Valuation: Newsletter – February 8, 2025

Where we are in class…

Lecture Notes Packet 1 (pdf)

As of last week: Page 37 ⟶

As of next week: Page 90 ⟶

Basics of DCF valuation
Riskfree Rates
Equity Risk Premiums
Betas & Cost of debt
Estimation of Cash Flows
Estimation of Growth Rates
Estimation of Growth Patterns
Choosing the Right Model
Dealing with Cash
Dealing with Options
Examples of Valuation
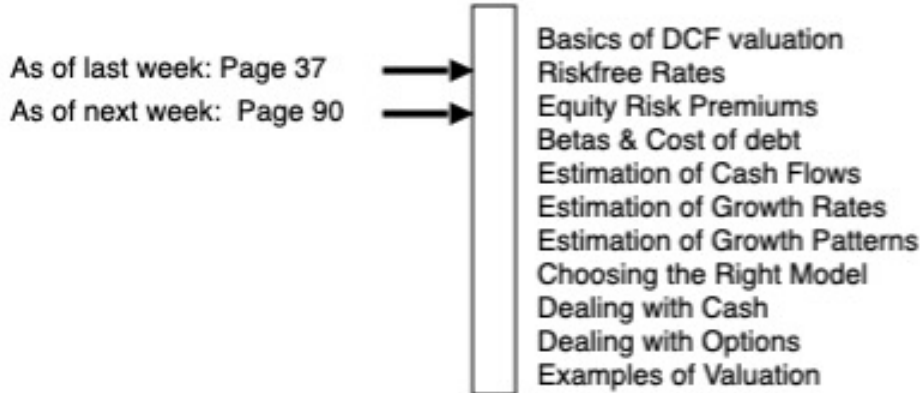
Where you should be in the project…

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…

You can get a riskfree rate in US dollars by going to:

https://www.bloomberg.com/markets/rates-bonds

You can also get bond rates from other countries by going to:

https://tradingeconomics.com/bonds

Next week, we will start on equity risk premiums, the next peg in estimating discount rates. We will look at the conventional practice of using historical risk premiums as estimates of future equity risk premiums and why this practice is becoming dangerous. We will look at alternatives to historical risk premiums, and in particular, an implied equity risk premium that you can back into form the current level of the index. To get a deeper look at all of these, you may want to look at my paper on equity risk premiums (which is updated once every year):

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4066060

I won't tell you that you will enjoy the read but you may find it useful.

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 if I cannot get a risk free rate in the local currency?

If, in spite of your best efforts, you cannot get a risk free rate in the local currency, you can do one of three things:

1. Do your valuation in real terms (using the TIPs rate as your risk free rate)
2. Do your valuation in an alternate currency, say US dollars
3. Build up to a synthetic riskfree rate

Should I normalize risk free rate?

Heck, no!