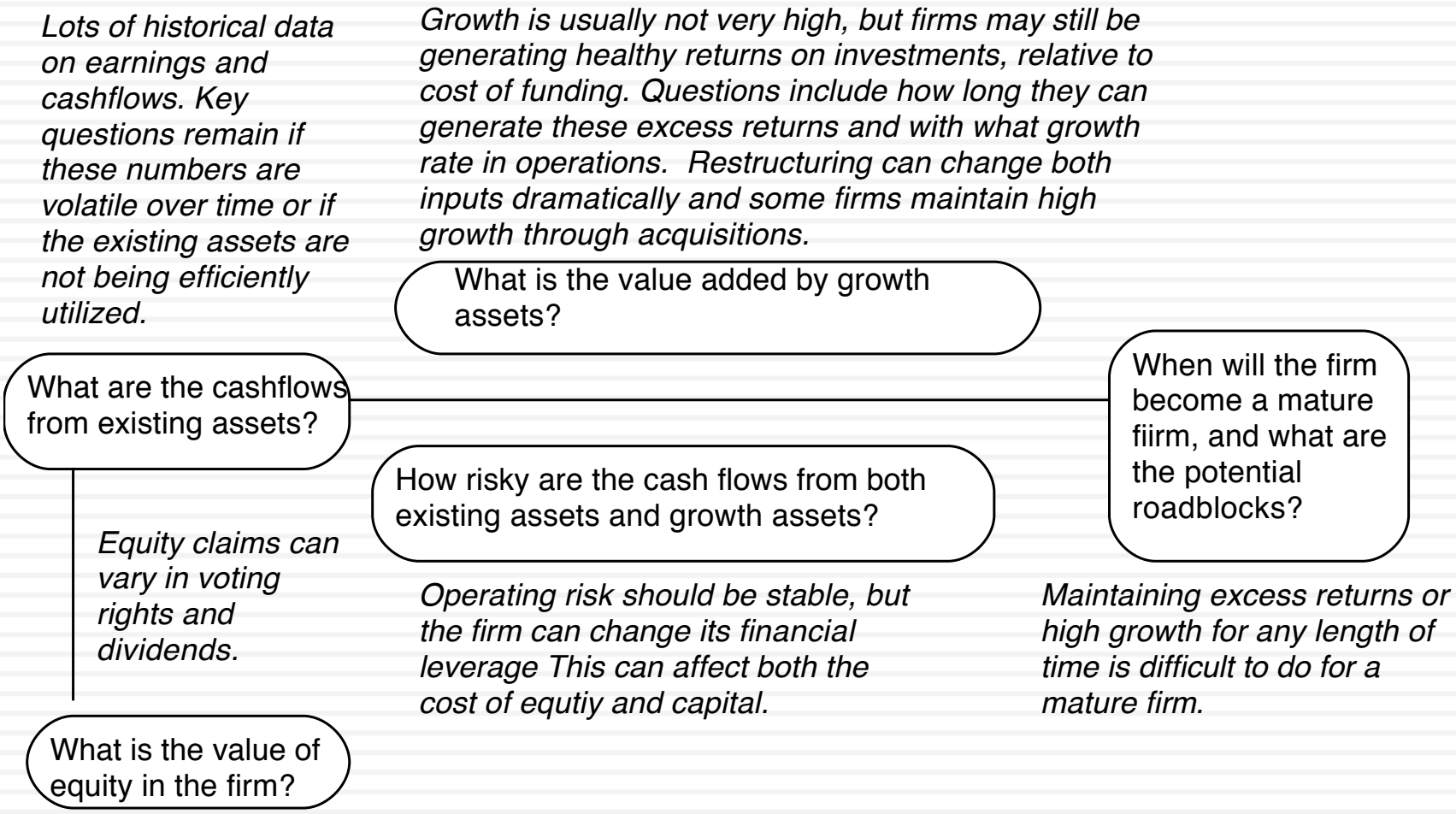
The perils of valuing mature companies…

Figure 7.1: Estimation Issues - Mature Companies



Hormel Foods: The Value of Control Changing

Hormel Foods sells packaged meat and other food products and has been in existence as a publicly traded company for almost 80 years. In 2008, the firm reported after-tax operating income of $315 million, reflecting a compounded growth of 5% over the previous 5 years.

The Status Quo

Run by existing management, with conservative reinvestment policies (reinvestment rate = 14.34% and debt ratio = 10.4%.

Anemic growth rate and short growth period, due to reinvestment policy

Low debt ratio affects cost of capital

Year	Operating income after taxes	Expected growth rate	ROC	Reinvestment Rate	Reinvestment	FCFF	Cost of capital	Present Value
Trailing 12 months	$315							
1	$324	2.75%	14.34%	19.14%	$62	$262	6.79%	$245
2	$333	2.75%	14.34%	19.14%	$64	$269	6.79%	$236
3	$342	2.75%	14.34%	19.14%	$65	$276	6.79%	$227
Beyond	$350	2.35%	7.23%	32.52%	$114	$4,840	7.23%	$3,974
Value of operating assets								$4,682
(Add) Cash								$155
(Subtract) Debt								$491
(Subtract) Management Options								$53
Value of equity in common stock								$4,293
Value per share								$31.91

New and better management

More aggressive reinvestment which increases the reinvestment rate (to 40%) and tlength of growth (to 5 years), and higher debt ratio (20%).

Operating Restructuring (1)
Expected growth rate = ROC * Reinvestment Rate
Expected growth rae (status quo) = 14.34% * 19.14% = 2.75%
Expected growth rate (optimal) = 14.00% * 40% = 5.60%
ROC drops, reinvestment rises and growth goes up.

Financial restructuring (2)
Cost of capital = Cost of equity (1-Debt ratio) + Cost of debt (Debt ratio)
Status quo = 7.33% (1-.104) + 3.60% (1-.40) (.104) = 6.79%
Optimal = 7.75% (1-.20) + 3.60% (1-.40) (.20) = 6.63%
Cost of equity rises but cost of capital drops.

Year	Operating income after taxes	Expected growth rate	ROC	Reinvestment Rate	Reinvestment	FCFF	Cost of capital	Present Value
Trailing 12 months	$315							
1	$333	5.60%	14.00%	40.00%	$133	$200	6.63%	$187
2	$351	5.60%	14.00%	40.00%	$141	$211	6.63%	$185
3	$371	5.60%	14.00%	40.00%	$148	$223	6.63%	$184
4	$392	5.60%	14.00%	40.00%	$260	$235	6.63%	$182
5	$414	5.60%	14.00%	40.00%	$223	$248	6.63%	$180
Beyond	$423	2.35%	6.74%	34.87%	$148	$6,282	6.74%	$4,557
Value of operating assets								$5,475
(Add) Cash								$155
(Subtract) Debt								$491
(Subtract) Management Options								$53
Value of equity in common stock								$5,085
Value per share								$37.80

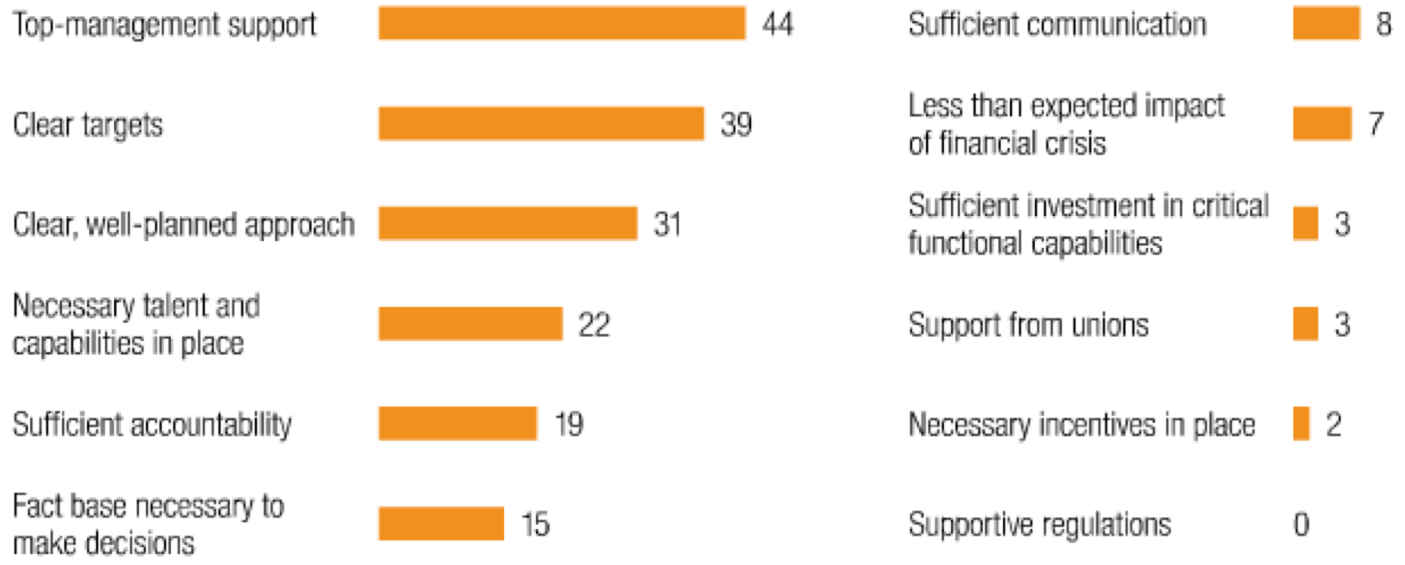
Probability of management change = 10% (3)
Expected value =$31.91 (.90) + $37.80 (.10) = $32.50 (4)

Lesson 1: Cost cutting and increased efficiency are easier accomplished on paper than in practice… and require commitment

Exhibit 4: **Top factors for meeting targets** expand

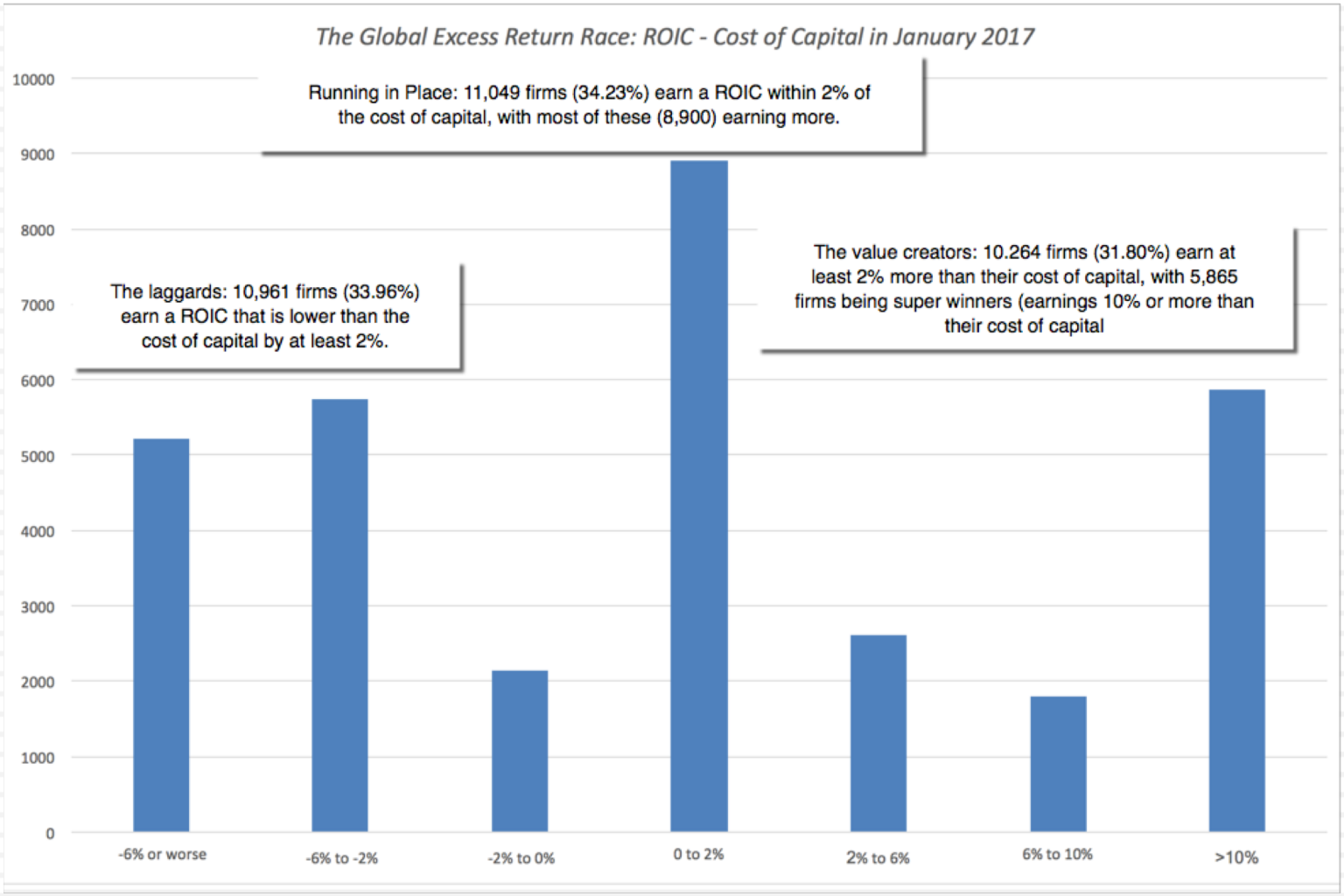
% of respondents whose companies have met their cost reduction strategies,[1] n = 178

Top two factors most responsible for companies meeting cost targets or goals



[1]Respondents who answered "don't know" are not shown.

Lesson 2: Increasing growth is not always a value creating option.. And it may destroy value at times..



Lesson 3: Financial leverage is a double-edged sword..

Exhibit 7.1: Optimal Financing Mix: Hormel Foods in January 2009

As debt ratio increases, equity becomes riskier.(higher beta) and cost of equity goes up. (1)

As firm borrows more money, its ratings drop and cost of debt rises (2)

Debt Ratio	Beta	Cost of Equity	Bond Rating	Interest rate on debt	Tax Rate	Cost of Debt (after-tax)	WACC	Firm Value (G)
0%	0.78	7.00%	AAA	3.60%	40.00%	2.16%	7.00%	$4,523
10%	0.83	7.31%	AAA	3.60%	40.00%	2.16%	6.80%	$4,665
10.39%	**0.83**	**7.33%**	**AAA**	**3.60%**	**40.00%**	**2.16%**	**6.79%**	**$4,680**
20%	0.89	7.70%	AAA	3.60%	40.00%	2.16%	6.59%	$4,815
30%	0.97	8.20%	A+	4.60%	40.00%	2.76%	6.57%	$4,834
40%	1.09	8.86%	A-	5.35%	40.00%	3.21%	6.60%	$4,808
50%	1.24	9.79%	B+	8.35%	40.00%	5.01%	7.40%	$4,271
60%	1.47	11.19%	B-	10.85%	40.00%	6.51%	8.38%	$3,757
70%	1.86	13.52%	CCC	12.35%	40.00%	7.41%	9.24%	$3,398
80%	2.70	18.53%	CC	14.35%	38.07%	8.89%	10.81%	$2,892
90%	5.39	34.70%	CC	14.35%	33.84%	9.49%	12.01%	$2,597

Current Cost of Capital

Optimal: Cost of capital lowest between 20 and 30%.

Debt ratio is percent of overall market value of firm that comes from debt financing.

At debt ratios > 80%, firm does not have enough operating income to cover interest expenses. Tax rate goes down to reflect lost tax benefits. (3)

As cost of capital drops, firm value rises (as operating cash flows remain unchanged)

III. Dealing with decline and distress…

Historial data often reflects flat or declining revenues and falling margins. Investments often earn less than the cost of capital.

Growth can be negative, as firm sheds assets and shrinks. As less profitable assets are shed, the firm's remaining assets may improve in quality.

What is the value added by growth assets?

What are the cashflows from existing assets?

When will the firm become a mature fiirm, and what are the potential roadblocks?

How risky are the cash flows from both existing assets and growth assets?

Underfunded pension obligations and litigation claims can lower value of equity. Liquidation preferences can affect value of equity

What is the value of equity in the firm?

Depending upon the risk of the assets being divested and the use of the proceeds from the divestuture (to pay dividends or retire debt), the risk in both the firm and its equity can change.

There is a real chance, especially with high financial leverage, that the firm will not make it. If it is expected to survive as a going concern, it will be as a much smaller entity.

a. Dealing with Decline

- In decline, firms often see declining revenues and lower margins, translating in negative expected growth over time.
- If these firms are run by good managers, they will not fight decline. Instead, they will adapt to it and shut down or sell investments that do not generate the cost of capital. This can translate into negative net capital expenditures (depreciation exceeds cap ex), declining working capital and an overall negative reinvestment rate. The best case scenario is that the firm can shed its bad assets, make itself a much smaller and healthier firm and then settle into long-term stable growth.
- As an investor, your worst case scenario is that these firms are run by managers in denial who continue to expand the firm by making bad investments (that generate lower returns than the cost of capital). These firms may be able to grow revenues and operating income but will destroy value along the way.

Figure 14.5: A Valuation of JC Penney

Declining business: Revenues expected to drop by 3% a year fo next 5 years

	Base year	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
Revenue growth rate		-3.00%	-3.00%	-3.00%	-3.00%	-3.00%	-2.00%	-1.00%	0.00%	1.00%	2.00%
Revenues	$ 12,522	$12,146	$11,782	$11,428	$11,086	$10,753	$10,538	$10,433	$10,433	$10,537	$10,748
EBIT (Operating) margin	1.32%	1.82%	2.31%	2.80%	3.29%	3.79%	4.28%	4.77%	5.26%	5.76%	6.25%
EBIT (Operating income)	$ 166	$ 221	$ 272	$ 320	$ 365	$ 407	$ 451	$ 498	$ 549	$ 607	$ 672
Tax rate	35.00%	35.00%	35.00%	35.00%	35.00%	35.00%	36.00%	37.00%	38.00%	39.00%	40.00%
EBIT(1-t)	$ 108	$ 143	$ 177	$ 208	$ 237	$ 265	$ 289	$ 314	$ 341	$ 370	$ 403
- Reinvestment		$ (188)	$ (182)	$ (177)	$ (171)	$ (166)	$ (108)	$ (53)	$ -	$ 52	$ 105
FCFF		$ 331	$ 359	$ 385	$ 409	$ 431	$ 396	$ 366	$ 341	$ 318	$ 298
Cost of capital		9.00%	9.00%	9.00%	9.00%	9.00%	8.80%	8.60%	8.40%	8.20%	8.00%
PV(FCFF)		$ 304	$ 302	$ 297	$ 290	$ 280	$ 237	$ 201	$ 173	$ 149	$ 129
Terminal value	$ 5,710										
PV(Terminal value)	$ 2,479										
PV (CF over next 10 years)	$ 2,362										
Sum of PV	$ 4,841										
Probability of failure =	20.00%										
Proceeds if firm fails =	$2,421										
Value of operating assets =	$4,357										

High debt load and poor earnings put survival at risk. Based on bond rating, 20% chance of failure and liquidation will bring in 50% of book value

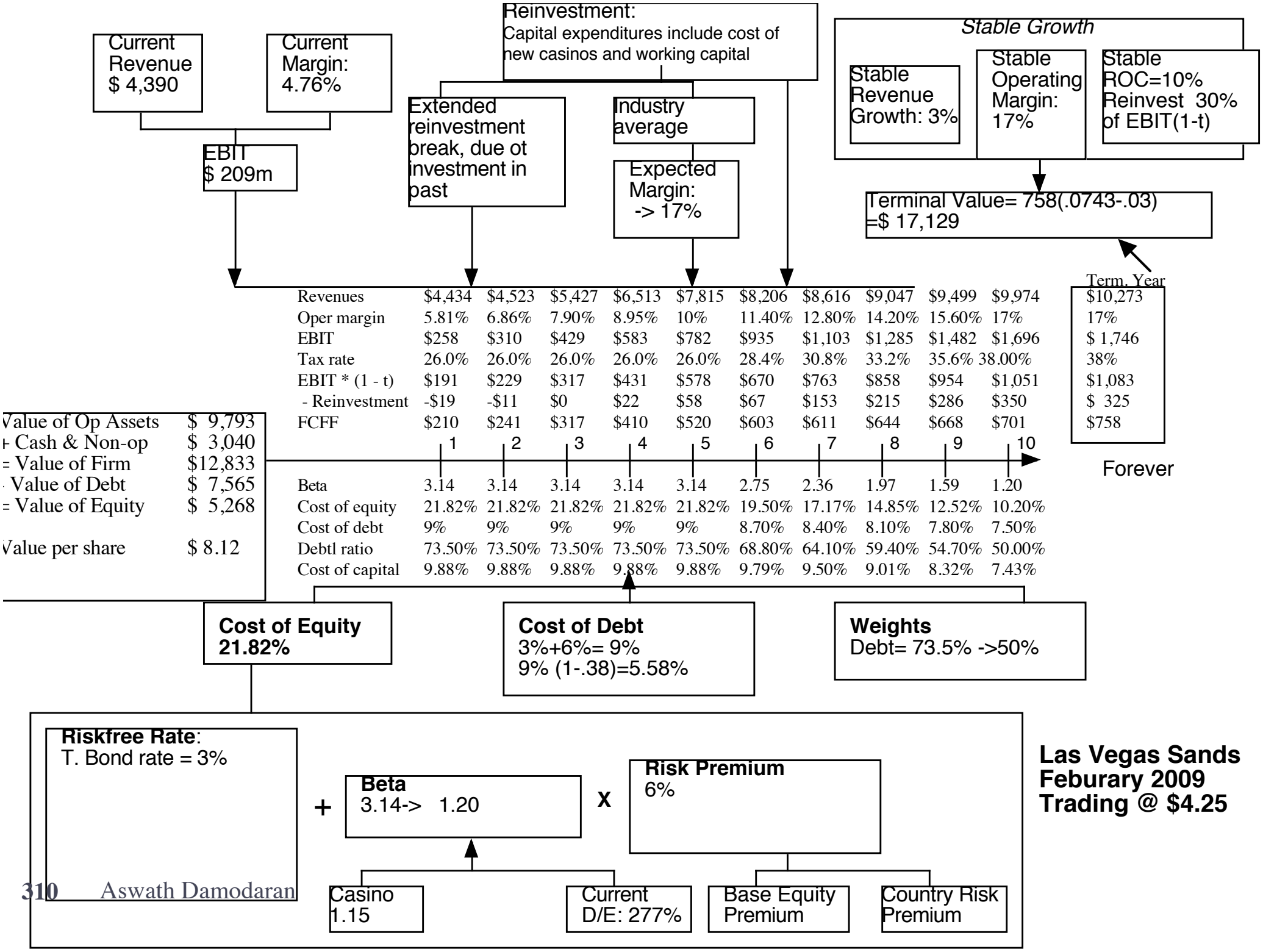
Margins improve gradually to median for US retail sector (6.25%)

As stores shut down, cash released from real estate.

The cost of capital is at 9%, higher because of high cost of debt.

b. Dealing with the "downside" of Distress

- A DCF valuation values a firm as a going concern. If there is a significant likelihood of the firm failing before it reaches stable growth and if the assets will then be sold for a value less than the present value of the expected cashflows (a distress sale value), DCF valuations will overstate the value of the firm.
- Value of Equity= DCF value of equity (1 - Probability of distress) + Distress sale value of equity (Probability of distress)
- There are three ways in which we can estimate the probability of distress:
  - Use the bond rating to estimate the cumulative probability of distress over 10 years
  - Estimate the probability of distress with a probit
  - Estimate the probability of distress by looking at market value of bonds..
- The distress sale value of equity is usually best estimated as a percent of book value (and this value will be lower if the economy is doing badly and there are other firms in the same business also in distress).


Current Revenue $ 4,390
Current Margin: 4.76%
EBIT $ 209m
Reinvestment: Capital expenditures include cost of new casinos and working capital
Extended reinvestment break, due ot investment in past
Industry average
Expected Margin: -> 17%
Stable Growth
Stable Revenue Growth: 3%
Stable Operating Margin: 17%
Stable ROC=10% Reinvest 30% of EBIT(1-t)
Terminal Value= 758(.0743-.03) =$ 17,129
Term. Year
Revenues $4,434 $4,523 $5,427 $6,513 $7,815 $8,206 $8,616 $9,047 $9,499 $9,974 $10,273
Oper margin 5.81% 6.86% 7.90% 8.95% 10% 11.40% 12.80% 14.20% 15.60% 17% 17%
EBIT $258 $310 $429 $583 $782 $935 $1,103 $1,285 $1,482 $1,696 $ 1,746
Tax rate 26.0% 26.0% 26.0% 26.0% 26.0% 28.4% 30.8% 33.2% 35.6% 38.00% 38%
EBIT * (1 - t) $191 $229 $317 $431 $578 $670 $763 $858 $954 $1,051 $1,083
- Reinvestment -$19 -$11 $0 $22 $58 $67 $153 $215 $286 $350 $ 325
FCFF $210 $241 $317 $410 $520 $603 $611 $644 $668 $701 $758
1 2 3 4 5 6 7 8 9 10
Forever
Value of Op Assets $ 9,793
+ Cash & Non-op $ 3,040
= Value of Firm $12,833
- Value of Debt $ 7,565
= Value of Equity $ 5,268
Value per share $ 8.12
Beta 3.14 3.14 3.14 3.14 3.14 2.75 2.36 1.97 1.59 1.20
Cost of equity 21.82% 21.82% 21.82% 21.82% 21.82% 19.50% 17.17% 14.85% 12.52% 10.20%
Cost of debt 9% 9% 9% 9% 9% 8.70% 8.40% 8.10% 7.80% 7.50%
Debtl ratio 73.50% 73.50% 73.50% 73.50% 73.50% 68.80% 64.10% 59.40% 54.70% 50.00%
Cost of capital 9.88% 9.88% 9.88% 9.88% 9.88% 9.79% 9.50% 9.01% 8.32% 7.43%
Cost of Equity 21.82%
Cost of Debt 3%+6%= 9% 9% (1-.38)=5.58%
Weights Debt= 73.5% ->50%
Riskfree Rate: T. Bond rate = 3%
+
Beta 3.14-> 1.20
X
Risk Premium 6%
Casino 1.15
Current D/E: 277%
Base Equity Premium
Country Risk Premium
Las Vegas Sands
Feburary 2009
Trading @ $4.25

Adjusting the value of LVS for distress..

- In February 2009, LVS was rated B+ by S&P. Historically, 28.25% of B+ rated bonds default within 10 years. LVS has a 6.375% bond, maturing in February 2015 (7 years), trading at $529. If we discount the expected cash flows on the bond at the riskfree rate, we can back out the probability of distress from the bond price:

$$529 = \sum_{t=1}^{t=7} \frac{63.75(1-\Pi_{Distress})^t}{(1.03)^t} + \frac{1000(1-\Pi_{Distress})^7}{(1.03)^7}$$

- Solving for the probability of bankruptcy, we get:
  - $\pi_{istress}$ = Annual probability of default = 13.54%
  - Cumulative probability of surviving 10 years = $(1 - .1354)^{10}$ = 23.34%
  - Cumulative probability of distress over 10 years = 1 - .2334 = .7666 or 76.66%
- If LVS is becomes distressed:
  - Expected distress sale proceeds = $2,769 million < Face value of debt
  - Expected equity value/share = $0.00
- Expected value per share = $8.12 (1 - .7666) + $0.00 (.7666) = $1.92

IV. Emerging Market Companies

Estimation Issues - Emerging Market Companies

Big shifts in economic environment (inflation, itnerest rates) can affect operating earnings history. Poor corporate governance and weak accounting standards can lead to lack of transparency on earnings.

Growth rates for a company will be affected heavily be growth rate and political developments in the country in which it operates.

What is the value added by growth assets?

What are the cashflows from existing assets?

When will the firm become a mature fiirm, and what are the potential roadblocks?

How risky are the cash flows from both existing assets and growth assets?

Cross holdings can affect value of equity

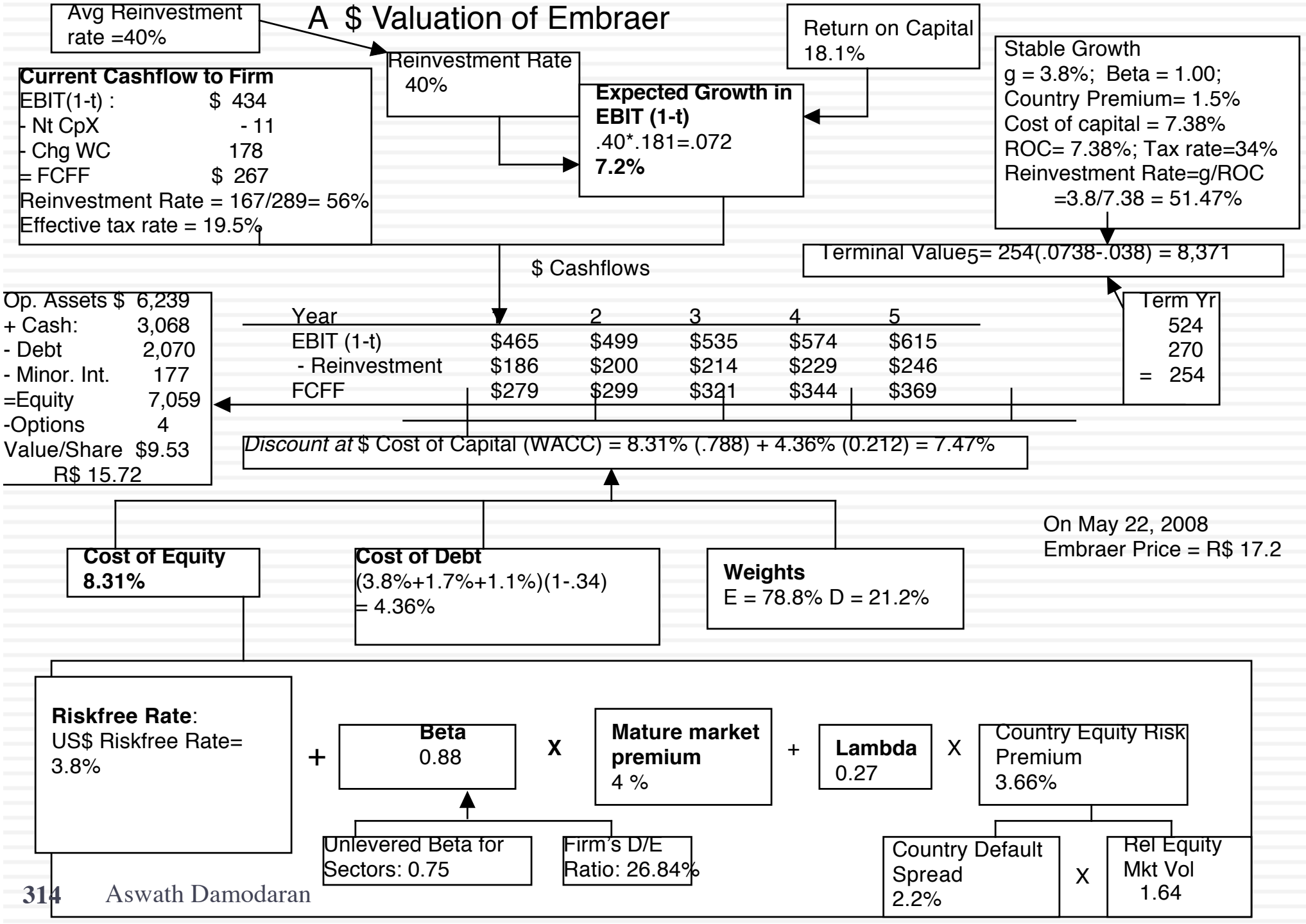
Even if the company's risk is stable, there can be significant changes in country risk over time.

Economic crises can put many companies at risk. Government actions (nationalization) can affect long term value.

What is the value of equity in the firm?

Lesson 1: Country risk has to be incorporated… but with a scalpel, not a bludgeon

- Emerging market companies are undoubtedly exposed to additional country risk because they are incorporated in countries that are more exposed to political and economic risk.
- Not all emerging market companies are equally exposed to country risk and many developed markets have emerging market risk exposure because of their operations.
- You can use either the "weighted country risk premium", with the weights reflecting the countries you get your revenues from or the lambda approach (which may incorporate more than revenues) to capture country risk exposure.


A $ Valuation of Embraer
Avg Reinvestment rate =40%
Reinvestment Rate 40%
Return on Capital 18.1%
Stable Growth
g = 3.8%; Beta = 1.00;
Country Premium= 1.5%
Cost of capital = 7.38%
ROC= 7.38%; Tax rate=34%
Reinvestment Rate=g/ROC
=3.8/7.38 = 51.47%
Current Cashflow to Firm
EBIT(1-t) : $ 434
- Nt CpX - 11
- Chg WC 178
= FCFF $ 267
Reinvestment Rate = 167/289= 56%
Effective tax rate = 19.5%
Expected Growth in EBIT (1-t)
.40*.181=.072
7.2%
Terminal Value5= 254(.0738-.038) = 8,371
$ Cashflows
Term Yr
524
270
= 254
Year 1 2 3 4 5
EBIT (1-t) $465 $499 $535 $574 $615
- Reinvestment $186 $200 $214 $229 $246
FCFF $279 $299 $321 $344 $369
Op. Assets $ 6,239
+ Cash: 3,068
- Debt 2,070
- Minor. Int. 177
=Equity 7,059
-Options 4
Value/Share $9.53
R$ 15.72
Discount at $ Cost of Capital (WACC) = 8.31% (.788) + 4.36% (0.212) = 7.47%
Cost of Equity 8.31%
Cost of Debt (3.8%+1.7%+1.1%)(1-.34) = 4.36%
Weights E = 78.8% D = 21.2%
On May 22, 2008
Embraer Price = R$ 17.2
Riskfree Rate: US$ Riskfree Rate= 3.8%
+
Beta 0.88
X
Mature market premium 4 %
+
Lambda 0.27
X
Country Equity Risk Premium 3.66%
Unlevered Beta for Sectors: 0.75
Firm's D/E Ratio: 26.84%
Country Default Spread 2.2%
X
Rel Equity Mkt Vol 1.64

Lesson 2: Currency should not matter

- You can value any company in any currency. Thus, you can value a Brazilian company in nominal reais, US dollars or Swiss Francs.
- For your valuation to stay invariant and consistent, your cash flows and discount rates have to be in the same currency. Thus, if you are using a high inflation currency, both your growth rates and discount rates will be much higher.
- For your cash flows to be consistent, you have to use expected exchange rates that reflect purchasing power parity (the higher inflation currency has to depreciate by the inflation differential each year).

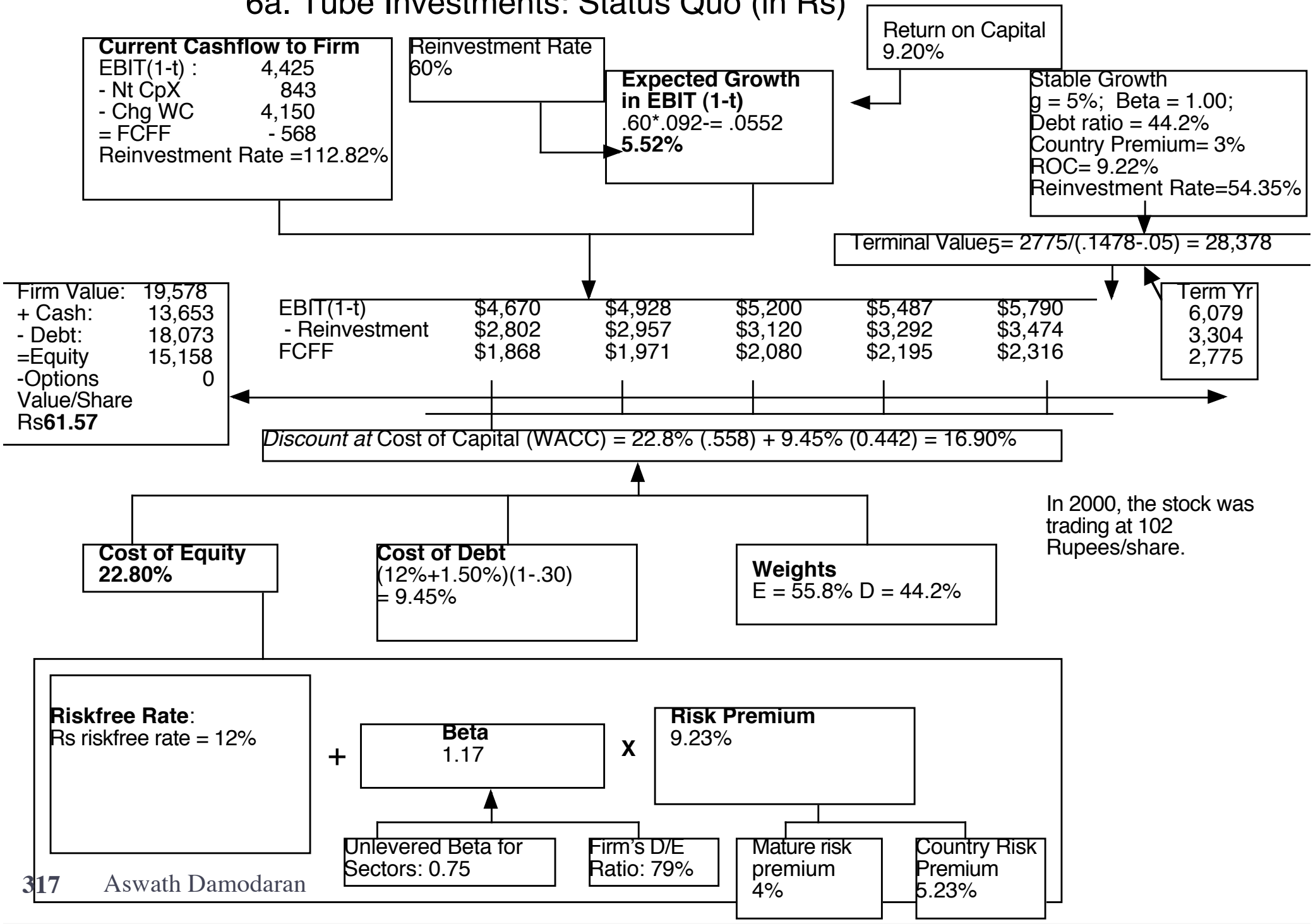
Lesson 3: The "corporate governance" drag

- Stockholders in Asian, Latin American and many European companies have little or no power over the managers of the firm. In many cases, insiders own voting shares and control the firm and the potential for conflict of interests is huge.
- This weak corporate governance is often a reason for given for using higher discount rates or discounting the estimated value for these companies.
- Would you discount the value that you estimate for an emerging market company to allow for this absence of stockholder power?

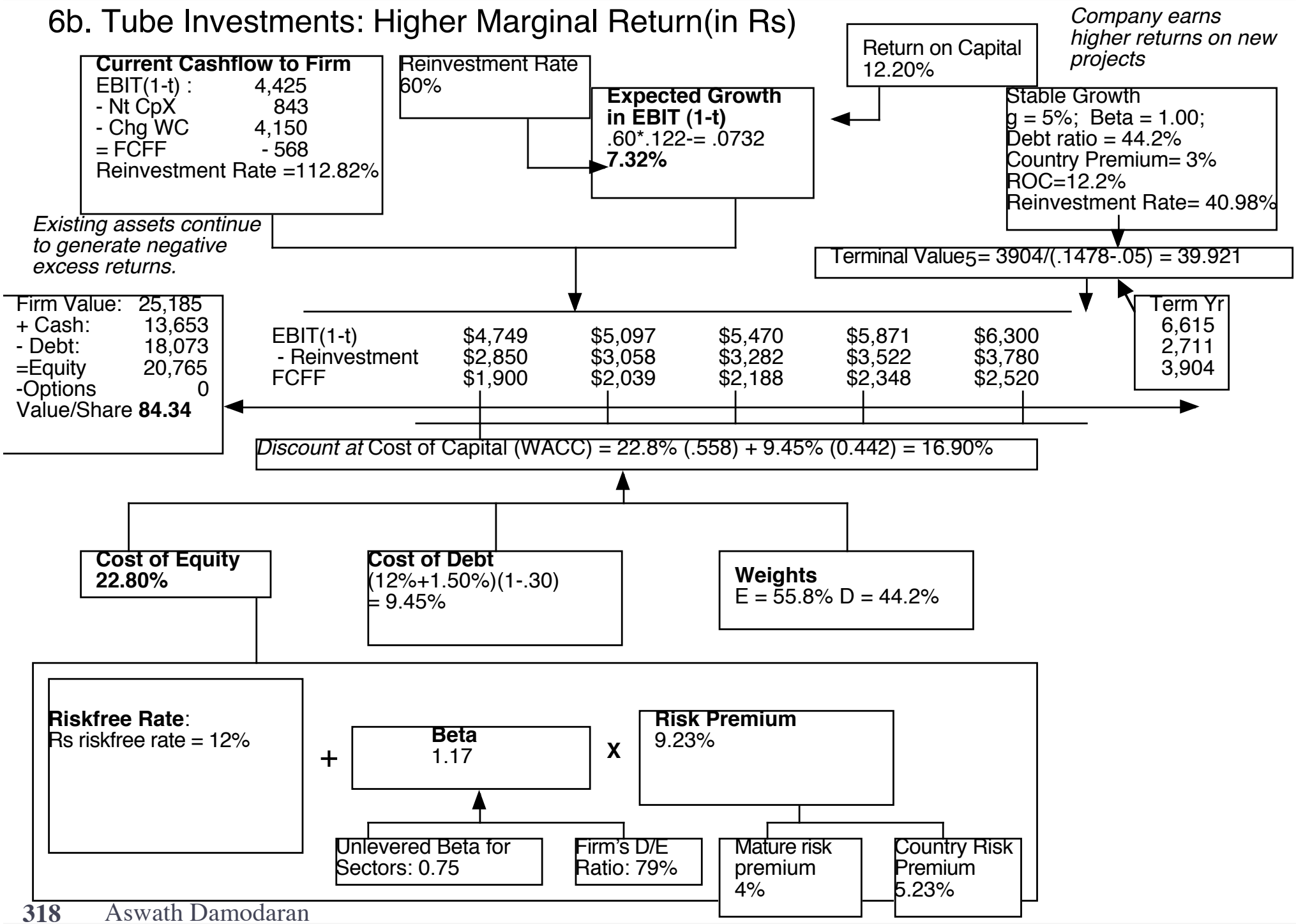
a. Yes

b. No.

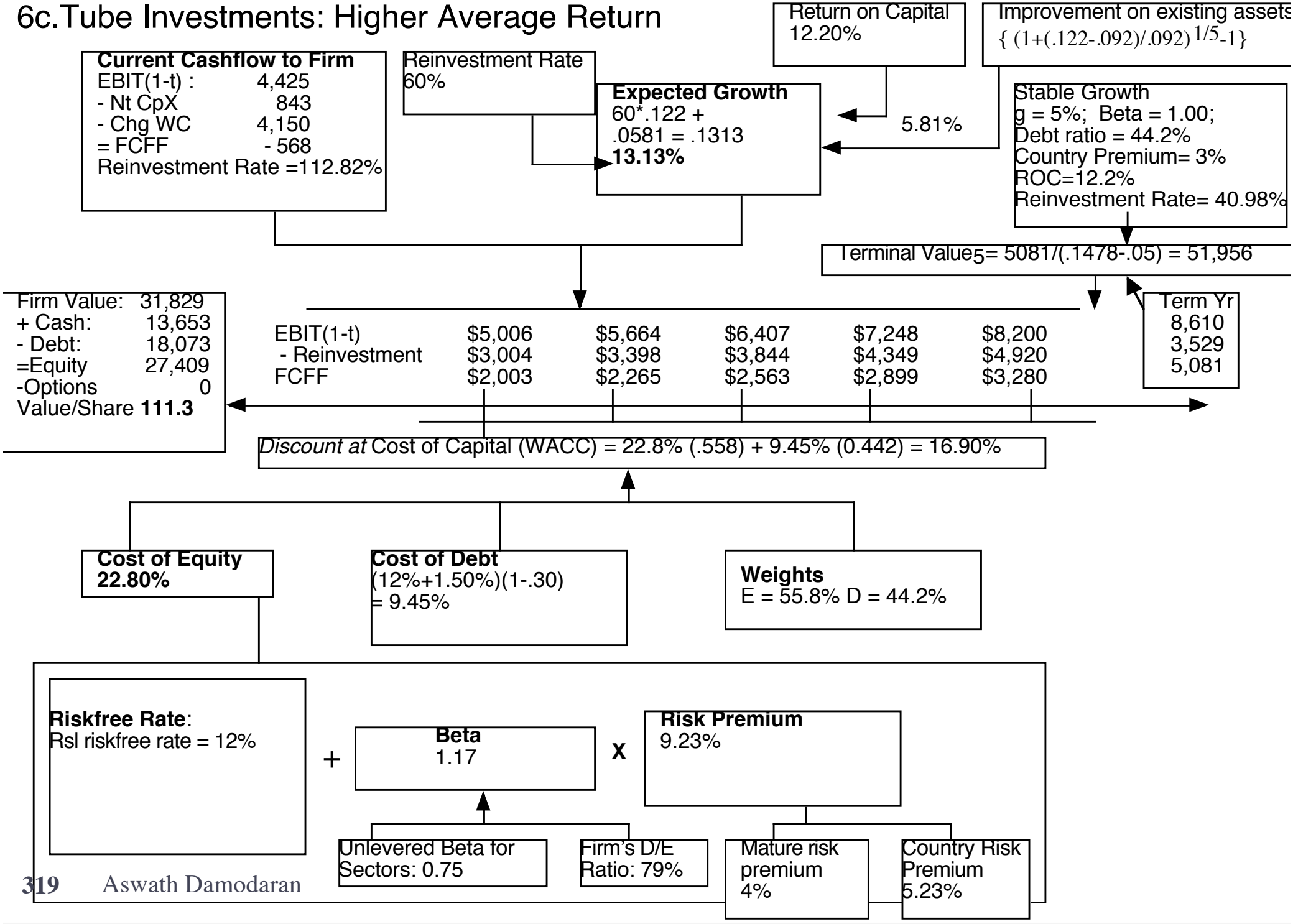
6a. Tube Investments: Status Quo (in Rs)



6b. Tube Investments: Higher Marginal Return(in Rs)



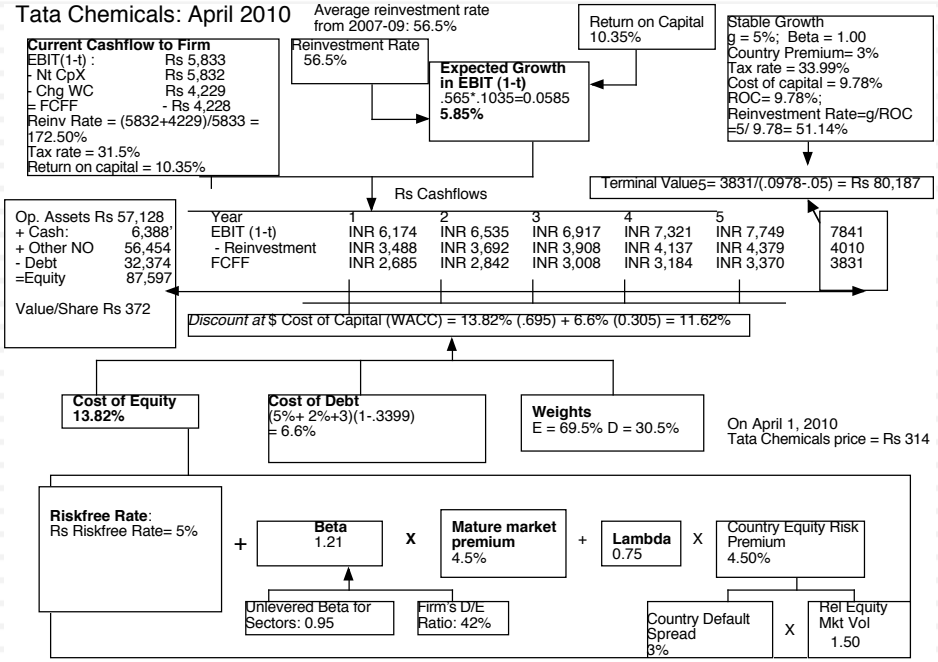
6c.Tube Investments: Higher Average Return

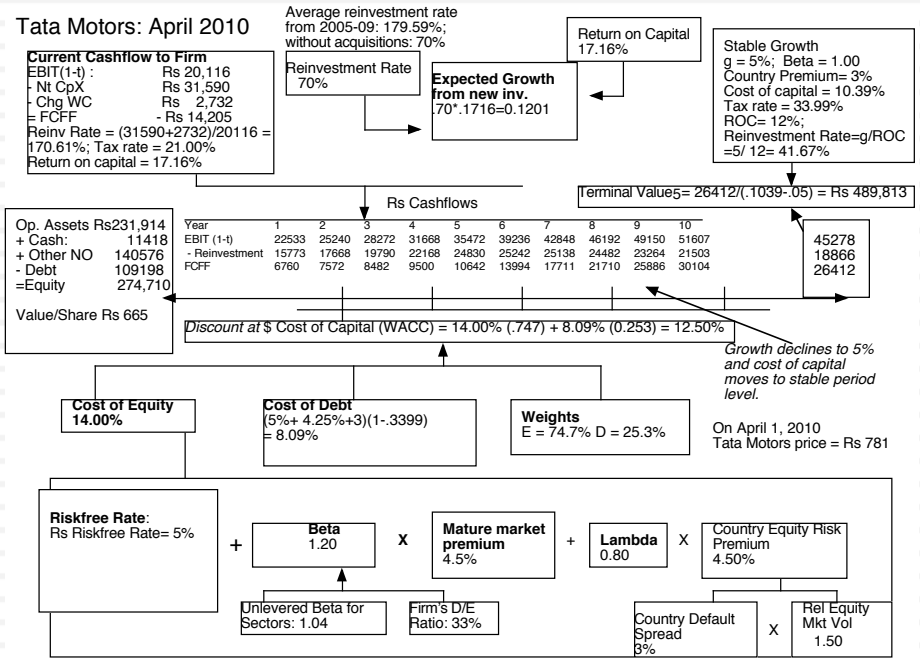


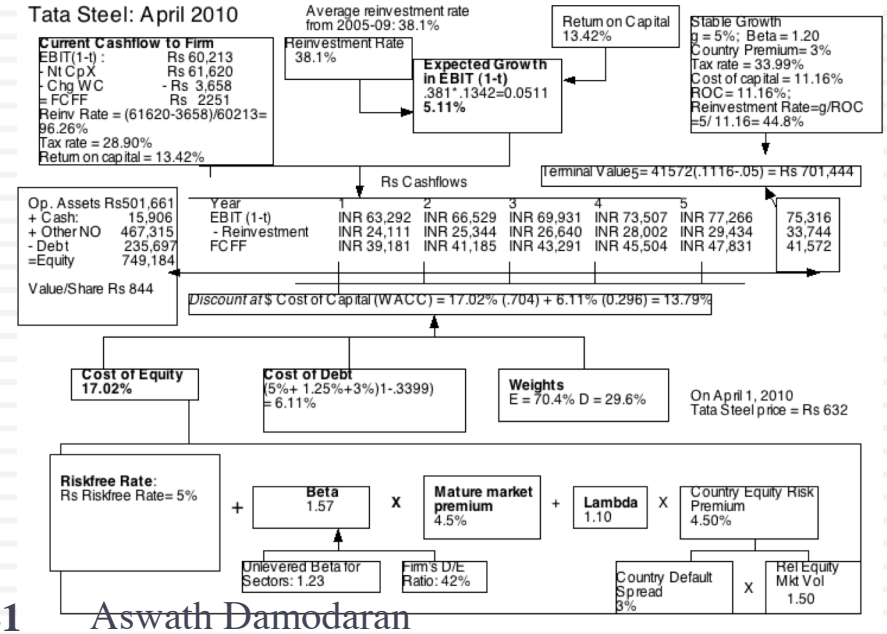
Lesson 4: Watch out for cross holdings…

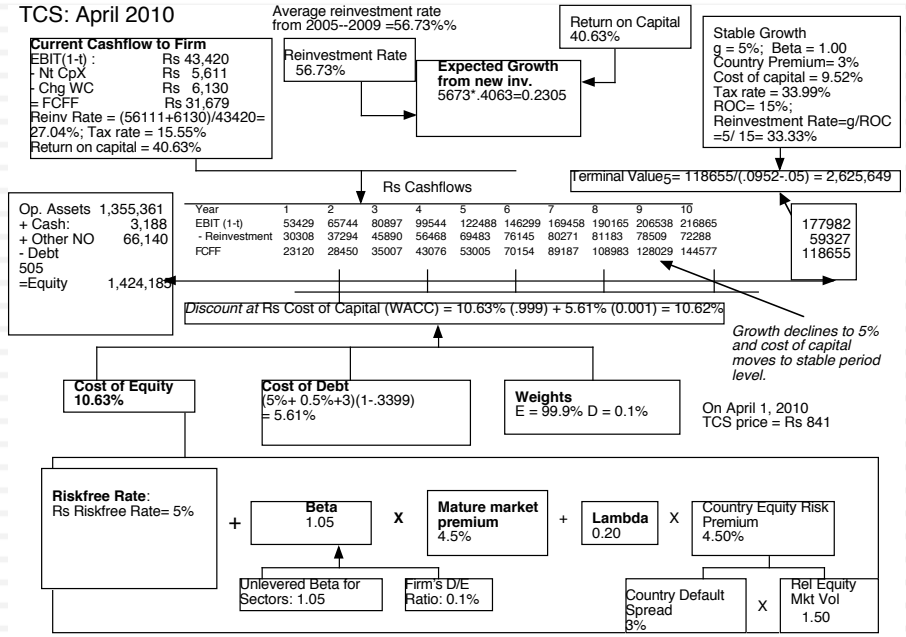
- Emerging market companies are more prone to having cross holdings that companies in developed markets. This is partially the result of history (since many of the larger public companies used to be family owned businesses until a few decades ago) and partly because those who run these companies value control (and use cross holdings to preserve this control).
- In many emerging market companies, the real process of valuation begins when you have finished your DCF valuation, since the cross holdings (which can be numerous) have to be valued, often with minimal information.

8. The Tata Group – April 2010



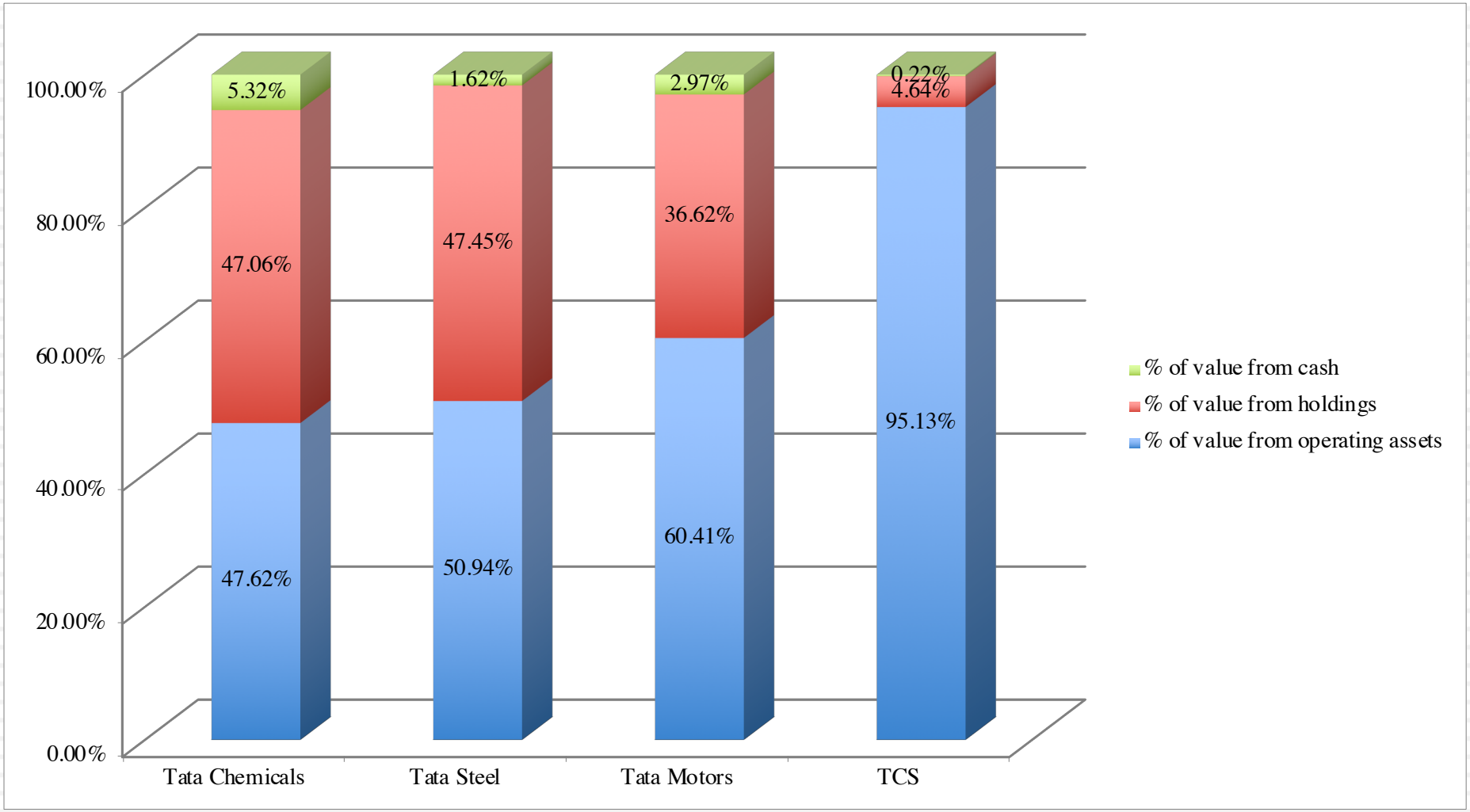






Tata Companies: Value Breakdown

322



Lesson 5: Truncation risk can come in many forms…

- Natural disasters: Small companies in some economies are much exposed to natural disasters (hurricanes, earthquakes), without the means to hedge against that risk (with insurance or derivative products).
- Terrorism risk: Companies in some countries that are unstable or in the grips of civil war are exposed to damage or destruction.
- Nationalization risk: While less common than it used to be, there are countries where businesses may be nationalized, with owners receiving less than fair value as compensation.

V. Valuing Financial Service Companies

Existing assets are usually financial assets or loans, often marked to market. Earnings do not provide much information on underlying risk.

Defining capital expenditures and working capital is a challenge.Growth can be strongly influenced by regulatory limits and constraints. Both the amount of new investments and the returns on these investments can change with regulatory changes.

What is the value added by growth assets?

What are the cashflows from existing assets?

When will the firm become a mature fiirm, and what are the potential roadblocks?

How risky are the cash flows from both existing assets and growth assets?

Preferred stock is a significant source of capital.

What is the value of equity in the firm?

For financial service firms, debt is raw material rather than a source of capital. It is not only tough to define but if defined broadly can result in high financial leverage, magnifying the impact of small operating risk changes on equity risk.

In addition to all the normal constraints, financial service firms also have to worry about maintaining capital ratios that are acceptable ot regulators. If they do not, they can be taken over and shut down.

CIB Egypt in December 2015
Valuation in Egyptian Pounds

ROE = 42.48%

Retention Ratio = 75.25%

Dividends
EPS = 4.04 EGP
* Payout Ratio 24.75%
DPS = 1.00 EGP

Expected Growth
75.25% *
42.48% = 31.96%

g =10%: ROE = 25%(=Cost of equity)
Beta = 0.81
Payout = (1- 10/25) = .60

	1	2	3	4	5	6	7	8	9	10
Expected Growth Rate	31.96%	31.96%	31.96%	31.96%	31.96%	27.57%	23.18%	18.79%	14.39%	10.00%
Earnings per share	5.33 ج.م.	7.04 ج.م.	9.28 ج.م.	12.25 ج.م.	16.17 ج.م.	20.63 ج.م.	25.41 ج.م.	30.18 ج.م.	34.52 ج.م.	37.97 ج.م.
Payout ratio	24.75%	24.75%	24.75%	24.75%	24.75%	31.80%	38.85%	45.90%	52.95%	60.00%
Dividends per share	1.32 ج.م.	1.74 ج.م.	2.30 ج.م.	3.03 ج.م.	4.00 ج.م.	6.56 ج.م.	9.87 ج.م.	13.85 ج.م.	18.28 ج.م.	22.78 ج.م.
Cost of Equity	23.25%	23.25%	23.25%	23.25%	23.25%	23.25%	23.25%	23.25%	23.25%	23.25%
Cumulative Cost of Equity	123.25%	151.90%	187.21%	230.73%	284.37%	350.48%	431.95%	532.37%	656.13%	808.66%
Present Value	1.07 ج.م.	1.15 ج.م.	1.23 ج.م.	1.31 ج.م.	1.41 ج.م.	1.87 ج.م.	2.29 ج.م.	2.60 ج.م.	2.79 ج.م.	2.82 ج.م.

Terminal Value
= EPS_6*Payout/(r-g)
= (37.97*.6)/(.2325-.10) = 189.20

Value of Equity per share = PV of Dividends & Terminal value = 41.93 EGP

Forever

Discount at Cost of Equity

In December 2015, CIB was trading at 36 EGP per share

Cost of Equity
10.53% + 0.81 (15.70%) = 23.25%

Riskfree Rate:
In EGP
10.53%

US $ risk free rate (2.27%) adjusted for diff inflation
(1.0227)*(1.097/1.015)-1

+

0.81

Average Beta for Banks

x

Equity Risk Premium
15.7%

100% in Egypt

2b. Goldman Sachs: August 2008

Left return on equity at 2008 levels. well below 16% in 2007 and 20% in 2004-2006.

Rationale for model

Why dividends? Because FCFE cannot be estimated

Why 3-stage? Because the firm is behaving (reinvesting, growing) like a firm with potential.

ROE = 13.19%

Retention Ratio = 91.65%

Dividends
EPS = $16.77 *
Payout Ratio 8.35%
DPS =$1.40
(Updated numbers for 2008 financial year ending 11/08)

Expected Growth in first 5 years =
91.65%*13.19% = 12.09%

g =4%: ROE = 10%(>Cost of equity)
Beta = 1.20
Payout = (1- 4/10) = .60 or 60%

Terminal Value= EPS_{10}*Payout/(r-g)
= (42.03*1.04*.6)/(.095-.04) = 476.86

Year	1	2	3	4	5	6	7	8	9	10
EPS	$18.80	$21.07	$23.62	$26.47	$29.67	$32.78	$35.68	$38.26	$40.41	$42.03
Payout ratio	8.35%	8.35%	8.35%	8.35%	8.35%	18.68%	29.01%	39.34%	49.67%	60.00%
DPS	$1.57	$1.76	$1.97	$2.21	$2.48	$6.12	$10.35	$15.05	$20.07	$25.22

Forever

Value of Equity per share = PV of Dividends & Terminal value = $222.49

Discount at Cost of Equity

Between years 6-10, as growth drops to 4%, payout ratio increases and cost of equity decreases.

In August 2008, Goldman was trading at $ 169/share.

Cost of Equity
4.10% + 1.40 (4.5%) = 10.4%

Riskfree Rate:
Treasury bond rate
4.10%

+

Beta
1.40

Average beta for inveestment banks= 1.40

X

Risk Premium
4.5%
Impled Equity Risk premium in 8/08

Mature Market
4.5%

Country Risk
0%

Lesson 1: Financial service companies are opaque…

- With financial service firms, we enter into a Faustian bargain. They tell us very little about the quality of their assets (loans, for a bank, for instance are not broken down by default risk status) but we accept that in return for assets being marked to market (by accountants who presumably have access to the information that we don't have).
- In addition, estimating cash flows for a financial service firm is difficult to do. So, we trust financial service firms to pay out their cash flows as dividends. Hence, the use of the dividend discount model.
- During times of crises or when you don't trust banks to pay out what they can afford to in dividends, using the dividend discount model may not give you a "reliable" value.

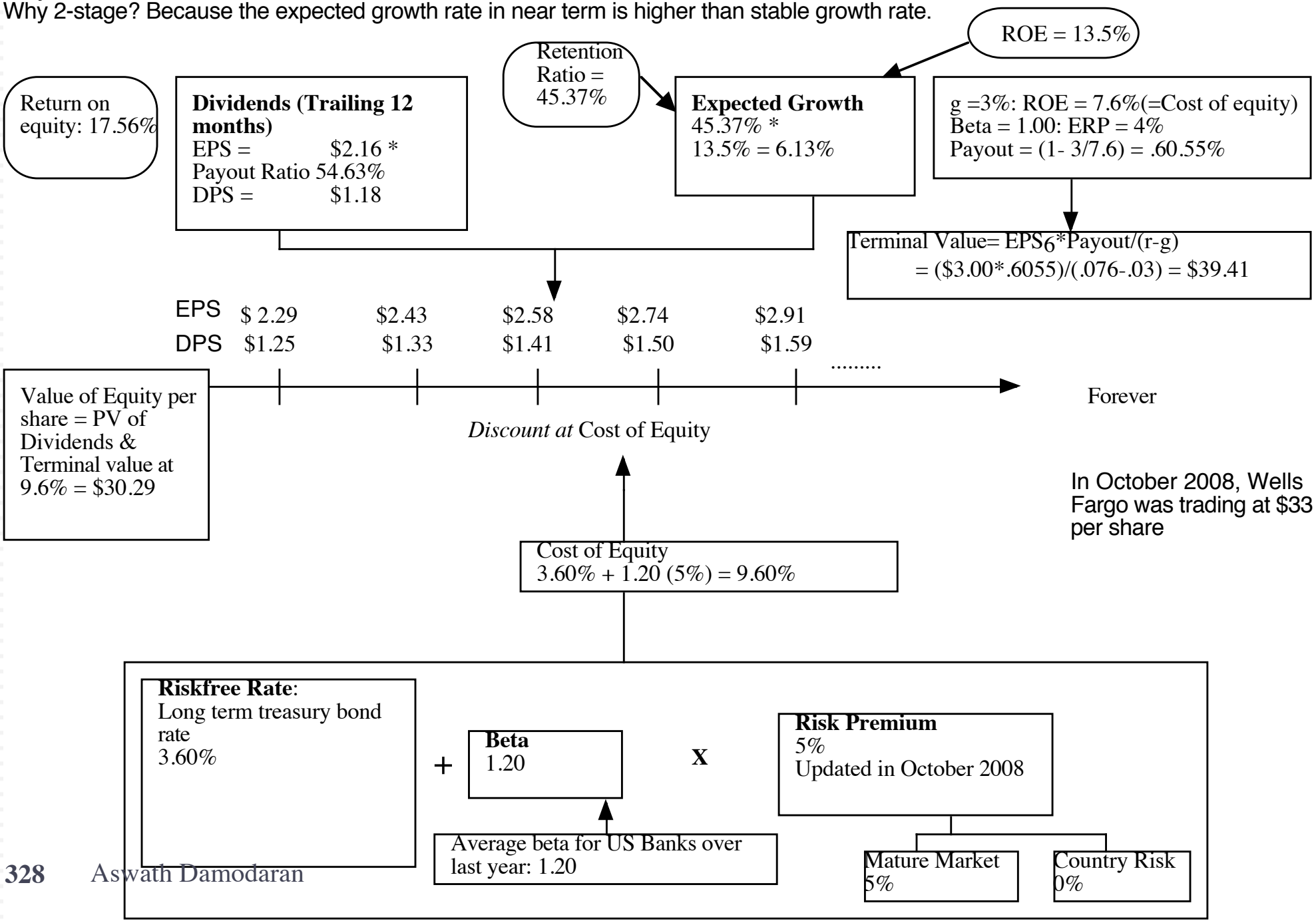
2c. Wells Fargo: Valuation on October 7, 2008

Assuming that Wells will have to increase its capital base by about 30% to reflect tighter regulatory concerns. (.1756/1.3 =.135

Rationale for model

Why dividends? Because FCFE cannot be estimated

Why 2-stage? Because the expected growth rate in near term is higher than stable growth rate.



In October 2008, Wells Fargo was trading at $33 per share

Lesson 2: For financial service companies, book value matters…

- The book value of assets and equity is mostly irrelevant when valuing non-financial service companies. After all, the book value of equity is a historical figure and can be nonsensical. (The book value of equity can be negative and is so for more than a 1000 publicly traded US companies)
- With financial service firms, book value of equity is relevant for two reasons:
  - Since financial service firms mark to market, the book value is more likely to reflect what the firms own right now (rather than a historical value)
  - The regulatory capital ratios are based on book equity. Thus, a bank with negative or even low book equity will be shut down by the regulators.
- From a valuation perspective, it therefore makes sense to pay heed to book value. In fact, you can argue that reinvestment for a bank is the amount that it needs to add to book equity to sustain its growth ambitions and safety requirements:
  - FCFE = Net Income – Reinvestment in regulatory capital (book equity)

Deutsche Bank: A Crisis Valuation (October 2016)

Risk adjusted assets grows at inflation rate of 1% a year forever.

Tier 1 capital ratio increases to 15.67%, the 75th percentile for all banks

Expected DOJ fine of $10 billions lower Tier 1 capital today

Common Equity increases in tandem with Tier 1 capital

Cost of equity starts at 10.2% (75th percentile of banks) & decreases after year 5 to 9.44% (median across banks).

	Current	1	2	3	4	5	6	7	8	9	10
Risk Adjusted Assets	$ 445,570	$ 450,026	$ 454,526	$ 459,071	$ 463,662	$ 468,299	$ 472,982	$ 477,711	$ 482,488	$ 487,313	$ 492,186
Tier 1 Capital Ratio	12.41%	13.74%	13.95%	14.17%	14.38%	14.60%	14.81%	15.03%	15.24%	15.46%	15.67%
Tier 1 Capital (Risk Adjusted Assets * T	$55,282	$61,834	$63,427	$65,045	$66,690	$68,361	$70,059	$71,784	$73,537	$75,317	$77,126
Change in regulatory capital (Tier 1)		$6,552	$1,593	$1,619	$1,645	$1,671	$1,698	$1,725	$1,753	$1,780	$1,809
Book Equity	$64,609	$71,161	$72,754	$74,372	$76,017	$77,688	$79,386	$81,111	$82,864	$84,644	$86,453
Expected ROE	-13.70%	-7.18%	-2.84%	0.06%	1.99%	5.85%	6.568%	7.286%	8.004%	8.722%	9.440%
Net Income (Book Equity * ROE)	$ (8,851)	$ (5,111)	$ (2,065)	$ 43	$ 1,512	$ 4,545	$ 5,214	$ 5,910	$ 6,632	$ 7,383	$ 8,161
- Investment in Regulatory Capital		$ 6,552	$ 1,593	$ 1,619	$ 1,645	$ 1,671	$ 1,698	$ 1,725	$ 1,753	$ 1,780	$ 1,809
FCFE		$ (11,663)	$ (3,658)	$ (1,576)	$ (133)	$ 2,874	$ 3,516	$ 4,185	$ 4,880	$ 5,602	$ 6,352
Terminal value of equity											$87,317
Present value		$ (10,583)	$ (3,012)	$ (1,178)	$ (90)	$ 1,768	$ 1,966	$ 2,129	$ 2,262	$ 2,370	$ 36,207
Cost of equity	10.20%	10.20%	10.20%	10.20%	10.20%	10.20%	10.048%	9.896%	9.744%	9.592%	9.440%
Cumulative Cost of equity		1.1020	1.2144	1.3383	1.4748	1.6252	1.7885	1.9655	2.1570	2.3639	2.5871
Value of equity today =	$31,838.74										
Number of shares outstanding =	1386.00										
DCF Value per share =	**$ 22.97**										
Probability of equity wipeout	10.00%										
Adjusted value per share =	**$ 20.67**										
Stock price on October 3, 2016=	**$ 13.33**										

Value per share adjusted for probability of catastrophic failure (bailout) resulting in complete loss of equity.

Return on equity increases to 5.85% (25th percentile of banks) in year 5 and 9,44% (cost of equity) in year 10

Aswath Damodaran