

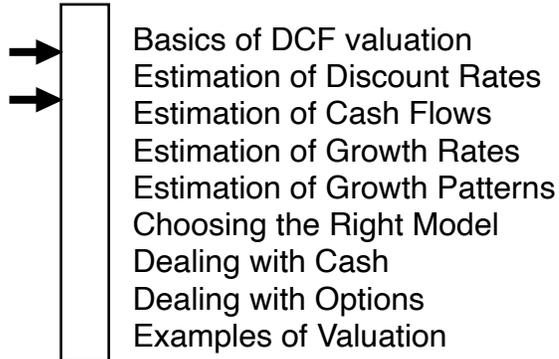
Valuation: Newsletter – February 15, 2020

Where we are in class...

Lecture Notes Packet 1 (pdf)

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Where you should be in the project...

DCF Valuation portion of Project

- | <i>Item</i> |
|------------------------------------------------------------------------|
| 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 risk free 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:

<http://www.tradingeconomics.com/bonds-list-by-country>

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 from 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=3378246

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 risk free rate

Should I normalize risk free rate?

Heck, no! Please revisit the discussion we had towards the end of the class on risk free rates to see why this practice is dangerous.