Equity Instruments: Newsletter – September 20, 2014

Where we are in class…

Lecture Notes Packet 1 (pdf)

Last session: Page 52

As of next week: Page 100

- Basics of DCF valuation
- Estimation of Discount Rates
- Estimation of Cash Flows
- Estimation of Growth Rates
- Estimation of Growth Patterns
- Choosing the Right Model
- Dealing with Loose Ends
- Valuation Examples
- The Dark Side of Valuation

Where you should be in the project…

DCF Valuation portion of Project

Item

1. Pick a firm
2. Obtain its financials
3. Find out the businesses that your firm operates in
4. Obtain a riskfree rate
5. Estimate a market risk premium ←
6. Estimate a bottom-up unlevered beta
7. Estimate the market value of equity and debt
8. Estimate a bottom-up levered beta
9. Estimate a pre-tax cost of debt (using actual or synthetic ratings)
10. Convert operating leases into debt
11. Estimate a tax rate
11. Estimate a cost of capital
12. Capitalize R&D expenses
13. Estimate an adjusted operating income
14. Estimate net capital expenditures
15. Estimate non-cash working capital
16. Estimate Free Cash Flow to Firm
17. Estimate Free Cash Flow to Equity
18. Estimate a historical growth rate in earnings
19. Obtain analyst forecasts of growth in earnings for your firm
20. Estimate growth in earnings from fundamentals
21. Choose a length for the high growth period
22. Choose a DCF model
23. Value the firm/stock

Data Notes…

You can get a riskfree rate for the US by going to:
http://www.cnnfn.com

You can also get bond rates from other countries by going to:
http://www.tradingeconomics.com/bonds-list-by-country

Next week, we will start on estimating betas. You can get a beta for comparable firms and a debt to equity ratio, on average, for these firms, by going to:
http://www.reuters.com/finance/stocks
Type in the symbol for your stock. You will get an average beta for the sector and average book value debt to equity ratio. You have to estimate the market value debt to equity ratio by doing the following:
Market D/E Ratio = Book D/E ratio/Price to book ratio
Use the average beta and the average market debt to equity ratio to estimate the unlevered beta (You can use a 35% tax rate).
If you want to find out how Barra adjusts its betas, you can try their site:
http://www.barra.com

Miscellaneous FAQs

I am analyzing a foreign company. Which riskfree rate should I get?
Your choice of riskfree rate will be determined by which currency you do your valuation in, and whether you use real or nominal cash flows.
What risk premium should I be using my valuations?
You know my views. I think you should use an implied equity risk premium in mature markets, where you can get the information to estimate it. If you cannot, you should add a country risk premium to the US implied equity risk premium.
My stock has not been listed long. Can I get a beta calculation off Bloomberg?
You can get the beta calculation, by using daily returns. The beta will probably not mean much, though.