



TYING UP LOOSE ENDS

The trouble starts after you tell me you are done..

But what comes next?

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Value of Operating Assets	Since this is a discounted cashflow valuation, should there be a real option premium?
+ Cash and Marketable Securities	Operating versus Non-operating cash Should cash be discounted for earning a low return?
+ Value of Cross Holdings	How do you value cross holdings in other companies? What if the cross holdings are in private businesses?
+ Value of Other Assets	What about other valuable assets? How do you consider under utilized assets?
Value of Firm	Should you discount this value for opacity or complexity? How about a premium for synergy? What about a premium for intangibles (brand name)?
- Value of Debt	What should be counted in debt? Should you subtract book or market value of debt? What about other obligations (pension fund and health care)? What about contingent liabilities? What about minority interests?
= Value of Equity	Should there be a premium/discount for control? Should there be a discount for distress
- Value of Equity Options	What equity options should be valued here (vested versus non-vested)? How do you value equity options?
= Value of Common Stock	Should you divide by primary or diluted shares?
/ Number of shares	
= Value per share	Should there be a discount for illiquidity/ marketability? Should there be a discount for minority interests?

1. The Value of Cash

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- The simplest and most direct way of dealing with cash and marketable securities is to keep it out of the valuation - the cash flows should be before interest income from cash and securities, and the discount rate should not be contaminated by the inclusion of cash. (Use betas of the operating assets alone to estimate the cost of equity).
- Once the operating assets have been valued, you should add back the value of cash and marketable securities.
- In many equity valuations, the interest income from cash is included in the cashflows. The discount rate has to be adjusted then for the presence of cash. (The beta used will be weighted down by the cash holdings). Unless cash remains a fixed percentage of overall value over time, these valuations will tend to break down.

An Exercise in Cash Valuation

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	<i>Company A</i>	<i>Company B</i>	<i>Company C</i>
Enterprise Value	\$1,000.0	\$1,000.0	\$1,000.0
Cash	\$100.0	\$100.0	\$100.0
Return on invested capital	10%	5%	22%
Cost of capital	10%	10%	12%
Trades in	US	US	Argentina

In which of these companies is cash most likely to be

- a) A Neutral Asset (worth \$100 million)
- b) A Wasting Asset (worth less than \$100 million)
- c) A Potential Value Creator (worth >\$100 million)

Should you ever discount cash for its low returns?

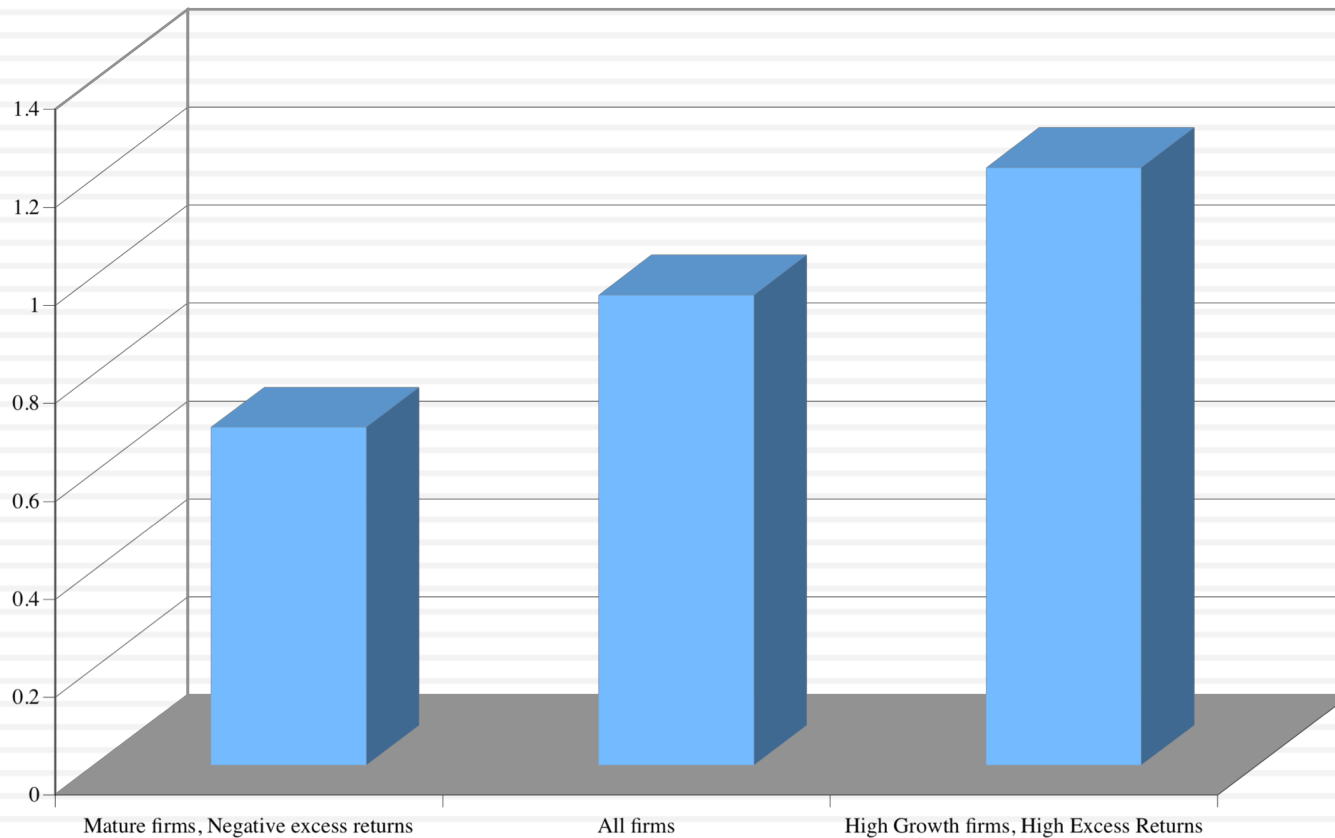
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- There are some analysts who argue that companies with a lot of cash on their balance sheets should be penalized by having the excess cash discounted to reflect the fact that it earns a low return.
 - Excess cash is usually defined as holding cash that is greater than what the firm needs for operations.
 - A low return is defined as a return lower than what the firm earns on its non-cash investments.
- This is the wrong reason for discounting cash. If the cash is invested in riskless securities, it should earn a low rate of return. As long as the return is high enough, given the riskless nature of the investment, cash does not destroy value.
- There is a right reason, though, that may apply to some companies... Managers can do stupid things with cash (overpriced acquisitions, pie-in-the-sky projects....) and you have to discount for this possibility.

Cash: Discount or Premium?

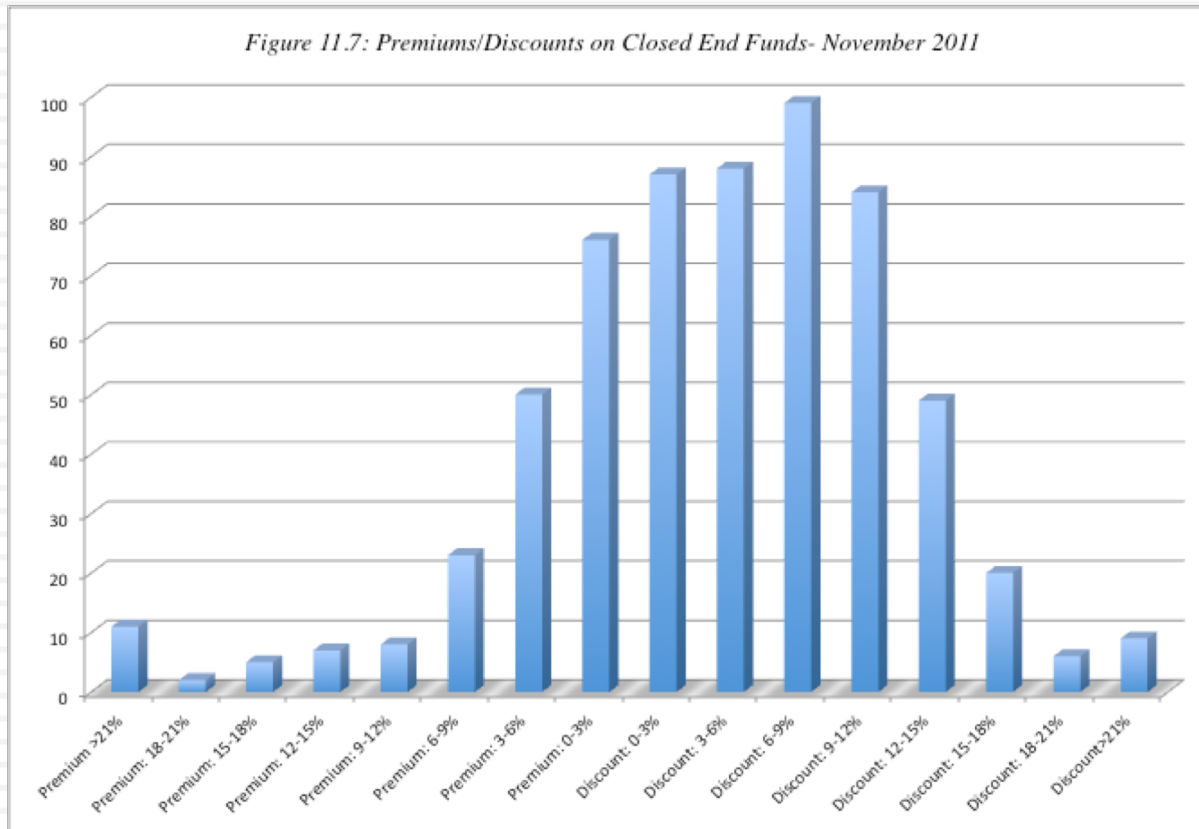
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*Market Value of \$ 1 in cash:
Estimates obtained by regressing Enterprise Value against Cash Balances*



A Detour: Closed End Mutual Funds

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- Assume that you have a closed-end fund that invests in ‘average risk’ stocks. Assume also that you expect the market (average risk investments) to make 11.5% annually over the long term. If the closed end fund underperforms the market by 0.50%, estimate the discount on the fund.

The Most Famous Closed End Fund in History?

Berkshire Hathaway: The Fading Buffett Premium

