

Equity Instruments: Newsletter – February 26, 2022

Where we are in class...

Lecture Notes Packet 1 (pdf)

As of last week: Page 130



As of next week: Page 180



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 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...

Next week, we will start on the discussion of growth and how best to estimate growth for a company. You can get analyst estimates of growth in earnings for your firm by visiting the Zacks web site

<http://www.zacks.com>

If you want to look at historical growth rates in revenues and earnings for your firms, check under updated data on my web site. Since we also link growth to fundamentals, you can also get a measure of the fundamentals that drive growth (retention ratio, reinvestment rates, return on equity and return on capital) for different sectors under the updated data site as well.

Miscellaneous FAQs

Which earnings should I compute growth in? Net income? Operating Income? Earnings per share?

At this stage in the process it is probably best to do all of the above. The differences will tell you a great deal about how this firm is growing and may affect your estimates for the future.

What happens if my firm is not followed by analysts or I cannot get analyst projections of growth?

Given how little information there is in these forecasts, it is not the end of the world.

Work with fundamental growth rates.

I am having trouble estimating historical growth. What should I do?

See answer to last question.