Equity Instruments: Newsletter – March 8, 2014

Where we are in class…

Lecture Notes Packet 1 (pdf)

	Basics of DCF valuation
	Estimation of Discount Rates
	Estimation of Cash Flows
As of last session: Page 165	Estimation of Growth Rates
	Estimation of Growth Patterns
	Choosing the Right Model
	Dealing with Cash
As of next week: Page 220	Dealing with Options
	Examples 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…

Now that you have the fundamental inputs for valuing your firm - the cash flows, the growth rate, the discount rate - you have to pick a valuation model. You can download a spreadsheet that will help in making this choice by going to

http://www.stern.nyu.edu/~adamodar/New_Home_Page/spreadsh.htm

To download any of the valuations that we will be doing in class in the next weeks, you can check out company valuations at

http://www.stern.nyu.edu/~adamodar/New_Home_Page/covals.htm

Miscellaneous FAQs

How do I decide on whether to use a stable growth, 2-stage or 3-stage model?

The choice is ultimately a subjective one. While historical growth is one input, you should also look at the growth of the market your firm serves and your firm's market share.

How do I know whether I should estimate FCFF or FCFE?

You do not, until you have picked a DCF model that fits your firm. I would estimate both. Once you have picked a DCF model, you can decide which one is more appropriate.

My company has negative earnings. Which stage model should I use?

If your firm has negative earnings, you first have to decide how you are going to normalize earnings. If you can normalize earnings instantaneously, you can then pick a stable growth or 2-stage model. If you cannot, you will have to forecast revenue growth over a period and an expected operating margin at the end; you would use these then to project free cash flows to the firm.