

A DETOUR: ASSET BASED VALUATION

Value assets, not cash flows?

What is asset-based valuation?

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- In intrinsic valuation, you value a business based upon the cash flows you expect that business to generate over time.
- In relative valuation, you value a business based upon how similar businesses are priced.
- In asset-based valuation, you value a business by valuing its individual assets. These individual assets can be tangible or intangible.

Why would you do asset-based valuation?

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- Liquidation: If you are liquidating a business by selling its assets piece meal, rather than as a composite business, you would like to estimate what you will get from each asset or asset class individually.
- Accounting mission: As both US and international accounting standards have turned to “fair value” accounting, accountants have been called upon to redo balance sheet to reflect the assets at their fair rather than book value.
- Sum of the parts: If a business is made up of individual divisions or assets, you may want to value these parts individually for one of two groups:
 - Potential acquirers may want to do this, as a precursor to restructuring the business.
 - Investors may be interested because a business that is selling for less than the sum of its parts may be “cheap”.

How do you do asset-based valuation?

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- Intrinsic value: Estimate the expected cash flows on each asset or asset class, discount back at a risk adjusted discount rate and arrive at an intrinsic value for each asset.
- Relative value: Look for similar assets that have sold in the recent past and estimate a value for each asset in the business.
- Accounting value: You could use the book value of the asset as a proxy for the estimated value of the asset.

When is asset-based valuation easiest to do?

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- Separable assets: If a company is a collection of separable assets (a set of real estate holdings, a holding company of different independent businesses), asset-based valuation is easier to do. If the assets are interrelated or difficult to separate, asset-based valuation becomes problematic. Thus, while real estate or a long-term licensing/franchising contract may be easily valued, brand name (which cuts across assets) is more difficult to value separately.
- Stand alone earnings/ cash flows: An asset is much simpler to value if you can trace its earnings/cash flows to it. It is much more difficult to value when the business generates earnings, but the role of individual assets in generating these earnings cannot be isolated.
- Active market for similar assets: If you plan to do a relative valuation, it is easier if you can find an active market for “similar” assets which you can draw on for transactions prices.

I. Liquidation Valuation

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- In liquidation valuation, you are trying to assess how much you would get from selling the assets of the business today, rather than the business as a going concern.
- Consequently, it makes more sense to price those assets (i.e., do relative valuation) than it is to value them (do intrinsic valuation).
 - ▣ For assets that are separable and traded (example: real estate), pricing is easy to do.
 - ▣ For assets that are not, you often see book value used either as a proxy for liquidation value or as a basis for estimating liquidation value.
- To the extent that the liquidation is urgent, you may attach a discount to the estimated value.

II. Accounting Valuation: Glimmers from FAS 157

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- The ubiquitous “market participant”: Through FAS 157, accountants are asked to attach values to assets/liabilities that market participants would have been willing to pay/ receive.
- Tilt towards relative value: “The definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price).” The hierarchy puts “market prices”, if available for an asset, at the top with intrinsic value being accepted only if market prices are not accessible.
- Split mission: While accounting fair value is tilted towards relative valuation, accountants are also required to back their relative valuations with intrinsic valuations. Often, this leads to reverse engineering, where accountants arrive at values first and develop valuations later.

III. Sum of the parts valuation

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- You can value a company in pieces, using either relative or intrinsic valuation. Which one you use will depend on who you are and your motives for doing the sum of the parts valuation.
- If you are long term, passive investor in the company, your intent may be to find market mistakes that you hope will get corrected over time. If that is the case, you should do an intrinsic valuation of the individual assets.
- If you are an activist investor that plans to acquire the company or push for change, you should be more focused on relative valuation, since your intent is to get the company to split up and gain the increase in value.

Let's try this:

United Technologies: Raw Data - 2009

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<i>Division</i>	<i>Business</i>	<i>Revenues</i>	<i>EBITDA</i>	<i>Pre-tax Operating Income</i>	<i>Capital Expenditures</i>	<i>Depreciation</i>	<i>Total Assets</i>
Carrier	Refrigeration systems	\$14,944	\$1,510	\$1,316	\$191	\$194	\$10,810
Pratt & Whitney	Defense	\$12,965	\$2,490	\$2,122	\$412	\$368	\$9,650
Otis	Construction	\$12,949	\$2,680	\$2,477	\$150	\$203	\$7,731
UTC Fire & Security	Security	\$6,462	\$780	\$542	\$95	\$238	\$10,022
Hamilton Sundstrand	Manufacturing	\$6,207	\$1,277	\$1,099	\$141	\$178	\$8,648
Sikorsky	Aircraft	\$5,368	\$540	\$478	\$165	\$62	\$3,985

The company also had corporate expenses, unallocated to the divisions of \$408 million in the most recent year.

United Technologies: Relative Valuation

Median Multiples

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<i>Division</i>	<i>Business</i>	<i>EBITDA</i>	<i>EV/EBITDA for sector</i>	<i>Value of Business</i>
Carrier	Refrigeration systems	\$1,510	5.25	\$7,928
Pratt & Whitney	Defense	\$2,490	8.00	\$19,920
Otis	Construction	\$2,680	6.00	\$16,080
UTC Fire & Security	Security	\$780	7.50	\$5,850
Hamilton Sundstrand	Industrial Products	\$1,277	5.50	\$7,024
Sikorsky	Aircraft	\$540	9.00	\$4,860
Sum of the parts value for business =				\$61,661

United Technologies: Relative Valuation Plus Scaling variable & Choice of Multiples

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Division	Business	Revenues	EBITDA	Operating Income	Capital Invested
Carrier	Refrigeration systems	\$14,944	\$1,510	\$1,316	\$6,014
Pratt & Whitney	Defense	\$12,965	\$2,490	\$2,122	\$5,369
Otis	Construction	\$12,949	\$2,680	\$2,477	\$4,301
UTC Fire & Security	Security	\$6,462	\$780	\$542	\$5,575
Hamilton Sundstrand	Industrial Products	\$6,207	\$1,277	\$1,099	\$4,811
Sikorsky	Aircraft	\$5,368	\$540	\$478	\$2,217
Total		\$58,895	\$9,277	\$8,034	\$28,287

Business	Best Multiple	Regression	R ²
Refrigeration systems	EV/EBITDA	$EV/EBITDA = 5.35 - 3.55 \text{ Tax Rate} + 14.17 \text{ ROC}$	42%
Defense	EV/Revenues	$EV/Revenues = 0.85 + 7.32 \text{ Pre-tax Operating Margin}$	47%
Construction	EV/EBITDA	$EV/EBITDA = 3.17 - 2.87 \text{ Tax Rate} + 14.66 \text{ ROC}$	36%
Security	EV/Capital	$EV/ \text{Capital} = 0.55 + 8.22 \text{ ROC}$	55%
Industrial Products	EV/Revenues	$EV/Revenues = 0.51 + 6.13 \text{ Pre-tax Operating Margin}$	48%
Aircraft	EV/Capital	$EV/ \text{Capital} = 0.65 + 6.98 \text{ ROC}$	40%

United Technologies: Relative Valuation

Sum of the Parts value

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Division	Scaling Variable	Current value for scaling variable	ROC	Operating Margin	Tax Rate	Predicted Multiple	Estimated Value
Carrier	EBITDA	\$1,510	13.57%	8.81%	38%	$5.35 - 3.55 (.38) + 14.17 (.1357) = 5.92$	\$8,944.47
Pratt & Whitney	Revenues	\$12,965	24.51%	16.37%	38%	$0.85 + 7.32 (.1637) = 2.05$	\$26,553.29
Otis	EBITDA	\$2,680	35.71%	19.13%	38%	$3.17 - 2.87 (.38) + 14.66 (.3571) = 7.31$	\$19,601.70
UTC Fire & Security	Capital	\$5,575	6.03%	8.39%	38%	$0.55 + 8.22 (.0603) = 1.05$	\$5,828.76
Hamilton Sundstrand	Revenues	\$6,207	14.16%	17.71%	38%	$0.51 + 6.13 (.1771) = 1.59$	\$9,902.44
Sikorsky	Capital	\$2,217	13.37%	8.90%	38%	$0.65 + 6.98 (.1337) = 1.58$	\$3,509.61
Sum of the parts value for operating assets =							\$74,230.37

United Technologies: DCF parts valuation

Cost of capital, by business

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Division	Unlevered Beta	Debt/Equity Ratio	Levered beta	Cost of equity	After-tax cost of debt	Debt to Capital	Cost of capital
Carrier	0.83	30.44%	0.97	9.32%	2.95%	23.33%	7.84%
Pratt & Whitney	0.81	30.44%	0.95	9.17%	2.95%	23.33%	7.72%
Otis	1.19	30.44%	1.39	12.07%	2.95%	23.33%	9.94%
UTC Fire & Security	0.65	30.44%	0.76	7.95%	2.95%	23.33%	6.78%
Hamilton Sundstrand	1.04	30.44%	1.22	10.93%	2.95%	23.33%	9.06%
Sikorsky	1.17	30.44%	1.37	11.92%	2.95%	23.33%	9.82%

United Technologies: DCF valuation

Fundamentals, by business

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<i>Division</i>	<i>Total Assets</i>	<i>Capital Invested</i>	<i>Cap Ex</i>	<i>Allocated Reinvestment</i>	<i>Operating income after taxes</i>	<i>Return on capital</i>	<i>Reinvestment Rate</i>
Carrier	\$10,810	\$6,014	\$191	\$353	\$816	13.57%	43.28%
Pratt & Whitney	\$9,650	\$5,369	\$412	\$762	\$1,316	24.51%	57.90%
Otis	\$7,731	\$4,301	\$150	\$277	\$1,536	35.71%	18.06%
UTC Fire & Security	\$10,022	\$5,575	\$95	\$176	\$336	6.03%	52.27%
Hamilton Sundstrand	\$8,648	\$4,811	\$141	\$261	\$681	14.16%	38.26%
Sikorsky	\$3,985	\$2,217	\$165	\$305	\$296	13.37%	102.95%

United Technologies, DCF valuation

Growth Choices

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<i>Division</i>	<i>Cost of capital</i>	<i>Return on capital</i>	<i>Reinvestment Rate</i>	<i>Expected growth</i>	<i>Length of growth period</i>	<i>Stable growth rate</i>	<i>Stable ROC</i>
Carrier	7.84%	13.57%	43.28%	5.87%	5	3%	7.84%
Pratt & Whitney	7.72%	24.51%	57.90%	14.19%	5	3%	12.00%
Otis	9.94%	35.71%	18.06%	6.45%	5	3%	14.00%
UTC Fire & Security	6.78%	6.03%	52.27%	3.15%	0	3%	6.78%
Hamilton Sundstrand	9.06%	14.16%	38.26%	5.42%	5	3%	9.06%
Sikorsky	9.82%	13.37%	102.95%	13.76%	5	3%	9.82%

United Technologies, DCF valuation

Values of the parts

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<i>Business</i>	<i>Cost of capital</i>	<i>PV of FCFF</i>	<i>PV of Terminal Value</i>	<i>Value of Operating Assets</i>
Carrier	7.84%	\$2,190	\$9,498	\$11,688
Pratt & Whitney	7.72%	\$3,310	\$27,989	\$31,299
Otis	9.94%	\$5,717	\$14,798	\$20,515
UTC Fire & Security	6.78%	\$0	\$4,953	\$4,953
Hamilton Sundstrand	9.06%	\$1,902	\$6,343	\$8,245
Sikorsky	9.82%	-\$49	\$3,598	\$3,550
<i>Sum</i>				\$80,250

United Technologies, DCF valuation

Sum of the Parts

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Value of the parts = \$80,250

Value of corporate expenses

$$= \frac{\text{Corporate Expenses}_{\text{Current}} (1 - t)(1 + g)}{(\text{Cost of capital}_{\text{Company}} - g)} = \frac{408(1 - .38)(1.03)}{(.0868 - .03)} = \$ 4,587$$

Value of operating assets (sum of parts DCF) = \$75,663

Value of operating assets (sum of parts RV) = \$74,230

Value of operating assets (company DCF) = \$71,410

Enterprise value (based on market prices) = \$52,261

GE in 2018: The Parts

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Business	Revenues- 2017	Revenue Growth in 2017	EBIT before G&A	EBIT after G&A	EBIT Margin	Invested Capital	ROIC in 2017	ROIC: 2013-2017	Cost of capital
Power	\$ 36.00	-1.64%	\$ 2.80	\$ 1.69	4.68%	\$328.34	3.85%	9.28%	4.91%
Renewable Energy	\$ 10.30	14.44%	\$ 0.70	\$ 0.41	4.00%	\$49.91	6.19%	8.00%	6.88%
Oil & Gas	\$ 17.20	33.33%	\$ 0.20	\$ (0.31)	-1.78%	\$275.95	-0.83%	3.71%	8.82%
Aviation	\$ 27.40	4.18%	\$ 6.60	\$ 5.80	21.19%	\$192.73	22.59%	20.27%	8.52%
Healthcare	\$ 19.10	4.37%	\$ 3.40	\$ 2.86	15.00%	\$132.81	16.18%	15.07%	7.97%
Transportation	\$ 4.20	-10.64%	\$ 0.80	\$ 0.70	16.56%	\$20.73	25.17%	26.67%	7.49%
Lighting	\$ 2.00	-58.33%	\$ 0.10	\$ 0.03	1.59%	\$3.34	7.16%	9.66%	8.50%
Capital	\$ 9.10	-16.51%	\$ (6.80)	\$ (7.04)	-77.40%	\$723.38	-7.30%	-2.81%	3.64%
Total	\$ 125.30	1.29%	\$ 7.80	\$ 4.15	3.31%	\$1,727.18	1.80%	4.50%	6.23%

GE: Value of the Parts

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Business	Revenues in 2017	Average EBIT Margin before G&A, 2013-17	Normalized EBIT before G&A	Normalized EBIT (with corporate expenses allocated)	Normalized EBIT (1-t)	Cost of Capital	ROIC - Next 5 years	Expected growth next 5 years	Value of Business
Power	\$ 35,990.00	14.34%	\$ 5,161.92	\$ 4,061.80	\$ 3,046.35	4.91%	9.28%	6.10%	\$ 73,138.18
Renewable Energy	\$ 10,280.00	8.24%	\$ 847.46	\$ 532.70	\$ 399.53	6.88%	8.00%	16.34%	\$ 6,455.88
Oil & Gas	\$ 17,231.00	10.97%	\$ 1,890.80	\$ 1,365.19	\$ 1,023.89	8.82%	3.71%	-0.13%	\$ 11,924.66
Aviation	\$ 27,375.00	22.09%	\$ 6,046.58	\$ 5,209.28	\$ 3,906.96	8.52%	20.27%	4.55%	\$ 52,849.35
Healthcare	\$ 19,116.00	17.01%	\$ 3,251.87	\$ 2,668.20	\$ 2,001.15	7.97%	15.07%	0.99%	\$ 26,233.80
Transportation	\$ 4,178.00	20.71%	\$ 865.41	\$ 737.06	\$ 552.80	7.49%	26.67%	-6.62%	\$ 6,075.26
Lighting	\$ 1,987.00	5.24%	\$ 104.14	\$ 43.03	\$ 32.27	8.50%	9.66%	-24.94%	\$ 280.49
Total (non-capital)	\$ 116,157.00	15.35%	\$ 17,829.69	\$ 17,551.60	\$ 13,163.70				\$ 176,957.62
GE Capital Business	\$ 9,070.00	3.00%	\$ 272.10	\$ (5.98)	\$ (4.49)	6.23%	0.00%	-4.25%	\$ 27,080.96
Value of businesses									\$ 204,038.59
- GE Debt									\$ 83,568.00
- GE Capital Debt									\$ 51,023.00
- Minority Interests									\$ 17,723.00
+ Cash									\$ 43,299.00
Value of equity									\$ 95,023.59
- Options									\$ 218.94
Value of equity in common stock									\$ 94,804.65
Value per share									\$ 10.92

GE: Pricing the Parts

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<i>Business</i>	<i>Revenues in 2017</i>	<i>Normalized EBIT, using average margin (2013-17)</i>	<i>DA in 2017</i>	<i>EBITDA</i>	<i>Peer Group EV/EBITDA</i>	<i>Estimated Pricing</i>
Power	\$ 35,990.00	\$ 4,061.80	\$ 1,358.00	\$ 5,419.80	10.55	\$ 57,179
Renewable Energy	\$ 10,280.00	\$ 532.70	\$ 259.00	\$ 791.70	15.13	\$ 11,978
Oil & Gas	\$ 17,231.00	\$ 1,365.19	\$ 1,026.00	\$ 2,391.19	12.15	\$ 29,053
Aviation	\$ 27,375.00	\$ 5,209.28	\$ 979.00	\$ 6,188.28	6.56	\$ 40,595
Healthcare	\$ 19,116.00	\$ 2,668.20	\$ 806.00	\$ 3,474.20	10.97	\$ 38,112
Transportation	\$ 4,178.00	\$ 737.06	\$ 135.00	\$ 872.06	11.22	\$ 9,785
Lighting	\$ 1,987.00	\$ 43.03	\$ 86.00	\$ 129.03	12.8	\$ 1,652
Total (non-capital)	\$ 116,157.00	\$ 17,551.60				\$ 188,353
GE Capital Business	\$ 9,070.00	\$ (5.98)	\$ 2,343.00	\$ 2,337.02	10.13	\$ 23,674
Pricing of Business						\$ 212,027.44
- GE Debt						\$ 83,568.00
- GE Capital Debt						\$ 51,023.00
- Minority Interests						\$ 17,723.00
+ Cash						\$ 43,299.00
Pricing of Equity						\$ 103,012.44
- Options						218.94
Pricing of Equity in common stock						\$ 102,793.50
Estimating Pricing per share						\$11.84



PRIVATE COMPANY VALUATION

Aswath Damodaran

Process of Valuing Private Companies

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- The process of valuing private companies is not different from the process of valuing public companies. You estimate cash flows, attach a discount rate based upon the riskiness of the cash flows and compute a present value. As with public companies, you can either value
 - ▣ The entire business, by discounting cash flows to the firm at the cost of capital.
 - ▣ The equity in the business, by discounting cashflows to equity at the cost of equity.
- When valuing private companies, you face two standard problems:
 - ▣ There is not market value for either debt or equity
 - ▣ The financial statements for private firms are likely to go back fewer years, have less detail and have more holes in them.

1. No Market Value?

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- Market values as inputs: Since neither the debt nor equity of a private business is traded, any inputs that require them cannot be estimated.
 1. Debt ratios for going from unlevered to levered betas and for computing cost of capital.
 2. Market prices to compute the value of options and warrants granted to employees.
- Market value as output: When valuing publicly traded firms, the market value operates as a measure of reasonableness. In private company valuation, the value stands alone.
- Market price based risk measures, such as beta and bond ratings, will not be available for private businesses.

2. Cash Flow Estimation Issues

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- Shorter history: Private firms often have been around for much shorter time periods than most publicly traded firms. There is therefore less historical information available on them.
- Different Accounting Standards: The accounting statements for private firms are often based upon different accounting standards than public firms, which operate under much tighter constraints on what to report and when to report.
- Intermingling of personal and business expenses: In the case of private firms, some personal expenses may be reported as business expenses.
- Separating “Salaries” from “Dividends”: It is difficult to tell where salaries end and dividends begin in a private firm, since they both end up with the owner.

Private Company Valuation: Motive matters..

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- You can value a private company for
 - ▣ ‘Show’ valuations
 - Curiosity: How much is my business really worth?
 - Legal purposes: Estate tax and divorce court
 - ▣ Transaction valuations
 - Sale or prospective sale to another individual or private entity.
 - Sale of one partner’s interest to another
 - Sale to a publicly traded firm
 - ▣ As prelude to setting the offering price in an initial public offering
- You can value a division or divisions of a publicly traded firm
 - ▣ As prelude to a spin off
 - ▣ For sale to another entity
 - ▣ To do a sum-of-the-parts valuation to determine whether a firm will be worth more broken up or if it is being efficiently run.

Private company valuations: Four broad scenarios

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1. Private to private transactions: You can value a private business for sale by one individual to another.
2. Private to public transactions: You can value a private firm for sale to a publicly traded firm.
3. Private to IPO: You can value a private firm for an initial public offering.
4. Private to VC to Public: You can value a private firm that is expected to raise venture capital along the way on its path to going public.

I. Private to Private transaction

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- In private-to-private transactions, a private business is sold by one individual to another. There are three key issues that we need to confront in such transactions:
 - Neither the buyer nor the seller is diversified. Consequently, risk and return models that focus on just the risk that cannot be diversified away will seriously under estimate the discount rates.
 - The investment is illiquid. Consequently, the buyer of the business will have to factor in an “illiquidity discount” to estimate the value of the business.
 - Key person value: There may be a significant personal component to the value. In other words, the revenues and operating profit of the business reflect not just the potential of the business but the presence of the current owner.

An example: Valuing a restaurant

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- Assume that you have been asked to value an upscale French restaurant for sale by the owner (who also happens to be the chef). Both the restaurant and the chef are well regarded, and business has been good for the last 3 years.
 - The potential buyer is a former investment banker, who tired of the rat race, has decide to cash out all of his savings and use the entire amount to invest in the restaurant.
 - You have access to the financial statements for the last 3 years for the restaurant. In the most recent year, the restaurant reported \$ 1.2 million in revenues and \$ 400,000 in pre-tax operating profit .
 - While the firm has no conventional debt outstanding, it has a lease commitment of \$120,000 each year for the next 12 years.

Past income statements...

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	3 years ago	2 years ago	Last year	
Revenues	\$800	\$1,100	\$1,200	Operating at full capacity
- Operating lease expense	\$120	\$120	\$120	(12 years left on the lease)
- Wages	\$180	\$200	\$200	(Owner/chef does not draw salary)
- Material	\$200	\$275	\$300	(25% of revenues)
- Other operating expenses	\$120	\$165	\$180	(15% of revenues)
Operating income	\$180	\$340	\$400	
- Taxes	\$72	\$136	\$160	(40% tax rate)
Net Income	\$108	\$204	\$240	

All numbers are in thousands

Step 1: Estimating discount rates

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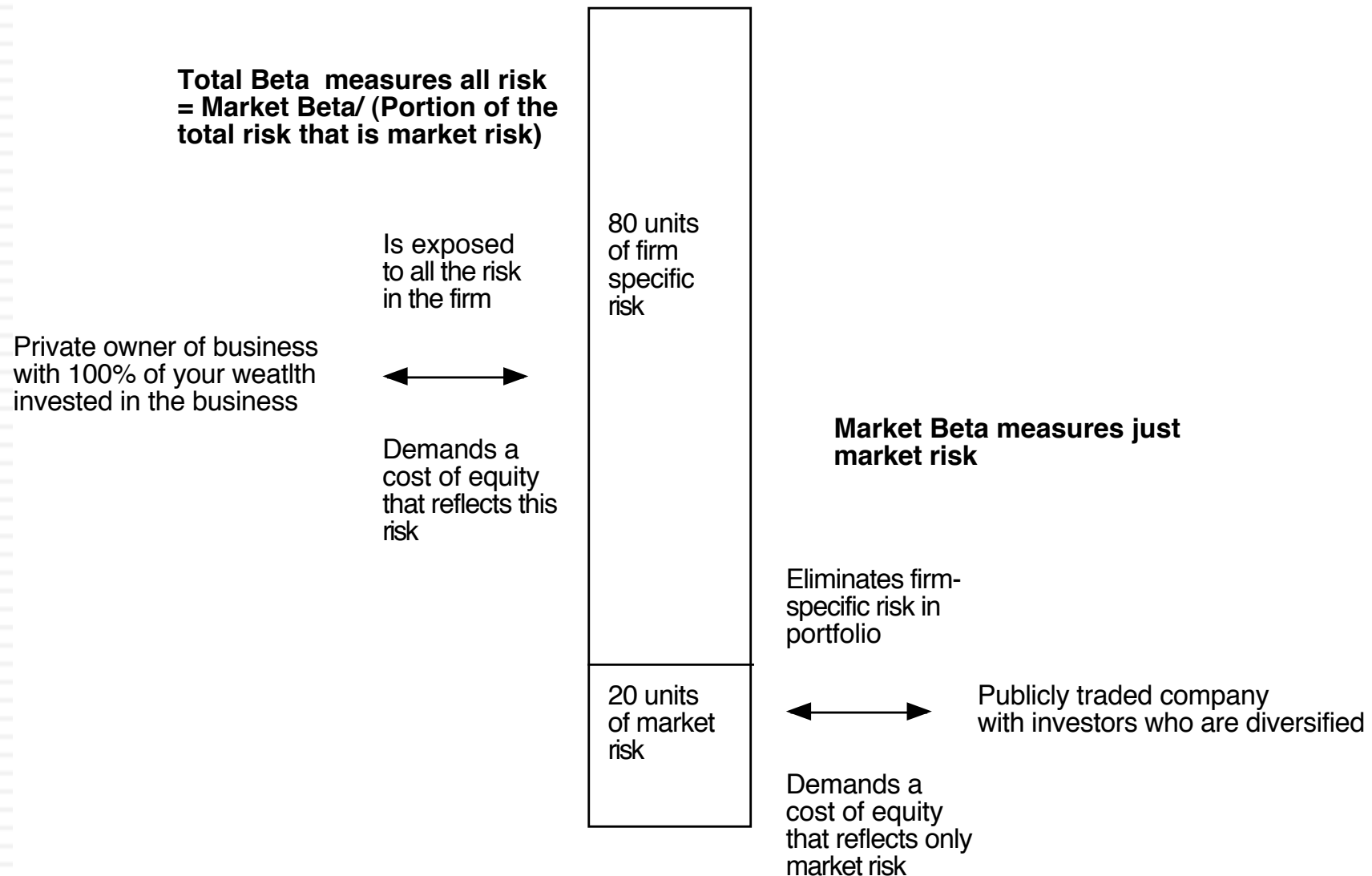
- Conventional risk and return models in finance are built on the presumption that the marginal investors in the company are diversified and that they therefore care only about the risk that cannot be diversified. That risk is measured with a beta or betas, usually estimated by looking at past prices or returns.
- In this valuation, both assumptions are likely to be violated:
 - As a private business, this restaurant has no market prices or returns to use in estimation.
 - The buyer is not diversified. In fact, he will have his entire wealth tied up in the restaurant after the purchase.

No market price, no problem... Use bottom-up betas to get the unlevered beta

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- The average unlevered beta across 75 publicly traded restaurants in the US is 0.86. Most of the publicly traded restaurants on this list are fast-food chains (McDonald's, Burger King) or mass restaurants (Applebee's, TGIF...). An upscale restaurant does not fit easily into this mix.
- There is an argument to be made that the beta for an upscale restaurant is more likely to reflect high-end specialty retailers than it is restaurants. The unlevered beta for 45 high-end retailers is 1.18.

Private Owner versus Publicly Traded Company Perceptions of Risk in an Investment



Estimating a total beta

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- To get from the market beta to the total beta, we need a measure of how much of the risk in the firm comes from the market and how much is firm-specific.
- Looking at the regressions of publicly traded firms that yield the bottom-up beta should provide an answer.
 - ▣ The average R-squared across the high-end retailer regressions is 25%.
 - ▣ Since betas are based on standard deviations (rather than variances), we will take the correlation coefficient (the square root of the R-squared) as our measure of the proportion of the risk that is market risk.
- Total Unlevered Beta
 - = Market Beta/ Correlation with the market
 - = $1.18 / 0.5 = 2.36$

The final step in the beta computation: Estimate a Debt to equity ratio and cost of equity

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- With publicly traded firms, we re-lever the beta using the market D/E ratio for the firm. With private firms, this option is not feasible. We have two alternatives:
 - ▣ Assume that the debt to equity ratio for the firm is similar to the average market debt to equity ratio for publicly traded firms in the sector.
 - ▣ Use your estimates of the value of debt and equity as the weights in the computation. (There will be a circular reasoning problem: you need the cost of capital to get the values and the values to get the cost of capital.)
- We will assume that this privately owned restaurant will have a debt to equity ratio (14.33%) similar to the average publicly traded restaurant (even though we used retailers to the unlevered beta).
 - ▣ Levered beta = $2.36 (1 + (1-.4) (.1433)) = 2.56$
 - ▣ Cost of equity = $4.25\% + 2.56 (4\%) = 14.50\%$
(T Bond rate was 4.25% at the time; 4% is the equity risk premium)

Estimating a cost of debt and capital

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- While the firm does not have a rating or any recent bank loans to use as reference, it does have a reported operating income and lease expenses (treated as interest expenses)
Coverage Ratio = Operating Income/ Interest (Lease) Expense
$$= 400,000 / 120,000 = 3.33$$

Rating based on coverage ratio = BB+ Default spread = 3.25%
After-tax Cost of debt = (Riskfree rate + Default spread) (1 – tax rate)
$$= (4.25\% + 3.25\%) (1 - .40) = 4.50\%$$
- To compute the cost of capital, we will use the same industry average debt ratio that we used to lever the betas.
 - Cost of capital = $14.50\% (100/114.33) + 4.50\% (14.33/114.33) = 13.25\%$
 - (The debt to equity ratio is 14.33%; the cost of capital is based on the debt to capital ratio)

Step 2: Clean up the financial statements

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	Stated	Adjusted	
Revenues	\$1,200	\$1,200	
- Operating lease expenses	\$120		Leases are financial expenses
- Wages	\$200	\$350	! Hire a chef for \$150,000/year
- Material	\$300	\$300	
- Other operating expenses	\$180	\$180	
Operating income	\$400	\$370	
- Interest expnses	\$0	\$69.62	7.5% of \$928.23 (see below)
Taxable income	\$400	\$300.38	
- Taxes	\$160	\$120.15	
Net Income	\$240	\$180.23	

Debt	0	\$928.23	! PV of \$120 million for 12 years @7.5%
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Step 3: Assess the impact of the “key” person

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- Part of the draw of the restaurant comes from the current chef. It is possible (and probable) that if he sells and moves on, there will be a drop off in revenues. If you are buying the restaurant, you should consider this drop off when valuing the restaurant.
- For instance, if 20% of the patrons are drawn to the restaurant because of the chef's reputation, the expected operating income will be lower if the chef leaves.
 - ▣ Adjusted operating income (existing chef) = \$ 370,000
 - ▣ Operating income (adjusted for chef departure) = \$296,000
- As the owner/chef of the restaurant, what might you be able to do to mitigate this loss in value?

Step 4: Don't forget valuation fundamentals

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- To complete the valuation, you need to assume an expected growth rate. As with any business, assumptions about growth have to be consistent with reinvestment assumptions. In the long term,

$\text{Reinvestment rate} = \text{Expected growth rate} / \text{Return on capital}$

- In this case, we will assume a 2% growth rate in perpetuity and a 20% return on capital.

$\text{Reinvestment rate} = g / \text{ROC} = 2\% / 20\% = 10\%$

- Even if the restaurant does not grow in size, this reinvestment is what you need to make to keep the restaurant both looking good (remodeling) and working well (new ovens and appliances).

Step 5: Complete the valuation

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□ Inputs to valuation

- ▣ Adjusted EBIT most recent year = \$ 296,000
- ▣ Tax rate = 40%
- ▣ Cost of capital (based on total beta) = 13.25%
- ▣ Expected growth rate = 2%
- ▣ Reinvestment rate (RIR) = 10%

□ Valuation

$$\begin{aligned}\text{Value of the restaurant} &= \text{Expected FCFF next year} / (\text{Cost of capital} - g) \\ &= \text{Expected EBIT next year} (1 - \text{tax rate}) (1 - \text{RIR}) / (\text{Cost of capital} - g) \\ &= 296,000 (1.02) (1 - .4) (1 - .10) / (.1325 - .02) \\ &= \$1.449 \text{ million}\end{aligned}$$

$$\begin{aligned}\text{Value of equity in restaurant} &= \$1.449 \text{ million} - \$0.928 \text{ million (PV of leases)} \\ &= \$0.521 \text{ million}\end{aligned}$$

Step 6: Consider the effect of illiquidity

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- In private company valuation, illiquidity is a constant theme. All the talk, though, seems to lead to a rule of thumb. The illiquidity discount for a private firm is between 20-30% and does not vary across private firms.
- But illiquidity should vary across:
 - ▣ Companies: Healthier and larger companies, with more liquid assets, should have smaller discounts than money-losing smaller businesses with more illiquid assets.
 - ▣ Time: Liquidity is worth more when the economy is doing badly and credit is tough to come by than when markets are booming.
 - ▣ Buyers: Liquidity is worth more to buyers who have shorter time horizons and greater cash needs than for longer term investors who don't need the cash and are willing to hold the investment.

The Standard Approach: Illiquidity discount based on illiquid publicly traded assets

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- Restricted stock: These are stock issued by publicly traded companies to the market that bypass the SEC registration process but the stock cannot be traded for one year after the issue.
- Pre-IPO transactions: These are transactions prior to initial public offerings where equity investors in the private firm buy (sell) each other's stakes.
- In both cases, the discount is estimated to be the difference between the market price of the liquid asset and the observed transaction price of the illiquid asset.
 - ▣ Discount Restricted stock = Stock price – Price on restricted stock offering
 - ▣ $\text{Discount}_{\text{IPO}} = \text{IPO offering price} - \text{Price on pre-IPO transaction}$

The Restricted Stock Discount

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- Aggregate discount studies
 - Maher examined restricted stock purchases made by four mutual funds in the period 1969-73 and concluded that they traded an average discount of 35.43% on publicly traded stock in the same companies.
 - Moroney reported a mean discount of 35% for acquisitions of 146 restricted stock issues by 10 investment companies, using data from 1970.
 - In a study of restricted stock offerings from the 1980s, Silber (1991) finds that the median discount for restricted stock is 33.75%.
- Silber related the size of the discount to characteristics of the offering:
$$\text{LN(RPRS)} = 4.33 + 0.036 \text{ LN(REV)} - 0.142 \text{ LN(RBRT)} + 0.174 \text{ DERN} + 0.332 \text{ DCUST}$$
 - RPRS = Relative price of restricted stock (to publicly traded stock)
 - REV = Revenues of the private firm (in millions of dollars)
 - RBRT = Restricted Block relative to Total Common Stock in %
 - DERN = 1 if earnings are positive; 0 if earnings are negative;
 - DCUST = 1 if there is a customer relationship with the investor; 0 otherwise;

Cross sectional differences in Illiquidity: Extending the Silber regression

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Figure 24.1: Illiquidity Discounts: Base Discount of 25% for profitable firm with \$ 10 million in revenues

