - Depreciation + Working Capital Needs)
An Example: FCFE Calculation

Consider the following inputs for Microsoft in 1996. In 1996, Microsoft’s FCFE was:

- Net Income = $2,176 Million
- Capital Expenditures = $494 Million
- Depreciation = $480 Million
- Change in Non-Cash Working Capital = $35 Million
- Debt Ratio = 0%

**FCFE =** Net Income - (Cap ex - Depr) (1-DR) - Chg WC (1-DR)

\[
= 2,176 - (494 - 480)(1-0) - 35(1-0) \\
= 2,127 \text{ Million}
\]

By this estimation, Microsoft could have paid $2,127 Million in dividends/stock buybacks in 1996. They paid no dividends and bought back no stock. Where will the $2,127 million show up in Microsoft’s balance sheet?
Companies are not created equal: The consequences of large cash balances…

[Graph showing Chrysler: FCFE, Dividends and Cash Balance]

- Cash Flow: $0, $500, $1,000, $1,500, $2,000, $2,500, $3,000
- Cash Balance: $0, $500, $1,000, $1,500, $2,000, $2,500, $3,000, $4,000, $5,000, $6,000, $7,000, $8,000, $9,000
- Cumulated Cash

Legend:
- Free CF to Equity
- Cash to Stockholders
- Cumulated Cash
Application Test: Estimating your firm’s FCFE

In General,

Net Income
+ Depreciation & Amortization
- Capital Expenditures
- Change in Non-Cash Working Capital
- Preferred Dividend
- Principal Repaid
+ New Debt Issued

= FCFE

Compare to

Dividends (Common)
+ Stock Buybacks

If cash flow statement used

Net Income
+ Depreciation & Amortization
+ Capital Expenditures
+ Changes in Non-cash WC
+ Preferred Dividend
+ Increase in LT Borrowing
+ Decrease in LT Borrowing
+ Change in ST Borrowing

= FCFE

-Common Dividend
- Decrease in Capital Stock
+ Increase in Capital Stock
A Practical Framework for Analyzing Dividend Policy

How much did the firm pay out? How much could it have afforded to pay out?

What it could have paid out | What it actually paid out
---|---
Net Income | Dividends
- (Cap Ex - Depr'n) (1-DR) | + Equity Repurchase
- Chg Working Capital (1-DR) = FCFE

Firm pays out too little
FCFE > Dividends

Do you trust managers in the company with your cash?
Look at past project choice:
Compare ROE to Cost of Equity
ROC to WACC

Firm has history of good project choice and good projects in the future
Give managers the flexibility to keep cash and set dividends

Firm has history of poor project choice
Force managers to justify holding cash or return cash to stockholders

Firm pays out too much
FCFE < Dividends

What investment opportunities does the firm have?
Look at past project choice:
Compare ROE to Cost of Equity
ROC to WACC

Firm has good projects
Firm should cut dividends and reinvest more

Firm has poor projects
Firm should deal with its investment problem first and then cut dividends
Case 1: Disney

- **FCFE versus Dividends**
  - Between 1994 and 2003, Disney generated $969 million in FCFE each year.
  - Between 1994 and 2003, Disney paid out $639 million in dividends and stock buybacks each year.

- **Cash Balance**
  - Disney had a cash balance in excess of $4 billion at the end of 2003.

- **Performance measures**
  - Between 1994 and 2003, Disney has generated a return on equity, on its projects, about 2% less than the cost of equity, on average each year.
  - Between 1994 and 2003, Disney’s stock has delivered about 3% less than the cost of equity, on average each year.
  - The underperformance has been primarily post 1996 (after the Capital Cities acquisition).
Dividend Flexibility at Disney

☐ Yes
☐ No

- Disney could have afforded to pay more in dividends during the period of the analysis.
- It chose not to, and used the cash for acquisitions (Capital Cities/ABC) and ill fated expansion plans (Go.com).
- While the company may have flexibility to set its dividend policy a decade ago, its actions over that decade have frittered away this flexibility.
- **Bottom line:** Large cash balances will not be tolerated in this company. Expect to face relentless pressure to pay out more dividends.
Case 2: Aracruz Celulose - A Paper & Pulp company

- FCFE versus Dividends
  - Between 1999 and 2003, Aracruz generated $37 million in FCFE each year.
  - Between 1999 and 2003, Aracruz paid out $80 million in dividends and stock buybacks each year.

- Performance measures
  - Between 1999 and 2003, Aracruz has generated a return on equity, on its projects, about 1.5% more than the cost of equity, on average each year.
  - Between 1999 and 2003, Aracruz’s stock has delivered about 2% more than the cost of equity, on average each year.
The Control Story

Aracruz’s managers have asked you for permission to cut dividends (to more manageable levels). Are you likely to go along?

- Yes
- No

The reasons for Aracruz’s dividend problem lie in its equity structure. Like most Brazilian companies, Aracruz has two classes of shares - common shares with voting rights and preferred shares without voting rights. However, Aracruz has committed to paying out 35% of its earnings as dividends to the preferred stockholders. If they fail to meet this threshold, the preferred shares get voting rights. If you own the preferred shares, would your answer to the question above change?

- Yes
- No
## Case 3: BP: Dividends- 1983-92

### Summary of calculations

<table>
<thead>
<tr>
<th></th>
<th>Average</th>
<th>Standard Deviation</th>
<th>Maximum</th>
<th>Minimum</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Free CF to Equity</strong></td>
<td>$571.10</td>
<td>$1,382.29</td>
<td>$3,764.00</td>
<td>($612.50)</td>
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<tr>
<td><strong>Dividends</strong></td>
<td>$1,496.30</td>
<td>$448.77</td>
<td>$2,112.00</td>
<td>$831.00</td>
</tr>
<tr>
<td><strong>Dividends+Repurchases</strong></td>
<td>$1,496.30</td>
<td>$448.77</td>
<td>$2,112.00</td>
<td>$831.00</td>
</tr>
<tr>
<td><strong>Dividend Payout Ratio</strong></td>
<td>84.77%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Cash Paid as % of FCFE</strong></td>
<td>262.00%</td>
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<td><strong>ROE - Required return</strong></td>
<td>-1.67%</td>
<td>11.49%</td>
<td>20.90%</td>
<td>-21.59%</td>
</tr>
</tbody>
</table>
BP: Just Desserts!

B.P.’s Shares Plummet After Dividend Is Slashed

By MATTHEW L. WALD

British Petroleum said yesterday that it would cut its dividend by 15 percent, just weeks after it announced a record operating profit, a stunning decision with strong implications for the world financial system. The oil giant forecast a 20 percent decline in earnings for the quarter ending September, the latest in a series of profit warnings from the world’s leading oil companies. The move came just days after a major shake-up at the top of the company’s board, with the departure of the chief executive, David A. McDonald, and the announcement of a major restructuring.

The company said that the dividend cut was part of a broader strategy to strengthen its balance sheet and reduce its debt. It also said that it would sell non-core assets and reduce its capital spending. B.P. is the world’s second-largest oil company, with operations in more than 80 countries.

The move comes as the oil industry is facing a major downturn, with global oil prices falling by more than 50 percent since their peak in 2014. B.P. has been hit hard by the decline, with its share price down by more than 40 percent since the start of the year.

The dividend cut is likely to be seen as a signal of weakness by many investors, who have already expressed concern about the company’s financial prospects. B.P. has been hit hard by the decline in oil prices, with its profits falling by more than 50 percent since 2014. The company has also been hit by a series of legal and regulatory issues, including a $18.2 billion fine in the United States for its role in the Deepwater Horizon disaster.

The company said that it was faced with a difficult environment, with oil prices remaining low and demand for oil continuing to weaken. It also said that it would focus on reducing costs and improving efficiency, with the aim of returning to profitability as soon as possible.

The move is likely to be seen as a warning to other oil companies, who may be forced to follow suit if they fail to address their own financial challenges. It is also likely to be seen as a sign of the broader impact of the oil industry’s crisis on the global economy, with the oil sector accounting for up to 7 percent of global GDP.

<table>
<thead>
<tr>
<th>Summary of calculations</th>
<th>Average</th>
<th>Standard Deviation</th>
<th>Maximum</th>
<th>Minimum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free CF to Equity</td>
<td>($34.20)</td>
<td>$109.74</td>
<td>$96.89</td>
<td>($242.17)</td>
</tr>
<tr>
<td>Dividends</td>
<td>$40.87</td>
<td>$32.79</td>
<td>$101.36</td>
<td>$5.97</td>
</tr>
<tr>
<td>Dividends+Repurchases</td>
<td>$40.87</td>
<td>$32.79</td>
<td>$101.36</td>
<td>$5.97</td>
</tr>
<tr>
<td>Dividend Payout Ratio</td>
<td>18.59%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash Paid as % of FCFE</td>
<td>-119.52%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROE - Required return</td>
<td>1.69%</td>
<td>19.07%</td>
<td>29.26%</td>
<td>-19.84%</td>
</tr>
</tbody>
</table>
Growth Firms and Dividends

High growth firms are sometimes advised to initiate dividends because its increase the potential stockholder base for the company (since there are some investors - like pension funds - that cannot buy stocks that do not pay dividends) and, by extension, the stock price. Do you agree with this argument?

- Yes
- No

Why?
## Tata Chemicals: The Cross Holding Effect

<table>
<thead>
<tr>
<th></th>
<th>Average</th>
<th>Standard Deviation</th>
<th>Maximum</th>
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</thead>
<tbody>
<tr>
<td><strong>Free CF to Equity</strong></td>
<td>INR 4,634.28</td>
<td>INR 4,732.30</td>
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<td><strong>Dividends</strong></td>
<td>INR 1,487.43</td>
<td>INR 197.90</td>
<td>INR 1,715.70</td>
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<tr>
<td><strong>Dividends+Repurchases</strong></td>
<td>INR 1,487.43</td>
<td>INR 197.90</td>
<td>INR 1,715.70</td>
</tr>
<tr>
<td><strong>Dividend Payout Ratio</strong></td>
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<td></td>
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<td><strong>Cash Paid as % of FCFE</strong></td>
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<td></td>
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<tr>
<td><strong>ROE</strong></td>
<td>INR 0.19</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Return on Stock</strong></td>
<td>INR 0.19</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Much of the cash held back was invested in LT investments and unspecified investments.
Summing up...

Figure 11.5: Analyzing Dividend Policy

Cash Returned < FCFE

Cash Returned > FCFE

ROE - Cost of Equity

Increase payout  
Reduce Investment  
Flexibility to accumulate cash

Cut payout  
Reduce Investment  
Cut payout  
Invest in Projects

Aracruz  
Disney  
Microsoft 2002  
Microsoft 2005
Valuation

Aswath Damodaran
First Principles

- Invest in projects that yield a return greater than the minimum acceptable hurdle rate.
  - The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners’ funds (equity) or borrowed money (debt).
  - Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.
- Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.
- If there are not enough investments that earn the hurdle rate, return the cash to stockholders.
  - The form of returns - dividends and stock buybacks - will depend upon the stockholders’ characteristics.

Objective: Maximize the Value of the Firm
Generic DCF Valuation Model

DISCOUNTED CASHFLOW VALUATION

Cash flows
Firm: Pre-debt cash flow
Equity: After debt cash flows

Expected Growth
Firm: Growth in Operating Earnings
Equity: Growth in Net Income/EPS

Firm is in stable growth: Grows at constant rate forever

Discount Rate
Firm: Cost of Capital
Equity: Cost of Equity

Length of Period of High Growth

Value
Firm: Value of Firm
Equity: Value of Equity

Terminal Value
Forever
I. Estimating Cash Flows

Cash Flows

To Equity

The Strict View
Dividends +
Stock Buybacks

The Broader View
Net Income
- Net Cap Ex (1-Debt Ratio)
- Chg WC (1 - Debt Ratio)
= Free Cashflow to Equity

To Firm

EBIT (1-t)
- (Cap Ex - Depreciation)
- Change in Working Capital
= Free Cashflow to Firm
Estimating FCFF in 2003: Disney

- EBIT = $2,805 Million  Tax rate = 37.30%
- Capital spending = $1,735 Million
- Depreciation = $1,254 Million
- Increase in Non-cash Working capital = $454 Million

Estimating FCFF

  EBIT * (1 - tax rate)          $1,759 : 2805 (1-.373)
  - Net Capital Expenditures     $481  : (1735 - 1254)
  - Change in Working Capital   $454
  Free Cashflow to Firm          $824

- Total Reinvestment = Net Cap Ex + Change in WC = 481 + 454 = 935
- Reinvestment Rate = 935/1759 = 53.18%
II. The Discount Rate
Disney’s Current Cost of Capital

- **Equity**
  - Cost of Equity = Riskfree rate + Beta * Risk Premium
    
    $\text{Cost of Equity} = 4\% + 1.25 \times (4.82\%) = 10.00\%$
  
  - Market Value of Equity = $55.101 \text{ Billion}$
  - Equity/(Debt+Equity) = 79%

- **Debt**
  - After-tax Cost of debt = (Riskfree rate + Default Spread) (1-t)
    
    $\text{After-tax Cost of debt} = (4\% + 1.25\%) (1 - 0.373) = 3.29\%$
  
  - Market Value of Debt = $14.668 \text{ Billion}$
  - Debt/(Debt+Equity) = 21%

- **Cost of Capital** = $10.00\% \times 0.79 + 3.29\% \times 0.21 = 8.59\%$

\[
\]
But costs of capital can and should change over time…

<table>
<thead>
<tr>
<th>Year</th>
<th>Expected Growth</th>
<th>Beta</th>
<th>Debt Ratio</th>
<th>Cost of Debt</th>
<th>Tax Rate</th>
<th>Cost of Capital</th>
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<td>1.25</td>
<td>21.02%</td>
<td>5.25%</td>
<td>37.30%</td>
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<td>1.25</td>
<td>21.02%</td>
<td>5.25%</td>
<td>37.30%</td>
<td>8.59%</td>
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<tr>
<td>3</td>
<td>6.38%</td>
<td>1.25</td>
<td>21.02%</td>
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<td>8.59%</td>
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<tr>
<td>4</td>
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<td>1.00</td>
<td>30.00%</td>
<td>5.25%</td>
<td>37.30%</td>
<td>7.16%</td>
</tr>
<tr>
<td>After yr 10</td>
<td>4.00%</td>
<td>1.00</td>
<td>30.00%</td>
<td>5.25%</td>
<td>37.30%</td>
<td>7.16%</td>
</tr>
</tbody>
</table>
III. Expected Growth

- **Net Income**
  - **Retention Ratio** = \(1 - \frac{\text{Dividends}}{\text{Net Income}}\)
  - **Return on Equity** = \(\frac{\text{Net Income}}{\text{Book Value of Equity}}\)

- **Operating Income**
  - **Reinvestment Rate** = \(\frac{\text{Net Cap Ex} + \text{Chg in WC}}{\text{EBIT}(1-t)}\)
  - **Return on Capital** = \(\frac{\text{EBIT}(1-t)}{\text{Book Value of Capital}}\)
Estimating Growth in EBIT: Disney

We begin by estimating the reinvestment rate and return on capital for Disney in 2003, using the numbers from the latest financial statements. We did convert operating leases into debt and adjusted the operating income and capital expenditure accordingly.

- Reinvestment Rate\textsuperscript{2003} = (\text{Cap Ex} – \text{Depreciation} + \text{Chg in non-cash WC})/ EBIT (1-t) = (1735 – 1253 + 454)/(2805(1-.373)) = 53.18%  
- Return on capital\textsuperscript{2003} = EBIT (1-t)\textsuperscript{2003} / (BV of Debt\textsuperscript{2002} + BV of Equity\textsuperscript{2002}) = 2805 (1-.373)/ (15,883+23,879) = 4.42%  
- Expected Growth Rate from existing fundamentals = 53.18% * 4.42% = 2.35%

We will assume that Disney will be able to earn a return on capital of 12% on its new investments and that the reinvestment rate will be 53.18% for the immediate future.

- Expected Growth Rate in operating income = Return on capital * Reinvestment Rate = 12% * .5318 = 6.38%
IV. Getting Closure in Valuation

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

\[
\text{Value} = \frac{\sum_{t=1}^{N} CF_t}{(1+r)^t} + \frac{\text{Terminal Value}}{(1+r)^N}
\]

- When a firm’s cash flows grow at a “constant” rate forever, the present value of those cash flows can be written as:

Value = Expected Cash Flow Next Period / (r - g)

where,

- r = Discount rate (Cost of Equity or Cost of Capital)
- g = Expected growth rate forever.

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

1. **Respect the cap**: The growth rate forever is assumed to be 4%

2. **Stable period excess returns**: The return on capital for Disney will drop from its high growth period level of 12% to a stable growth return of 10%. This is still higher than the cost of capital of 7.16% but the competitive advantages that Disney has are unlikely to dissipate completely by the end of the 10th year.

3. **Reinvest to grow**: The expected growth rate in stable growth will be 4%. In conjunction with the return on capital of 10%, this yields a stable period reinvestment rate of 40%:

   \[ \text{Reinvestment Rate} = \frac{\text{Growth Rate}}{\text{Return on Capital}} = \frac{4\%}{10\%} = 40 \%
   \]

4. **Adjust risk and cost of capital**: The beta for the stock will drop to one, reflecting Disney’s status as a mature company.

   \[
   \text{Cost of Equity} = \text{Riskfree Rate} + \beta \times \text{Risk Premium} = 4\% + 4.82\% = 8.82\%
   \]

   The debt ratio for Disney will rise to 30%. Since we assume that the cost of debt remains unchanged at 5.25%, this will result in a cost of capital of 7.16%:

   \[
   \text{Cost of capital} = 8.82\% \times 0.70 + 5.25\% \times (1 - 0.373) \times 0.30 = 7.16\%
   \]
Disney: Valuation

Current Cashflow to Firm

EBIT(1-t) : 1,759
- Nt CpX 481
- Chg WC 454
= FCFF $824
Reinvestment Rate=(481+454)/1759 = 53.18%

Expected Growth in EBIT (1-t)
0.5318*.12=0.0638
6.38%

EBIT (1-t) $1,871 $1,990 $2,117 $2,252 $2,396 $2,538 $2,675 $2,808 $2,934 $3,051
- Reinvestment $995 $1,058 $1,126 $1,198 $1,274 $1,283 $1,282 $1,271 $1,251 $1,220
FCFF $876 $932 $991 $1,055 $1,122 $1,255 $1,394 $1,537 $1,683 $1,831

In transition phase, debt ratio increases to 30% and cost of capital decreases to 7.16%
Growth drops to 4%

Terminal Value10= 1,904/0.0716-.04 = 60,219

Cost of Equity 10%

Cost of Debt
4.00%+1.25%(1-.373)
3.29%

Weights
E = 79% D = 21%

Return on Capital 12%

Stable Growth
g = 4%; Beta = 1.00;
Cost of capital = 7.16%
ROC= 10%
Reinvestment Rate=g/ROC =4/ 10= 40%

Terminal Value10= 1,904/0.0716-.04 = 60,219

Discount at Cost of Capital (WACC) = 10.00% (.79) + 3.29% (0.21) = 8.59

Value/Sh $11.14

Riskfree Rate: 4%
Beta 1.2456
Mature market premium 4%
Unlevered Beta for Sectors: 1.0674
Firm’s D/E Ratio: 24.77%

Disney was trading at about $26 at the time of this valuation.
**The Investment Decision**
Invest in projects that earn a return greater than a minimum acceptable hurdle rate.

**The Dividend Decision**
If you cannot find investments that earn more than the hurdle rate, return the cash to the owners of the business.

**The Financing Decision**
Choose a financing mix that minimizes the hurdle rate and match your financing to your assets.

**Expected Growth Rate**
\[ \text{Expected Growth Rate} = 12\% \times 53.18\% = 6.38\% \]

**Existing Investments**
ROC = 4.22%

**Current EBIT (1-t)**
$1,759

**New Investments**
Return on Capital 12%
Reinvestment Rate 53.18%

---

**Cost of capital**
\[ \text{Cost of capital} = 10\% \times 0.79 + 3.29\% \times 0.21 = 8.59\% \]

**Year** | **Expected Growth** | **EBIT** | **EBIT (1-t)** | **Reinvestment Rate** | **Reinvestment** | **FCFF** | **Cost of capital** | **PV of FCFF** |
--- | --- | --- | --- | --- | --- | --- | --- | --- |
Current | 6.38% | $2,805 | $1,759 | 53.18% | $994.92 | $876.06 | 8.59% | $806.74 |
1 | 6.38% | $2,984 | $1,871 | 53.18% | $1,058.41 | $931.96 | 8.59% | $790.31 |
2 | 6.38% | $3,174 | $1,990 | 53.18% | $1,125.94 | $991.43 | 8.59% | $774.22 |
3 | 6.38% | $3,377 | $2,117 | 53.18% | $1,197.79 | $1,054.70 | 8.59% | $758.45 |
4 | 6.38% | $3,592 | $2,252 | 53.18% | $1,274.23 | $1,122.00 | 8.59% | $743.00 |
5 | 6.38% | $3,822 | $2,396 | 53.18% | $1,352.66 | $1,191.37 | 8.59% | $727.33 |
6 | 5.90% | $4,047 | $2,538 | 50.54% | $1,433.03 | $1,265.13 | 8.31% | $711.00 |
7 | 5.43% | $4,267 | $2,675 | 47.91% | $1,513.41 | $1,338.90 | 8.02% | $694.92 |
8 | 4.95% | $4,478 | $2,808 | 45.27% | $1,593.78 | $1,412.62 | 7.73% | $678.37 |
9 | 4.48% | $4,679 | $2,934 | 42.64% | $1,674.15 | $1,486.34 | 7.45% | $661.90 |
10 | 4.00% | $4,866 | $3,051 | 40.00% | $1,754.51 | $1,559.97 | 7.16% | $645.31 |

**Terminal Value**
$60,219.11

**Value of Operating Assets** = $35,372.62
+ Cash & Non-op Assets = $3,432.00
Value of firm = $38,804.62
- Debt = $14,668.22
- Options = $1,334.67
Value of equity in stock = $22,801.73
Value per share = $11.14
### The Investment Decision
Invest in projects that earn a return greater than a minimum acceptable hurdle rate.

### The Dividend Decision
If you cannot find investments that earn more than the hurdle rate, return the cash to the owners of the business.

### The Financing Decision
Choose a financing mix that minimizes the hurdle rate and match your financing to your assets.

**Return on Capital**
15%

**Reinvestment Rate**
53.18%

**Expected Growth Rate** = 15% * 53.18% = 7.98%

**Cost of capital** = 10.53% (.70) + 3.45% (.30) = 8.40%

---

<table>
<thead>
<tr>
<th>Year</th>
<th>Expected Growth</th>
<th>EBIT</th>
<th>Reinvestment</th>
<th>Reinvestment</th>
<th>FCFF</th>
<th>Cost of capital</th>
<th>PV of FCFF</th>
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</tbody>
</table>

**Value of Operating Assets =** 
$74,900

**Value of Operating Assets =** 
$3,432

**Value of firm =** 
$78,332

**Debt =** 
$14,649

**Options =** 
$1,335

**Value of equity in stock =** 
$62,349

**Value per share =** 
$30.45
First Principles

- Invest in projects that yield a return greater than the minimum acceptable hurdle rate.
  - The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners’ funds (equity) or borrowed money (debt)
  - Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.
- Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.
- If there are not enough investments that earn the hurdle rate, return the cash to stockholders.
  - The form of returns - dividends and stock buybacks - will depend upon the stockholders’ characteristics.

Objective: Maximize the Value of the Firm