

# Chapter 1

## Introduction – Problems with Finance Theory and Practice

### Finance Gods

I have had stops and starts at writing this book for many years. When I began the book, I admired famous people in finance like Merton Miller, Harry Markowitz, Bob Hamada, William Sharpe, Fisher Black, Myron Scholes, and Eugene Fama. In the late 1970's and 1980's I was impressed by the seeming elegance of the capital asset pricing model (CAPM), and at the same time I was anxious to understand all the fancy techniques used by investment bankers. I was desperate to know what fancy methods they used for things like creating a selection of comparable companies in merger and acquisition (M&A) transactions and how project finance professionals used sophisticated techniques to derive target values for the debt service coverage ratio and the equity internal rate of return (IRR). My original idea in writing this book was to provide a comprehensive guide to support my professional development classes that would go through practical modelling applications of the famous ideas as well as the magic applied by investment bankers. But after re-reading numerous articles and books about finance; providing expert testimony on cost of capital in many courtrooms; working as a banker on large financing transactions; building thousands of corporate and project finance models; living through financial crises; consulting on M&A transactions; observing bull markets and low credit spreads; and, most of all meeting practitioners all around the world while teaching my courses, I have come to conclude that very much (not all) of the finance theory taught in MBA courses and written in Finance Books is either useless or fundamentally incorrect.

### Finance is Where Medicine was Before Louis Pasteur and where Electricity was before Michael Faraday

I am now brave enough to assert my beliefs that the very foundations of finance are often



flawed (I don't work for a big bank anymore and I don't have to worry about being careful about what I say). I have instead come to believe that the subject of finance is something like the understanding of electricity early in the 19<sup>th</sup> century before the discoveries of Michael Faraday. Before Faraday's discovery of electromagnetism and his invention of an electric motor, electricity was known to be an energy force, but it was thought to be some kind of mysterious thing that could not be used in a practical way. In the case of medicine, before Louis Pasteur, many foundations of medicine were not understood well, and a

lot of treatment was analogous to magic potion. Pasture's work on the understanding of the causes and preventions of diseases, sterilisation, germ theory and vaccines provided much more solid foundations for much of medicine.

I am convinced that finance academia, investment bankers and others blindly follow approaches that are mysterious ideas not founded with concrete concepts as did people before Faraday and Pasture. Analysis techniques like CAPM, simplistic terminal value formulas, irrelevant financial statement analysis of earned returns, application of meaningless country risk premiums, useless valuation multiples, irrelevant valuation of start-up ventures, flawed assumptions about statistical properties of stock prices and many other things that drive financial ideas are derived from implicit or explicit assumptions that cannot be described as anything other than mysterious forces and magic potion. I go even further and suggest that finance concepts taught in business schools have led to social problems, aggravated difficulties faced by companies attempting to construct new investments in developing countries and arguably led to disastrous environmental problems. I do not assert my ideas in this book can fix any problem and I do not claim that my suggestions can change anything. My basic objective is to point out fundamental problems in finance and give you some alternative ideas to think about.



### **Getting Your Hands Dirty with Financial Models Rather Wasting Time with Finance Theory**

It may seem arrogant for a person without a finance PHD (me), who has spent much of his life simply writing financial models in excel and other programming languages to suggest that there are so many things wrong with finance theory and practice. But when you get your hands dirty working with real valuation issues and writing a financial model you can question everything about data analysis, valuation methods, interpretation of accounting equations, metrics used in finance equations and even risk philosophy. For example, when evaluating a financial ratio such as Enterprise Value/Earnings Before Interest Depreciation and Amortisation (“EV/EBITDA”) in valuation analysis, you can make a little financial model that proves how the economic life of investments, tax rates, investment age, working capital levels and other items affect the EV part of the equation on top but not the EBITDA at the bottom. Then you can clearly see that it is irrelevant to compare the EV/EBITDA of two companies that have assets with different economic operating lives, ages of assets, effective tax rates, working capital levels, rates of return on investment or expected growth from new investments. You can try to make adjustments for all of these things, but it will be clear that companies that appear very similar can in no way be compared in terms of the ratio. Another example of many is that when trying to measure the cost of capital and the equity market risk premium (“EMRP”), you can retrieve data on stock prices into an excel file and then understand how to test for mean reversion and compute the earned premium above government bond yields yourself. After you get your hands dirty with financial models that can be quite simple, you will see that you arrive at very

different numbers if you consider capital gains from changes in the cost of capital differently from the underlying earning power of corporations.

When I began teaching classes in financial analysis more than two decades ago, I was insecure, and I thought the most important thing I could impart to participants in the class was the mechanics of financial modelling. This is something quite concrete and I thought I could at least leave students with some practical excel tricks. I even wrote a long and boring book about modelling.<sup>1</sup> Later, I gained a little more confidence and began to emphasize the use of modelling in evaluating contracts and investment case studies with project financing structuring. In this book I move further away from the modelling mechanics and deal with theory, practice and philosophical questions at the heart of finance. But using financial models to prove that many fundamental concepts in are wrong is an essential element of the book and indeed I argue that a problem with people who teach and develop financial theory is that they do not construct enough nuanced real financial models (I understand why as it can certainly be painful and boring). This time, instead of focusing on excel tricks and modelling mechanics, I use financial models to demonstrate the problems with the way finance is taught and practiced. All that said, I hope not to detract from the ideas of the book with discussion of modelling mechanics. Instead, I have put documentation of the mechanics for the various models in accompanying webpages. There is a video explaining the financial modelling mechanics for each chapter.<sup>2</sup>

### **Proofs with Financial Models Rather than Reading Articles with a Bunch of Integration Formulas**

Use of financial models to evaluate finance theory contrasts to the irritating academic articles written by finance professors that have seem to require a lot of integral calculus which do not really mean anything. Nicholas Taleb stated the issue more eloquently with respect to the academic papers: “[t]he discussions are jargon-laden and heavily mathematical to give the illusion of science.”<sup>3</sup> Consider for example, the many attempts to prove or disprove the CAPM where the question is whether the beta statistic is the only measure of risk that investors are paid for. The excerpt below is just one equation (of many) from a study where stock price changes after merger announcements was evaluated.<sup>4</sup> I suggest that you do not need to work through equations like this to understand problems with many of the foundations of finance.

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<sup>1</sup> Corporate and Project Finance Modelling, Wiley.

<sup>2</sup> The descriptions of financial modelling techniques can be found at [www.edbodmer.com](http://www.edbodmer.com).

<sup>3</sup> Fooled by Randomness, page 175.

<sup>4</sup> DESSAINT, Olivier; OLIVIER, Jacques; OTTO, Clemens A.; and THESMAR, David. CAPM-based company (mis)valuations. (2018). 1-68. Research Collection Lee Kong Chian School Of Business. Available at: [https://ink.library.smu.edu.sg/lkcsb\\_research/5925](https://ink.library.smu.edu.sg/lkcsb_research/5925)

$\gamma \times \mu$  for some  $\gamma \in [0, 1]$ , so that the cumulative abnormal return of the bidder's stock in response to the bid announcement is given by<sup>24</sup>

$$CAR_t^{Bidder} = \rho \times \frac{\pi \times FCF_{t+1}}{E_t^{Bidder}} \times \left[ \frac{1}{r_f + (\gamma \times \beta_A + 1 - \gamma) \times \mu - g} - \frac{1}{r_f + \beta_A \times \mu - g} \right]. \quad (15)$$

Later on, if you can manage to continue reading this book, I will demonstrate that the problem of the CAPM has a lot more to do with measurement of variables than with the question of whether beta in theory is the one and only way to measure risk. The EMRP and not the beta is in fact the most important driver in the CAPM, and this number is often plucked out from some general study of past performance. These studies do not make sense in the context of the very simple idea that the real value of stocks cannot always grow faster than the real economy without the investor class becoming really rich at the expense of the non-investing population. Another example is the academics think they are doing something useful by taking surveys of CFO's as what kind of cost of capital assumptions that they use. These and other surveys mean almost nothing as finance executives have an obvious incentive to exaggerate the cost of capital estimates in their quest to achieve higher returns. Academics who study the cost of capital typically do not even mention the most realistic way to assess the cost of capital which is deriving the cost of capital from stock prices and expected cash flow.

### Liquidity Springing Reserve Accounts

My criticism of finance academics is mild compared to complaints I have about financial consultants and bankers. A book written by McKinsey consultants named "Valuation Measuring and Managing the Value Companies" that some people call the Bible of finance is one of my favourite targets. This book that essentially touts the benefits of monopoly profits and suggests an economy works well when company can earn high returns (by charging high prices and transferring wealth to the investor class) supposedly contains practical ways to implement finance and valuation. Authors of this book imply that return on invested capital (ROIC) can be accurately computed from financial statements along with the weighted cost of capital from the CAPM. They also suggest that the tired old discounted cash flow can be applied to all sorts of different investments. One example is when addressing the crucial question of terminal value, authors of the McKinsey book suggest that the formula shown below this paragraph should be used. They label terminal value as continuing value and advocate using an absurd equation with all sorts of different returns and growth rates along with presuming that monopoly profits from current activities can be extended forever (the initial term, Economic Profit/WACC). If you make it to my chapters on terminal value, you will see that I suggest that predicting trends in future returns is much better accomplished by an interpolation process and that terminal value cannot be established with a bureaucratic formula.<sup>5</sup>

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<sup>5</sup> McKinsey Book Version 6, page 278.

$$\begin{aligned}
CV = & \frac{\text{Economic Profit}_{t+1}}{\text{WACC}} \\
& + \left[ \frac{\text{NOPLAT}_{t+1} \left( \frac{g_A}{\text{RONIC}_A} \right) (\text{RONIC}_A - \text{WACC})}{\text{WACC}(\text{WACC} - g_A)} \right] \left[ 1 - \left( \frac{1 + g_A}{1 + \text{WACC}} \right)^N \right] \\
& + \frac{\text{NOPLAT}(1 + g_A)^N \left( \frac{g_B}{\text{RONIC}_B} \right) (\text{RONIC}_B - \text{WACC})}{\text{WACC}(\text{WACC} - g_B)(1 + \text{WACC})^N}
\end{aligned}$$

Many years ago, when I worked for a bank, we would put something called a dividend covenant into loan agreements that limited the ability of a corporation to pay dividends when things are getting bad, and a financial ratio was below a defined level. We called this a dividend restriction covenant. I recently met a person named Aly in a workshop who was creative and had a refreshing open mind about financial analysis. He asked me about something called a liquidity springing reserve which it turns out is the same as a dividend restriction. This fancy term – liquidity springing reserve -- demonstrates what finance seems to be about these days. When explaining finance to engineers and others who what to understand how finance works, I tell them that the trick to being a finance expert is to: (1) talk really fast; (2) use big words and, (3) if you sense that people are still understanding you, make up new words. My friend Conrad (a lawyer) gave me the following explanation description of finance expertise:

A medical doctor, an engineer, and a finance professor are at a cocktail party.

- ✓ The medical doctor pompously asserts that the medical profession is the oldest profession. He cites a passage from the Bible, in Genesis where God creates man and woman. "Surely," he says, "this was the first medical act."
- ✓ The engineer jumps in and says, "I remember a passage prior to that, which says, out of the chaos and confusion, God created the earth. Surely, this was the first act of engineering and predates the first medical act."
- ✓ "Aha!" says the finance professor, "who created the confusion?!"

### **Simplistic Valuation Formulas in Practice**

At the opposite end of the spectrum from the seemingly sophisticated equations and confusing language, the people who practice finance often apply simplistic formulas, arbitrary benchmarks and crude use of financial statement information which can be an even bigger problem. One example of this simplicity is use of the constant growth formula below for terminal value without adjustments for the required associated investment (capital expenditures) to support the growth.

Terminal Value = Terminal Period Cash Flow x (1+Terminal Growth)/(WACC – Terminal Growth)

It does not take much deep thought to understand the very general idea that without making investments it is impossible to grow (this applies to a lot more than money and business). But the terminal growth formula does not make this fundamental connection because investments are buried in the terminal period cash flow, and it is not clear how much investment is made to support the terminal growth. It is shocking that people still use this formula without thinking about the level of returns that a business entity can earn in the long run.

A second example of simplistic analysis in finance is the way performance and prospective value is (or is not) assessed with calculation of return on investment (net profit after depreciation and taxes divided by the level of investment). If you continue reading this book you will see that I harp on the fairly obvious point that value depends on estimating the prospective rate of return. It is not revolutionary to suggest that in evaluating the future rate of return, you would like to understand something about the historic return as a starting point -- this is no different than starting with history to make assessments of what can happen to other things in the future, ranging from the GDP per capita of a country, to divorce rates, to the profitability of an MBA degree, to the price of oil. But you will see that because of distortions from straight line depreciation, impairment write-offs and many other accounting conventions, finding the true economic rate of return is not possible using conventional financial statement analysis.

### **Problems with DCF, Multiples, Return Measurement, Terminal Value, Financial Statement Analysis, CAPM and Other Techniques Used in Finance**

I structure my critique of finance theory and practice in the context of a basic notion that to create value, a firm should earn a return above the cost of capital and then make investments in capital expenditures, development activity, inventory, advertising, employee education, technology, general research and other things where potential – i.e., uncertain benefits exceed the investment costs. There is a lot of practical (some would say boring) stuff in the rest of the book where I try to prove my ideas and suggest alternative analytical techniques. A few of the principal arguments and some nuances that which correspond to subsequent chapters include:

1. The basic idea that you should always strive for growth and return is simplistic and ignores the very high risk of getting into businesses (or professions or even romantic partners) that seemingly have high benefits. But these high benefit and high growth objectives come along with high risk of others wanting the same thing and can lead to high anxiety and risk. In many business and personal situations, the ultimate objective is to have a boring existence and to keep calm and carry on.
2. The most fundamental idea taught in finance is the decision rule to make an investment that has a positive present value. But this seemingly obvious notion requires a cost of capital assumption that supposedly accounts for risk. Practitioners rightfully try get around the present value rule and find other metrics like the IRR precisely because it avoids the need to directly worry about the unmeasurable cost of capital. The IRR is ridiculed by finance academics (because of something called the re-investment assumption) and there are to be sure problems with the statistic. But rather than

wasting time measuring the cost of capital, IRR problems can be resolved by using a method that I label the earned risk premium (the earned return relative to the risk-free rate which does not depend on a risk adjusted cost of capital).

3. Given the basic idea that value depends on achieving good returns, financial statement analysis should be about searching for the true realized return on investment for a portfolio of projects developed by a corporation. But when you understand that return on investment and IRR are the same and then try to compute return on invested capital from financial statements the rate of return is just about always a distorted if not irrelevant statistic. The uselessness of financial statement analysis comes about because of straight line depreciation, asset write-offs and impairment, inflation, acquisition accounting and other issues. These distortions and the fact that the objective in valuation boils down to understanding and predicting changes and the sustainability in the true rate of return, imply that conventional financial statement analysis is largely a waste of time. A better approach to computing the rate of return applies project finance ideas.
4. Most people realise that use of multiples like P/E and EV/EBITDA are problematic because of the way supposedly comparative companies are selected and because of the wide ranges that generally exist for companies in the same industry. These critiques are certainly valid. But the more important point is that multiples have a series of theoretical distortions that can be demonstrated with a little bit of modelling and analysis. Biases include the way multiples are driven by expected changes in return; the way the important EV/EBITDA and Debt/EBITDA multiples are influenced by the average lifetime of investments; the way that multiples can be affected by the age of assets in a portfolio; and differences in implied cost of capital that is inherent in the multiples. Once the underlying problems with multiples are understood, a more nuanced analysis can be made to compare investments.
5. Valuing something that has an indefinite life – a corporation -- depends more on your philosophy with respect to the ability of a company to continue earning economic rent than a financial formula. Once you understand this you can see that using the classic DCF formula to value a company and applying terminal growth rates or applying valuation multiples renders the whole valuation exercise useless. Terminal valuation must consider how the return on capital can evolve and whether it can last forever. A better method to compute terminal value is to explicitly consider changes in long-term growth rate and interpolated changes in the return on invested capital (project IRR) to assure that projected income is supported by investments.
6. Instead of being divorced from corporate finance, the study of project finance (valuation and risk of a single investment) should be the foundation for understanding valuation and returns. Using project financed investments to evaluate rates of return and risks on the portfolio of projects that make up a corporation is an effective way to think about valuation and risk of an entire corporation which is a collection of investment projects.

Project finance concepts demonstrate distortions in return measurement as a function of age, expected long-term returns, changes in risk of a corporation, distributions of cash flow that are skewed, biases in multiples, implied cost of capital and many other issues central to corporate finance.

7. Risks from making investments change dramatically or in a minor way over the lifetime of the investment. This not only means that applying a constant cost of capital WACC to the cash flow is absurd, but that the idea of using the same model in different life stages does not make sense. In the early stages of the life of an investment where the risk of failure is high, you should directly account for the probability of success rather than traditional techniques derived from expected cash flow and a discount rate. In assessing the true return earned on a mature project, the upside from capital gains that are realized when risks decline should be part of the investment process. As a corporation is made up of projects that are in different stages with different risks, discount rates and valuation should in theory account for this change in risk.
8. The CAPM (and arbitrage pricing model variants) are hopeless tools in providing an effective measurement of the cost of capital (the minimum return you need before walking away from an investment). Derivation of the cost of capital from expected cash flows using a careful terminal value is much more sensible way to derive the cost of capital. A good way to approximate the cost of capital is to look around and find a company that has a price to book ratio of 1.0 and has reasonably stable returns.
9. Typical cost of capital measurement falls apart because the WACC formula is mechanically incorrect when it comes to correctly measuring the value of interest tax shields; because stock prices do not have statistical properties (no mean reversion) that permit accurate calculation of betas; because debt does not necessarily have a lower cost than equity capital and because there is no such thing as beta on debt.

### **Nineteen Specific Things that are Wrong with Finance**

If DCF mechanics are wrong; typical techniques for measuring IRR to assess an investment are wrong; use of comparative multiples is wrong; standard techniques for measuring the cost of capital are wrong; the WACC formula is wrong; measuring the return on invested capital from financial statement analysis is wrong; terminal valuation techniques are wrong; the assumption that stock prices follow a random walk is wrong and the general proposition that debt has a lower cost than equity is wrong, this may be enough material for a book. But I assert that there are more specific problems with finance. So that you can see this book is not about general blah blah discussions but addresses specific problems, I have included a list of particular items that academics, consultants, investment bankers and others get wrong about finance (my son calls me der wütender alter trottel):

1. the manner by which the financial professionals assume that growth in stock indices and represent underlying earnings power of corporations when computing the EMRP

without considering capital gains that come about because of changes in the cost of capital (the stock market goes up when real interest rates decline, and this has nothing to do with corporations earning a higher return);

2. valuation analysts who believe the McKinsey value driver formula :  $\text{Value} = \text{Income} \times (1 - \text{Return}/\text{Growth})/(\text{Cost of Capital} - \text{Growth})$  can be applied in practice without understanding that the formula falls apart as soon as changing returns and changing growth rates are assumed;
3. the way people in finance look at a website (Damodoran) and add a country risk premium to the cost of debt and equity capital for developing countries assuming that the risk of producing chocolate and drinking beer are much higher in Nigeria than in Switzerland without evaluating detailed stock and bond data and without understanding distortions in country credit spreads;
4. suggestions made by McKinsey and others that it is appropriate to compute the modified IRR (MIRR) which does nothing more than give you back the discount rate that you input or to present the multiple of invested capital which is just another way of computing an old fashion payback period;
5. doctrines of finance experts that cash flow to the firm – cash flow from both debt and equity investors should always be used in financial analysis without recognizing that financiers who structure debt implicitly provide the best information about the risk of investments (meaning that equity IRR rather than project IRR and ROIC should be the basis of valuation);
6. Harvard case studies and analysts who apply or recommend terminal value calculations that miss essential points about required capital investments to replace equipment and maintain returns, and do not evaluate gradual changes in returns, gradual changes in growth and trends in the cost of capital in the long-term;
7. investment bankers in M&A presentations performing the senseless exercise of un-gearing and re-gearing betas without considering the risk of debt or assuming the debt beta can be computed in a reasonable manner;
8. the proposition in CFA materials that that the cost of equity is always higher than the cost of debt without considering the basic idea that debt has downside and no upside other than earning the credit spread while equity has an unlimited upside.
9. loudmouth stock analysts on television who imply that P/E and EV/EBITDA ratios have some kind of inherent meaning without ever having made the effort to study all of the factors that can cause seemingly very similar companies to have very different metrics;

10. finance academics who acknowledge that the CAPM does not work and who suggest the Arbitrage Pricing Model as an alternative without recognizing the arbitrage pricing model makes most sense in the context of an investment that can be hedged with forward prices so as to eliminate risk premiums from the valuation analysis;
11. all sorts of financial analysts who compute the WACC through multiplying the interest rate by one minus the tax rate and not recognizing that the value of the tax shield is analogous to a government grant which suggests that the amount of the debt rather than the interest rate should be adjusted;
12. Standard and Poors and Moody's crazy metrics to evaluate risk without starting with the fundamental notion that some risks related to weather, commodity prices or economic cycles are mean reverting and other risks related to fashion, obsolescence and political events are permanent;
13. finance professors who show off by creating a Monte Carlo simulation without making attempts to measure mean reversion and without properly testing for the presence of mean reversion;
14. finance textbooks (e.g. Damodaran, McKinsey and other) that apply the same valuation model for an investment in the start-up or development stage as in the a mature stage and that do not recognize that valuation models must explicitly consider probability of failure in the early stage of an investment;
15. finance programs (e.g., the Amsterdam Institute of Finance) that assert a finance expert can find innovative ways to interpret financial statements without understanding that it is virtually impossible to construct useful information for the central statistic required of valuation analysis which is the economic rate of return on invested capital and the economic return on equity capital.
16. finance academics who discuss the CAPM but have never worked through real world problems with different betas being computed if daily, weekly or monthly prices are used; if different historic EMRP if different databases are used; and if different risk free rates are used with different implicit inflation forecasts;
17. valuation analysts who cannot take a step back and realise that the long run value of a corporation above the historic investment that has been made comes from two pots, the first being the ability to earn economic profit from existing operations and the second being the ability of management to continue to make investments that earn monopoly profit;
18. Value line and MarketWatch who publish betas that are artificially pushed towards 1.0 in an arbitrary manner using a paper published in 1975 even though it is easy to demonstrate that for mature companies no such movement towards 1.0 exists.

19. financial economists who assert that societies with companies that are earning high returns (i.e., monopoly profits) and generating high growth (with negative environmental impacts) are good for society.

### **Remaining Chapters and Structure of this Book**

I have struggled about how to structure the discussion of finance theory and valuation in this book. I had an idea about showing how Harvard Business School (“HBS”) case studies that worship management have turned into disasters and demonstrating problems with the curriculums of prominent MBA programs. Classic case studies that would be good to work through include Harvard praising Enron for its attempts to inflate the cost and return of the Dabhol plant in India and suggesting that the Petrozuata project in Venezuela was an example of “the effective uses of project finance.” My favourite example is the quote from Rebecca Mark in a Harvard Case Study that I have copied as Figure xxx.<sup>6</sup> Rebecca (not surprisingly, the holder of a Harvard MBA) proudly asserts that Enron will “spread the privatization gospel”, have “missionary zeal” and bring “market mentality” in countries that “desperately need this kind of thinking.” She does not tell you in the quote that Enron would have made a 43% IRR from the project. I keep trying to imagine young Harvard students eating this stuff up.

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<sup>6</sup> Enron Development Corporation: The Dabhol Power Project in Maharashtra, India (A). Harvard Business School 9-596-099. Rev. July 6, 1998

As they inched along the traffic jam of Bombay taxi cabs on Marine Drive, Rebecca Mark and Joe Sutton reflected upon the intense negotiation efforts of the past year and what had been accomplished. Their company, Enron Development Corporation (EDC), the development arm of the Enron Corporation, had been attempting entry into the potentially huge Indian market. EDC was headed by Rebecca Mark, its youthful, energetic president and CEO. She summed up her philosophy and mission:

We are a very eclectic bunch with some ex-military people and some ex-entrepreneurs. We are brought together with a certain amount of missionary zeal which I think you have to have in this business. It demands so much of you all the time that you really have to believe in what you're doing. I think for us that missionary zeal has three parts—first, that these projects are good for the country. They get the economy moving by bringing in power and they bring in investment. Second, these plants are environmentally safe and without equal when you consider the options of coal or nuclear power. Third, we are bringing a market mentality and spreading the privatization gospel in countries that desperately need this kind of thinking. We are in the business of doing deals. This deal mentality is central to what we do. It's never a question of finding deals but of finding the kind of deals we like to do. We like to be pioneers.

### ***Figure 1 – Excerpt from HBS Case Study on the Enron Dabhol Plant and Enron's Missionary Work to Spread the Privatization Gospel***

Using HBS cases would have been fun, but I found that discussing all of the biases and mistakes in the analysis it would be difficult to keep focused and on track. I also thought about working through the McKinsey book chapter by chapter and showing where conventional ideas about finance are wrong. Instead, I have tried to keep the book more structured. I begin with some corporate finance ideas; then I move to project finance as a much more precise way to evaluate risk and return; towards the end of the book, I have written my comments about measuring the cost of capital. I do refer to selected cases that demonstrate how the ideas work in practise, but I do not work through the cases in a lot of detail.

The text is structured according to the fundamental idea that valuation, assessment of management performance, evaluation of multiples and other finance issues come from the simple notion of earning a return above the cost of capital and smartly making investments to grow or, often more important, contract a business depending on whether you are generating real earnings. This business of realising a risk premium on your investment is used to evaluate how and when to make new investments; as the basis of computing terminal value; as a way to assess whether multiples like P/E ratios are reasonable; as the foundation of a way to get away from the CAPM; and as a way to evaluate investments in new developments. I do present my alternative for computing the cost of capital, but I put the cost of capital discussion at the end

not at the beginning because of the general notion that financial analysts want to get away from depending on such a flimsy number. The remaining chapters include:

**Chapter 2: Finance, Valuation and Capitalism is All About Growth.** The cost of capital, the rate of return, interest rates, IRR's and most other statistics in finance are measures of growth. The classic competitive strategy diagram with return and growth is a way to think about finance but it can lead you astray. A more nuanced base is to apply different models and criteria to investments at different stages where the ultimate goal is to have to end with the ability to keep calm and carry-on like my Uncle Gerald who developed the company that made Queen Elizabeth's handbag for many decades.

**Chapter 3: Looking for Analysis that Does Depend on Cost of Capital - IRR is Not Perfect, but it is Not Bull Shit.** Finance theorists insist that investment analysis begin with CAPM and arrogantly scoff at the IRR. Practitioners on the other hand want valuation criteria that assess investment without using the cost of capital. A potentially more interesting approach to evaluate questions like whether Justin Bieber's music is really worth \$200 million discussed in this chapter is to compute the risk premium earned using the risk-free rate.

**Chapter 4: Finding the Future Return on Invested Capital is the Holy Grail but Using Financial Statement Analysis to Evaluate this Number Leads You Astray.** Accountants are often proud of how financial statement data in valuation. But the accounting data cannot be used to measure the economic rate of return earned on investments which is the essential statistic behind valuation. This chapter describes how the return on invested capital ratio is completely distorted by accounting conventions that include straight line depreciation, impairment write-offs and not applying life to the investment. Other issues in using financial statement data to compute the ROIC including deferred taxes, operating cash and non-operating assets are also discussed.

**Chapter 5: You Can Find the True Rate of Return Using Project Finance Concepts, but You Need to Fix Depreciation to Make the Return Useful.** McKinsey and other consultants can come into a company and measure the performance of management by attempting to compare ROIC to WACC. This chapter introduces project finance and explains that valuation and risk issues can be better understood through evaluating project IRR and adjusting accounting data with investment criteria in project finance apply the project IRR and equity IRR which represent the true economic return on a project. Measuring returns with economic depreciation reconciles the IRR and ROIC and can be used as a basis to understand distortions in financial metrics.

**Chapter 6: Multiples such as P/E, EV/EBITDA and Debt/EBITA are Useless Even If a Banker Waves a Magic Wand and Gives you a Number:** Most people who have thought about valuation multiples understand that financial analysts on television who use the term valuation for the P/E ratio do not mean much in the context of an individual stock. To go deeper and understand why multiples don't mean anything, this chapter shows how a simple little model can be used to understand why comparative multiples without adjustment are just about

always irrelevant. This chapter delves into more subtle problems than the typical HBS case studies and quantifies biases in the multiples from return, growth, age of assets, economic asset lives, degradation, tax rates, working capital levels and the cost of capital.

**Chapter 7: The Sin of Simplistic Terminal Value Formulas in Valuation – the Elephant in the Room.** Finance courses, valuation analysts, and HBS case studies do not focus on the philosophy or the mechanics of terminal value which should be the most important number in a valuation. This chapter goes further than the typical HBS case studies and demonstrates how to quantify biases in the changing growth rates, replacement capital expenditures, prospective capital expenditures required to support growth and returns that gradually move to levels that reflect increasing competition.

**Chapter 8: Terminal Value Cases – You Don't Have to Bureaucratically Apply Formulas to Compute Value.** Developing a valuation analysis that occurs forever is certainly not easy and has more to do with philosophy than with developing a standard formula. This chapter includes a few examples of computing value where you think more creatively about how to compute terminal value beginning with a hypothetical company that was able to monetize Beethoven's music.

**Chapter 9: Absurd Idea that the Same Valuation Models and the Same Cost of Capital Can Be Used Over the Life of and Investment Project.** The desire to create successful start-up companies that will become like Tesla or Amazon is understandable and most investments ranging have a risky start-up phase. Suggestions that you can use a DCF approach or evaluate the decision to invest in a development project using and IRR are silly. Instead, different models should be used for different phases of an investment.

**Chapter 10: A Different Way to Think About Risk and Return with Project Finance.** How financiers can tell you about risk and return with careful structuring of debt around the pattern and the variability of cash flow.

**Chapter 11: A Tour through CAPM Problems – Inflation Risk and  $R_f$ ; Income Transfers from Workers to Investors and EMRP; Alternative Beta from Daily or Monthly Returns and Mean Reversion; Country Risk and Stealing from Developing Countries.**

**Chapter 12: Stealing Money from People who Live in Developing Countries Otherwise Known as the Country Risk Premium.** Is Eating Chocolate Really Riskier in Nigeria than in Switzerland and Cost of Capital for Nestle Subsidiaries Around the World

**Chapter 13: Debt versus Equity Cost, WACC, Mean Reversion Parameter.** Why do finance people say that debt is riskier than equity when debt has no upside; the tax effect of interest deduction should be treated like other government grants; computing the mean reversion parameter.

# Chapter 2:

## Finance, Valuation and Capitalism is Ultimately About Growth

### There are Only Two Things in Finance – Future Cash Flow and Risk of Than Cash Flow

Finance and economic analysis of capitalism can be reduced to a couple of simple and fairly obvious ideas that are often not explicitly covered in basic courses in corporate finance; but which should be the starting point in finance. The most basic idea of valuation is that you try to find something good – an effective strategy that can generate a high profit -- and then grow that good thing you have found by making new investments in the activity. In the context of finance, you should find business activities that earn a return above the minimum acceptable growth rate adjusted for risk (i.e., the cost of capital) and then make investments (whether the investment is for capital expenditures, advertising, education of employees, development of new information technology systems, inventories etc.) to grow these parts of your business. Alternatively, if your return is low, you should get out of the business and stop making investments – this can be a lot more difficult to do than growing a business. Any rate of return or interest rate can be thought of as a growth rate as it measures the incremental increase in your investment -- income divided by prior level of the investment.

A second and related fundamental idea of finance must be that any valuation of a bond, a stock, a strategy, a factory, an education, gambling or even a decision like getting married comes from two things. The first is making a forecast of happiness -- future cash flow (that depends on both returns and growth in investment). The second is anxiety -- assigning risk to that cash flow. All subjects in finance deal directly or indirectly with these two things: (1) prediction of future cash flow, and (2) risk associated with that forecast. It may seem pretty simple that all you have to do is make a prediction and then assign risk to your projection of the future; but making prognostications of the future and coming up with a way to measure risk of future uncertainty are the foundation of many if not most issues in economics.

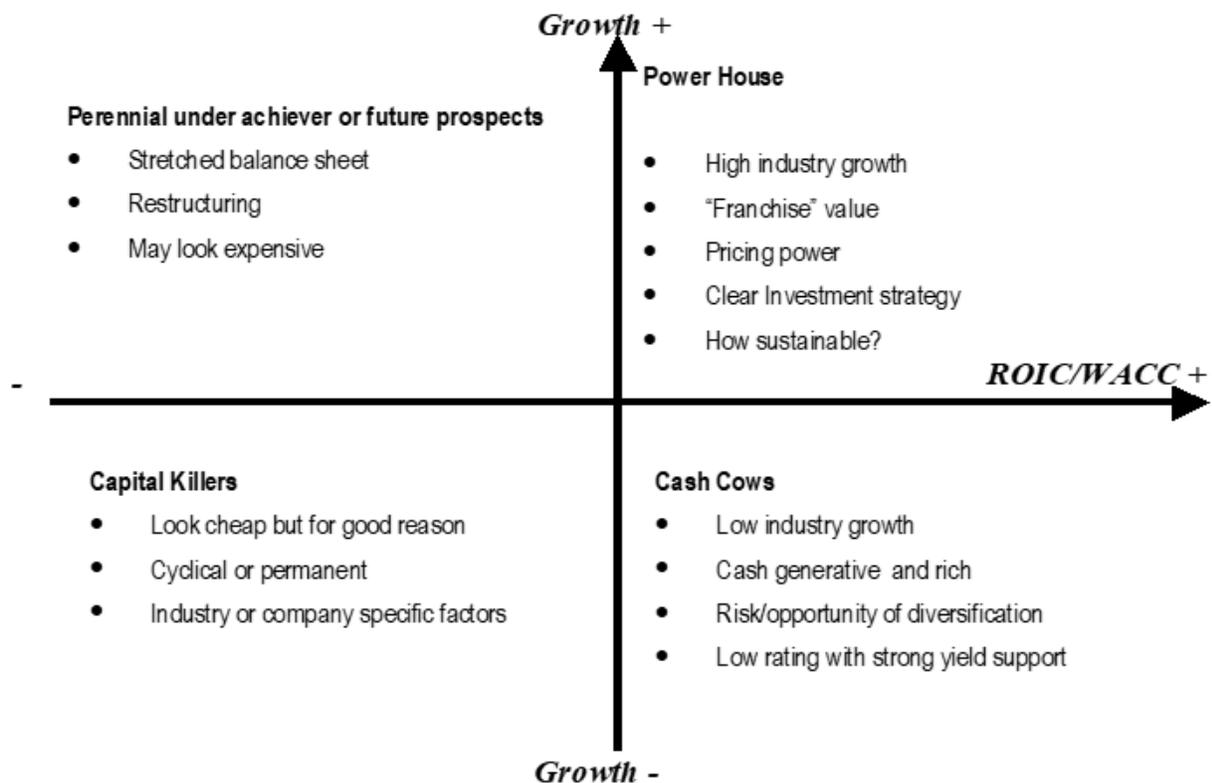
A basic philosophical problem with the basic notion of finance is how and whether we can really measure risk. If you use the cost of capital to measure risk (the minimum required growth in your money given the level of risk), then the cost of the capital can be thought of as your minimum desired rate of growth in cash flow. Your basic objective is to find investments where the projected (uncertain) rate of growth is above the minimum rate of growth required to accept the risk of the project. This may seem very basic, but understanding fundamentals of

what is return, what is an investment, what is the cost of capital are at the bottom of finance and should be the starting point of a finance text.

While this is a bit of a diversion, I cannot go on without noting that this obsession with growth that is at the foundation of finance is now a problem in the world. Growth for a particular company in the entire economy can occur from the desire to make people think they need 5G, new iPhones with slightly different features or making you want bigger houses, bigger seats on airplanes, bigger wardrobes, bigger SUV's, bigger steaks, bigger hotel rooms, bigger roller coasters at Disney World or longer vacations to further away places. These things that increase value are arguably the root cause of many things including climate change. A similar statement can be made with respect to risk. When Disney remakes the same film rather than encouraging something more creative; when a bunch of chain restaurants populate your town; when you see the same big SUVs or 4x4s on the road, it probably reflects somebody at a corporation minimizing risk and doing the safe thing that has worked in the past. I am sorry about going off the subject; but understanding the most fundamental ideas of finance can make us think more deeply about basic institutions and ways of measuring where so many problems come from.

### **Classic Competitive Strategy Matrix**

Many years ago, I was asked to substitute for another instructor and the lead a valuation course. The other instructor gave me his power point slides that included the diagram replicated in Figure xxxx. I don't like power point slides in general, but I thought this graph with four boxes could be a good way to think about competitive strategy. The vertical axis is growth, and the horizontal axis is the return on investment relative to the cost of capital, so it incorporates future cash flow (return and growth) and the risk of the cash flow. The general idea is that if you can grow and earn a good return relative to the risk you take, you will be rich and successful and land in the powerhouse company box. To get here, you are supposed to have a sustainable competitive advantage by managing all sorts of aspects of the company well from product development to quality control to cost management developing the skills of the staff. While the axes may be a good framework for thinking about valuation, I hope you find comments in the boxes as repulsive as I do. The diagram inappropriately implies that the bottom left square – capital killers -- is the worst place to be, and the top right is the best.



**Figure 2 – Classic Competitive Strategy and Value Diagram with Irritating Descriptions**

The graph is a reasonable starting point in the sense that any valuation analysis or financial model analysis should explicitly demonstrate the return on investment and the growth of cash flow. While I proceed with this graph, I will argue that this graph is not only simplistic, but the idea of always wanting to get to the powerhouse square is wrong. You can think of valuation as assessing directly or indirectly changes in return, growth and risk and whether potential change in these three things have already incorporated correctly in the value of a company. This contrasts with the obsession that analysts have with short-term earnings per share that does not explicitly consider the investment you need to achieve growth.

This graph can be translated to value if we make the heroic assumption that: (1) return on invested capital (ROIC) can be properly defined (it cannot); (2) we can reasonably measure risk with the cost of capital (you cannot); (3) we can define what represents growth (you need investment); and (4) the return, cost of capital and growth do not change over time (this is the whole point). Assumptions that you can measure these things are obviously crazy and coming up with ways to deal with the problems in measuring the drivers underlies the central theme of this book. Serious issues relating to evaluating the return on invested capital are related to

defining investment, measuring depreciation of investment, writing off investment, taxing returns on the investment, making adjustments for the age of investments, and whether you should use equity or overall returns on all of the debt and equity investment.

Problems with measuring cost of capital are even bigger as anybody who has spent time working through details of the CAPM knows. Estimates of the equity market risk premium (EMRP), the beta, the country risk premium and even the risk-free rate are not only vague, but they are generally upwardly biased. Alternative cost of capital estimates computed from derived cash flow depend on a reasonable terminal value which falls apart because of simplistic formulas using distorted multiples or crazy constant growth models that do not even account for variation in capital investment driven by changes in growth. The third item in the graph – growth projection must depend in one way or another on the investment that is made. Incorporating estimates of growth in long-term valuation explicitly through terminal growth rates or through implied growth in multiples generally is arbitrary and ignores the most obvious fact of economics that you must make some kind of direct or indirect investment (and periodically replace that investment) in order to grow.

### **Profit from Making People Addicted to Your Products and Danger of People Copying You**

Value is highest in the power-house square when you have continuing monopoly power and lowest not in the bottom left box but rather in the left upper box where growth is high, and return is below the cost of capital. The fundamental objective of valuation analysis can be thought of as evaluating the ability of a company to get into the power-house box; the ability to remain in one of the good squares; and consider the danger of getting into the worst throwing money away/surplus capacity square with low returns and high growth. A big problem is that when a company gets into the power-house square, other companies want to do a similar thing and a lot of capital expenditures are made with optimistic expectations. Then supply in the industry increases when a lot of companies make investments to enter the business. With increased supply, returns decline and you quickly arrive in the worst square because of overcapacity. The real disaster occurs when the investments are long-term and the growth rate in the industry slows down.

In thinking about this diagram, I remember the comments of an engineer when we were discussing the potential to earn high returns from manufacturing solar panels. Somehow the discussion moved to the rate of return Apple makes on iPhones. The young engineer made the point that you cannot compare returns earned on iPhones with returns on solar projects because people have an addiction to their iPhone that has been carefully developed and managed by Apple. We can read up a lot about sustainable competitive advantage and Porter's five forces, but I found this basic point about making monopoly profits by getting people addicted to a product a better way to explain value and strategy than most of the stuff you are fed in business schools.

You want some monopoly power through brand loyalty (the notion of getting people addicted to your products like Coke, Apple, Disney, McDonalds, Starbucks, Tesla); innovation that is

difficult to copy; size and economies of scale that create barriers to entry; and a variety of other things that result in what economists call economic rent (that is bad for overall society). Then, once you have a sustainable competitive advantage, you want to grow your economic rent by making people desperate for the latest version or by making old versions of your products obsolete so you can grow. We can all think about these philosophical ideas in working through the valuation objective of achieving high IRR's (compound growth rates), but for the moment I can only focus on the financial mechanisms rather than the social implications.

### **Evaluation of Business Cases should Begin with Considering the Earned Return**

I have followed MBA finance courses thirty years after I was in a similar program. These days there are more case studies and excel files are provided that go along with the cases. I was review a course in private equity, a course in mergers and acquisitions and a course in financial equations like duration as well as courses that focused on diversity in the workplace. I found two things remarkable when reviewing the case studies and discussion. The first was the lack of discussion about fundamental questions surrounding return on investment and limited discussion of whether the prospects for a company make sense in terms of competitive strategy. The second thing that I found irritating was the presumption that you can easily and objectively compute cost of capital from the CAPM (equity market risk premium and beta) without seriously questioning the model and without understanding that small differences in assumptions that drive the CAPM can have a large impact on value and investment decisions. I have been called an angry old man for questioning some of the basic ideas.

### **Proof of the Value Formula that Includes Return, Cost of Capital and Growth**

When you read the McKinsey book a formula appears from nowhere and seems to be some kind of magic equation that can be used in valuation. Instead of just presenting the formula I think deriving the formula should be a starting point in the study of finance (I did not see this formula much less its derivation in Harvard Case Studies or MBA programs). Before working through the problems with measuring each of the variables – these problems strike at the very heart of valuation and finance – we can see how the fundamental return and growth parameters translate into value. When you see the value driver formula:  $\text{Value} = \text{Earnings} \times (1 - \text{ROI}/\text{Growth}) / (\text{Cost of Capital} - \text{Growth})$  that considers the three fundamental drivers of value - return on investment, growth, and cost of capital you should be able to prove it. You should also be able to do a little algebra to adjust it for evaluating price to book, enterprise value to invested capital, price to earnings. Finally, you really should understand why the formula is not very useful without adjustments for changing returns and changing growth.

Instead of presenting a formula that may seem to be a black box, I work through a tiny bit of algebra with two basic equations. (If you read the McKinsey Book<sup>7</sup> you will see this formula all over the place, but never any documentation or proof.) The first is the classic perpetuity formula and the second is the growth formula. I once had to prove that a cash flow taking to

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<sup>7</sup> Value of Corporations ....

perpetuity is the next period cash flow divided by the discount rate using an integral formula  $\int e^{-rt} = 1/r$  (I cannot do this anymore). As growth -- abbreviated as  $g$  -- is like a reduction in the discount rate (abbreviated as  $k$ ), you can write the formula for value as:  $\text{value} = CF_1/(k-g)$ . For a stock, this formula gives you the value per share can be expressed as the dividend per share and (abbreviated as  $D_1$ ) divided by the discount rate minus the growth (this is like the common terminal value formula that I complain so much about). Attributing this simple formula to somebody named Gordon who promoted high returns for utility companies and calling it "Gordon's method" illustrates how finance cannot handle anything complex.

A second equation is the basic accounting idea that you need to retain cash to make investments and grow. In the case of your own personal finance, you can consider this savings along with the return you earn from savings. If you save more, then the value of this savings depends on the future income you will make on the savings. If your investment does not grow, then the income does not grow if the return does not change.

$$\text{Wealth Growth} = \text{Savings Percent} \times \text{Return on Savings}$$

$$\text{Wealth Growth} = \text{Savings Percent} \times \text{Return on Investment}$$

This formula uses the return on investment which is the income received divided by the investment made (I use the return on equity which can be replaced return on invested capital if you assume that the company is all equity financed with total investment equal to equity). If the income is re-invested in the company, the company then grows by the return on investment. The investment grows by the return (you can see that return and growth are essentially the same thing which is arguably one of the biggest issues with capitalism in the world today). As the growth continues from the earning the return, the growth can be expressed as return on investment multiplied by the investment. On the other hand, if you do not retain any income and instead pay it all out, then the investment will not grow. This means that the growth rate can be expressed as the return on equity (abbreviated as ROE) multiplied by the amount of income retained which is one minus the dividend pay-out ratio (abbreviated as 1-DPO). These two formulas as shown below:

$$\text{Value} = D_1/(k-g)$$

$$\text{Growth (g)} = \text{ROE} \times (1-\text{DPO})$$

While these two formulas are the basis for valuation, they are useless in terms of terms used in valuation these days (unlike the 1950's were nice and boring dividend growth for companies like General Electric, Consolidated Edison and General Foods were the basis for valuation). First, dividends are driven by growth and not the other way around (you do not want companies like Amazon to pay dividends if the company can grow) and the focus is on earnings rather than dividends. You can then re-arrange the growth formula and use the fact that dividend per share is the earnings per share multiplied by the dividend pay-out ratio to derive

the dividends ( $D = \text{EPS} \times \text{DPO}$ ). This leads to the classic value driver formula where value is driven by return (ROE), growth (g) and the cost of capital (k).

$$\text{DPO} = 1 - g/\text{ROE}$$

$$\text{Value} = (E_1 \times \text{DPO})/(k-g)$$

$$\text{Value} = E_1 \times (1-g/\text{ROE})/(k-g)$$

Earnings can be expressed as return multiplied by the book value of investment --  $E_1 = \text{ROE} \times B$ , and then a number of variants of the formula can be used to illustrate valuation ratios if you assume that return can be computed, and you assume that cost of capital can be computed. We will return to these equations later, but let's look at a couple of them. The first,  $[P/B = (\text{ROE}-g)/(k-g)]$  illustrates that price to book is driven by the ability to earn a return above the cost of capital. If ROE is equal to k, the P/B is one. What a nice trick this would be to find companies with P/B equal to 1.0 and then find the ROE. This is then the cost of capital. This formula can be extended to derive the following:

1. The P/E ratio:  $[P/\text{EPS}_1 = (1-g/\text{ROE})/(k-g)]$ . This comes from defining Value as P and dividing the equation by EPS.
2. The cost of capital:  $[k = E_1/P \times (1-g/\text{ROE}) - g]$ . This comes from re-arranging the equation and demonstrates that how cost of capital can be derived from expected cash flow.
3. The enterprise value:  $[EV = \text{NOPAT}_1 \times (1-g/\text{ROIC})/(\text{WACC}-g)]$ . This is the same formula as above, but earnings is replaced by earnings before financing (still after tax), return is replaced by return on invested capital, and the cost of equity is replaced by the overall cost of capital for both debt and equity that finance the total investment.
4. EV as a Function of Invested capital:  $[EV = \text{Invested Capital}_0 \times \text{ROIC}_1 \times (1-g/\text{ROIC})/(\text{WACC}-g)]$ . This formula is the same as above except that income (NOPAT) is replaced by  $= \text{Invested Capital}_0 \times \text{ROIC}_1$ .
5. The price to book:  $[P/B = (\text{ROE}-g)/(k-g)]$ . This comes from the equation that income = ROE x Book Value of Investment. When the ROE = k, the top and the bottom of the equation are the same and the price to book is 1.0. This implies that if you find companies that have a price to book of 1.0 with a consistent return, this return is about the same as the cost of capital.
6. The WACC:  $[\text{WACC} = EV/\text{Invested Capital} \times (1-g/\text{ROIC}) - g]$ . This is like the formula for k above but allows you to derive the WACC.

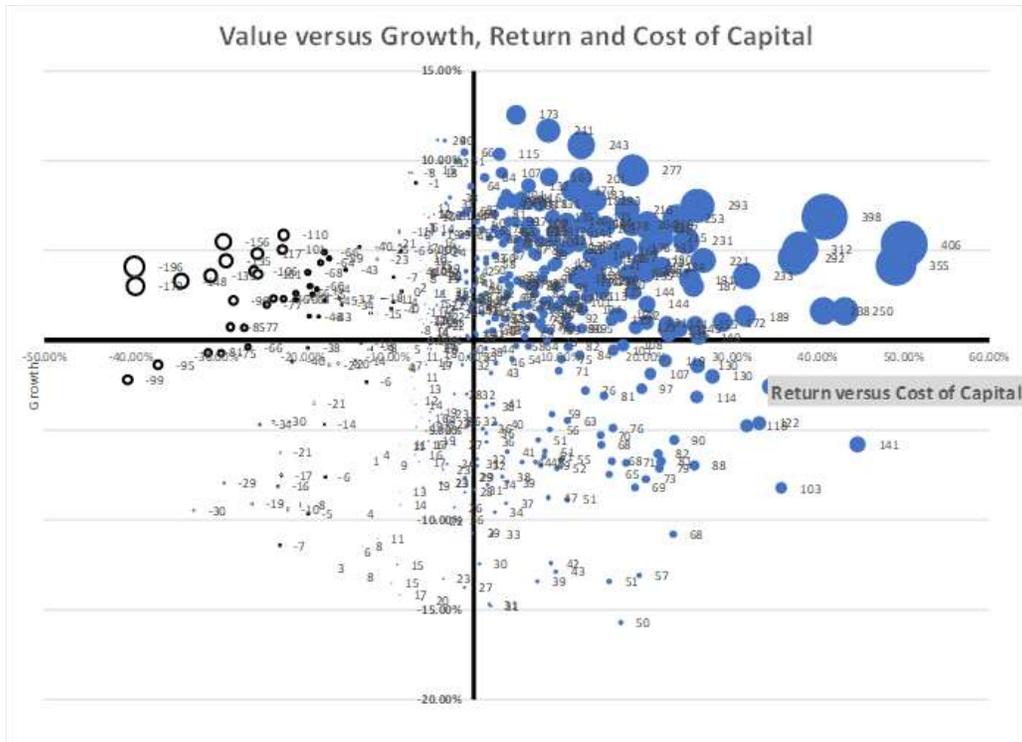
## Illustration of Returns, Growth, Risk and Value - Simple Case to Demonstrate Value from Return and Growth

Using the value driver equation above and holding constant the current earnings and the cost of capital, I have made a whole lot of different scenarios with random draws of future return and growth to illustrate ranges in value. I have summarized the different values in a bubble chart<sup>8</sup> in Figure xxx. The graph demonstrates how value explodes as with both high return and high growth – the big blue bubbles. The graph also shows how growth with negative return can result in negative value – the circles without blue colour are negative values. The box at the bottom right shows that cash cows can still create value while the box at the bottom left shows that exiting a low return business can protect you against the worst-case values from positive growth and returns below the cost of capital. Note that this type of graph does not work with the P/E ratio or the EV/EBITDA ratio as both the numerator and the denominator change with different scenarios. If you had a course in corporate value or you make some valuations you probably ignore returns and use a simple growth model for terminal value with arbitrary and fixed capital expenditures that do not vary with growth (don't worry, everybody does this). The graph made from the simplistic value equation demonstrates the danger in not explicitly considering returns.

Figure xxx is not very relevant or realistic because the returns, growth and the cost of capital are not constant, and companies can move from box to box quickly. When analysts make projections of a company and discuss things like how people will never be able to use a phone different from an Apple phone after they purchase one or how Tesla cars are so different from any other car that people will become addicted to the brand and never buy any other petrol or electric car. In short, the competitive advantage that allows companies to stay in the top right powerhouse square (not my term) may stay there for a long time because of creating addiction (think of how McDonald's starts with children and happy meals) or through real innovation (sorry about not recounting Porter's five forces in a more polite way).

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<sup>8</sup> You can see how to make the bubble chart and watch an associated video at [www.edbodmer.com](http://www.edbodmer.com)



**Figure 3 – Illustration of Value Created from Assumed Stable Returns and Growth Illustrating Biggest Value in Box 1 and Negative Value in Box 2**

### IRR Growth and Yahoo Adjusted Stock Price from Re-investing Dividends

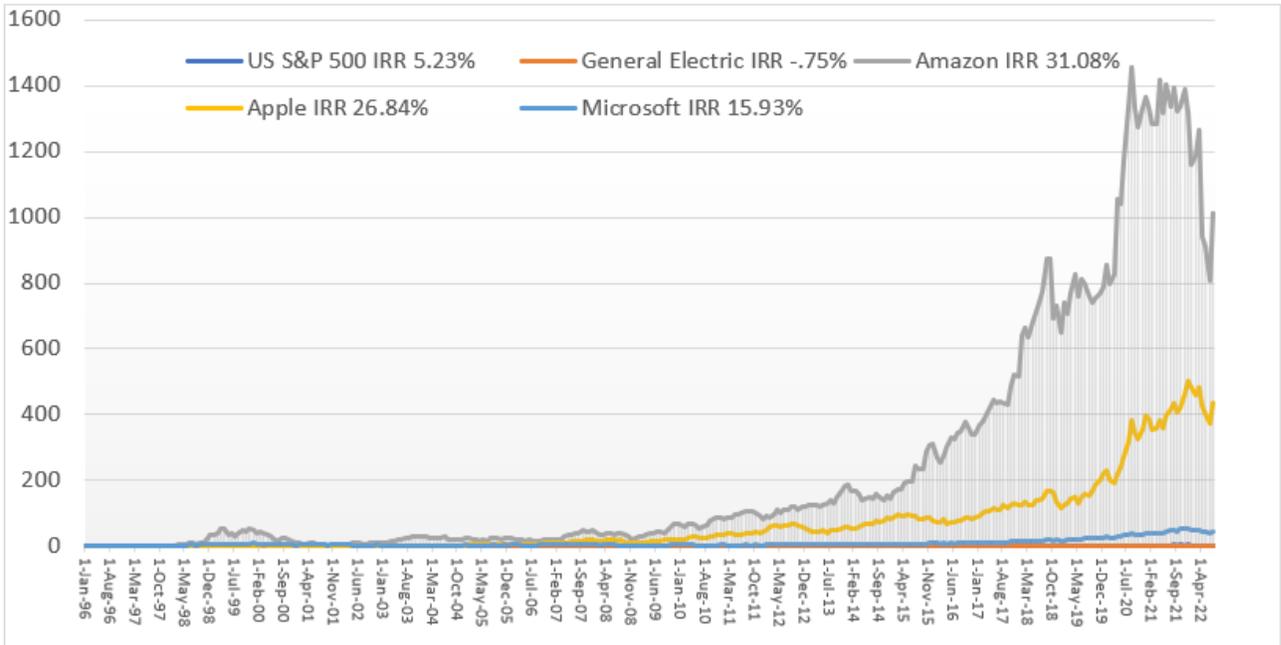
When you look at historic stock prices, you should use adjusted prices from finance.yahoo.com (that includes re-investment income from dividends) to compute the return (growth rate) you gained from an historic investment. This demonstrates that at the end of the day, valuation is about growth and that IRR is the same as growth rate when evaluating stocks.

To evaluate issues with valuation, growth and cost of capital I use the case of GE and Amazon at various points in this book. Not so long ago (for me because I am old), General Electric would have been considered a power-house company (the most valuable company in the world) as its CEO Jack Welch focused on earning high returns with his strong incentive programs for employees (every manager had to fire one of ten people every year) and his emphasis on growing through acquisition after which GE imposed similar policies to increase returns. There have been many Harvard case studies written supporting the policies of Welch. But things have changed a lot in the past decades. GE apparently made many acquisitions that did not work out.

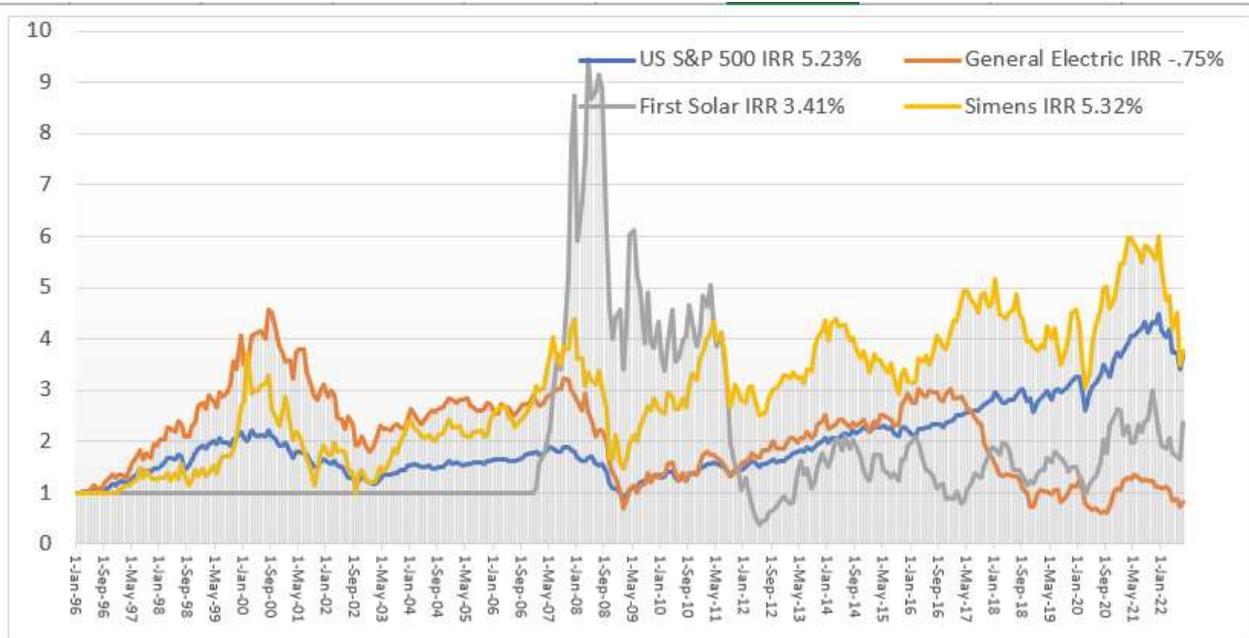
It became bloated and is now somewhere on the bottom boxes on Figure xxx. This is illustrated on figure xxx which shows the growth rate and an estimate of the ROIC for GE.

These days Amazon is a company that is much talked about with a high growth rate and an increase in return on invested capital (maybe it too will turn out like GE). As the return has increased and the growth is expected to continue, the stock price has exploded. This has allowed Jeff Bezos to pay his ex-wife 38 billion USD in a divorce settlement (Jack Welch only paid 180 million USD to his ex-wife in a much bitterer divorce). The Amazon case demonstrates that valuation is much about projecting return on investment – GE's ROIC declined, and Amazon's has increased. Figure xxx shows that the story of GE and Amazon can be explained by growth and ROIC for the two companies.

Financial and valuation results of the two companies can be demonstrated by how much money you would have made if you invested and then held the stocks. This amount of money you make from an investment is the ultimate value that we want to measure with DCF, terminal value, WACC multiples and so forth. The value can be represented as the amount of money made relative to the amount invested or the IRR. Both are really the same and represent the growth rate. This type of analysis must pick some initial investment period and a holding period. If we make an investment at a certain date and then re-invest the dividends, we can measure the historic value created. The amount of money you get at the end of the holding period relative to the start can be measured with the compound growth rate which is exactly the same as the IRR. The IRR and the growth rate are the same because there are only two cash flows and nothing in between. The first outflow and then an inflow. The amount you have at the end is real money. The graphs below illustrate something called the adjusted stock prices that are published by finance.yahoo.com.



**Figure 4 – Illustration of Adjusted Stock Index (with Reinvestment of Dividends) for Successful Stocks and for the Overall Market since 1996 Demonstrating the Dramatic Value Created from High Compound Real Returns**



**Figure 5 – Stock Price Index for Selected Stocks including GE which has Realized a Negative Real Return Relative to the Overall Market Real Return of 5.23%.**

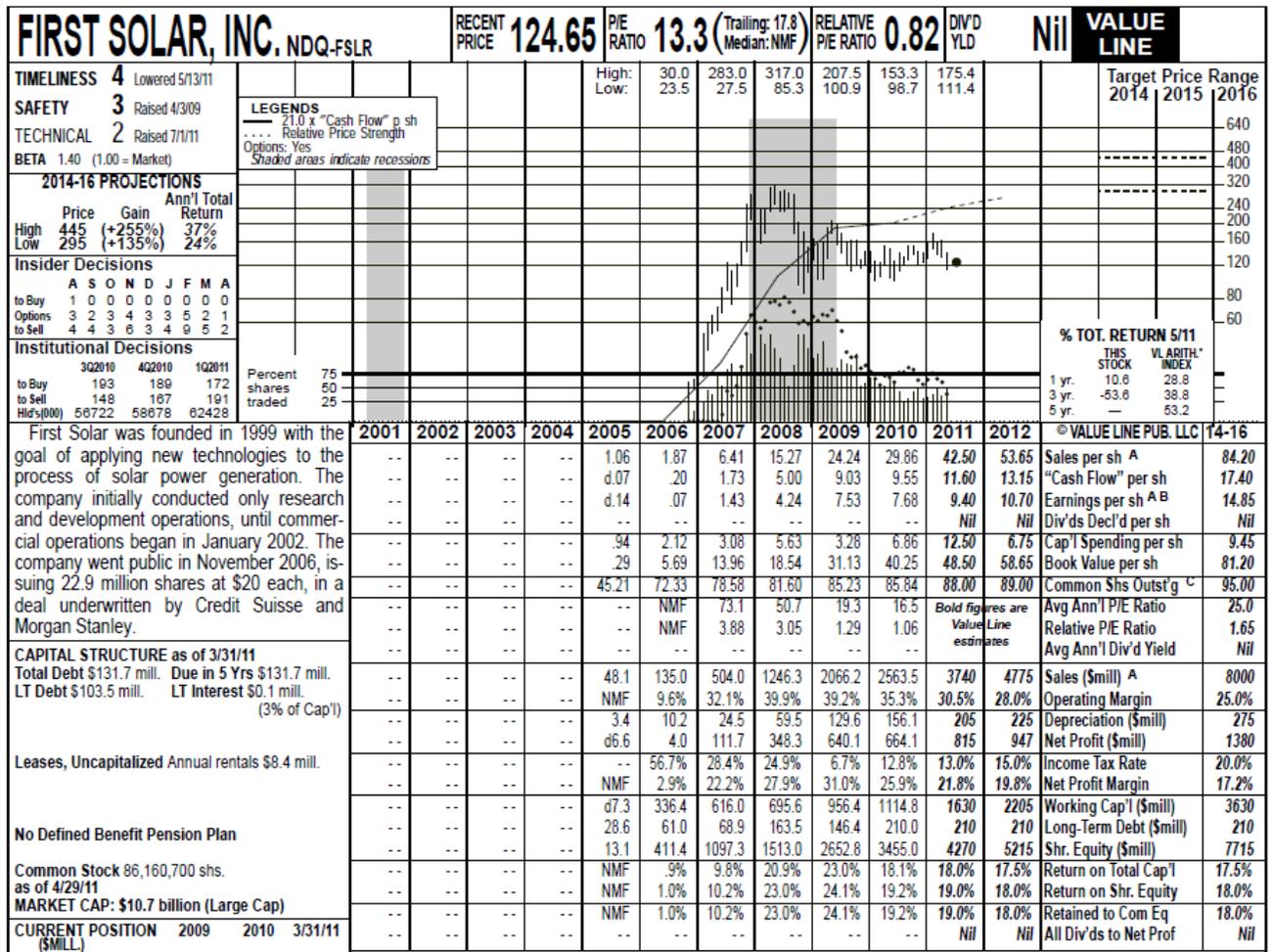
In subsequent chapters I will show how if measure the difference in the results. You will see that if the return on investment is measured with the correct economic life, economic depreciation, and does not include write-offs, then you can start to think sensibly about valuation. With a reasonable measure of the prospective return, you can assess multiples in a better way; you can derive a better way of computing terminal value; you can assess historic performance and other issues.

### **First Solar and Moving from the Powerhouse Matrix to the Surplus Capacity Square**

In teaching my classes I have tried in the past to find case studies that are relevant to subjects I teach so I go onto the HBS website and sometimes spend money on what seems to be a relevant case. Even though the cases only cost a few dollars, they are generally a waste of money and I find the manner in which they praise companies very irritating.<sup>9</sup> One example is a case written by Stanford professors that praised First Solar Corporation. When the company went public, First Solar seemed to be an ideal example of a powerhouse company. According to the case (written by Stanford), the company was the leader in solar manufacturing using a

<sup>9</sup> FIRST SOLAR, INC. IN 2010, Stanford Business School, CASE: SM-190 DATE: 10/01/10

production method called thin film (that now has a small portion of the market) and it was in an industry that was clearly going to grow. The case begins as follows: "Sitting in his office in Tempe, Arizona, Bruce Sohn reflected on his three-year tenure as president of First Solar, and on the remarkable achievements of the exceptional people he had worked with for the past seven years. First Solar had been in operation for only 10 years but had managed to cross the 1 gigawatt threshold in terms of annual solar module production capacity and to achieve a sub \$1.00 cost per watt of electricity—the lowest in the industry." Figure XXX which is an excerpt from a Value Line analyst report shows that analysts believed growth would be above 23% while the company was to earn a return on capital of 17.5% (I will explain later why these reports are not some kind of dinosaur reports that are irrelevant in the face of Bloomberg). This resulted in an estimated stock price range of between 295 and 445 as shown in the top Figure XXX. But solar panels are not like iPhones and factories that make panels are not that difficult to build. Chinese companies entered in the market and within a short period the stock price dropped to 32 as the company was in the box where there is surplus capacity and any investment made is throwing money away. This example illustrates the danger of powerhouse companies moving to the left into the worst matrix and that has surplus capacity and then not being able to exit the business.

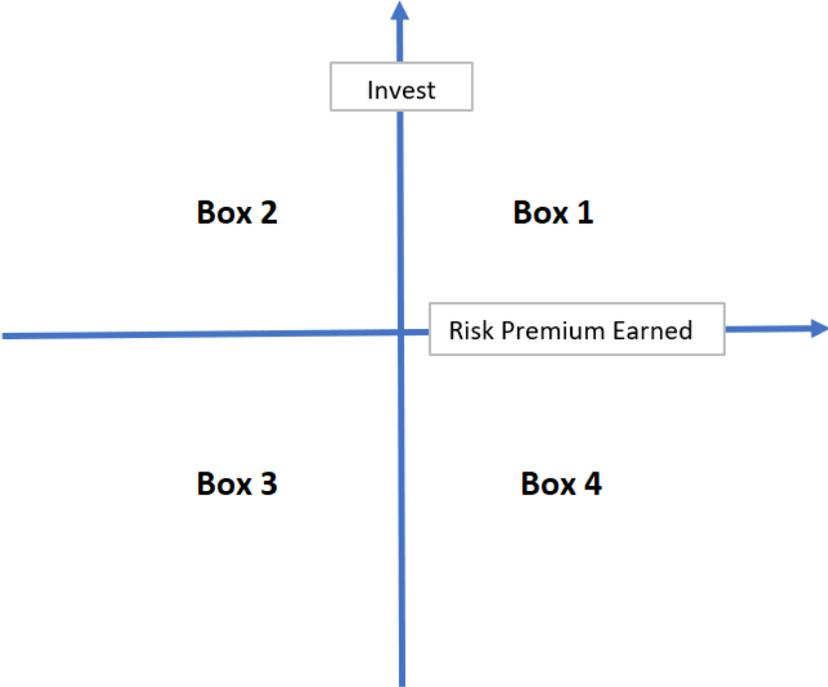


**Figure 6 – Value Line Analyst Report Demonstrating the Danger of Companies that Are Apparently in Square 1, the Powerhouse Square – the Actual Price fell to 32 Relative to Predicted High Price of 445 and the Predicted Low Price of 295**

### Alternative Competitive Strategy and Valuation Matrix

In thinking about valuation, careers and relationships, I suggest a different way to look at the competitive strategy to evaluate different valuation models over the life of an investment

or the life of a corporation or your own life. The first thing I change is the growth rate on the vertical axis. I argue that with the exception of inheriting money and marrying into money, you cannot realize growth without making some kind of investment. The competitive strategy graph implies that you can grow money without making investments like those adverts you get on YouTube explaining that you can make really big profits without taking any risk. Even if you have incredible skills which allows you to earn a large fortune (like Zinedine Zidane), you have to make some kind of investment in skill development to realize your return. Second, I have changed the rate of return versus WACC to the earned risk premium on your investment to emphasize difficulties in measuring return and the cost of capital. The graph with ROIC/WACC does not adequately emphasize that the bottom right box may have lower growth, but it also may come along with a lot lower risk. The ROIC/WACC scale also is deceptive in that it makes it seem that you can easily compute the WACC. So, on the horizontal scale I have put the risk premium relative to the risk-free rate. Figure xxx illustrates the revised matrix with the four boxes marked.



***Figure 7 – Alternative Competitive Strategy and Value Diagram Highlighting Difficulty in Estimating the Cost of Capital and the Need to Make Investments to Grow***

## Gerald and the Queen's Handbag

I replace the trite descriptions on Figure xxx like “stretched balance sheet” which means absolutely nothing with hopefully more relevant actions related to valuation in Figure yyy. The revised matrix in Figure yyy suggests there

are big risks of being in the powerhouse square (box 1); the ability to see when surplus capacity is coming (box 2); the importance of making decisions to exit failing businesses (box 3); and the benefits of a low growth and stable business (box 4) which I label keep calm and carry on. The revised business makes me think of one of the people I admire in business, my good friend and uncle, Gerald. Gerald began working in the early 1960's by borrowing



money for a VW and selling leather goods out of the back seat. In 1982 he purchased a bankrupt leather goods manufacturer that happened to have the royal warrant to sell handbags to the queen of England. Over the years he experienced quality problems; he ran a gifts business where he bought goods from Asia and sold them to teenagers; he purchased a trade magazine; he had normal difficulties with employees, and he developed the leather goods business. He made investments in developing a website; a consultant who publicized the handbags; a small showroom in London; inventories of leather raw materials from Italy; in researching different luxury good styles; and in carefully developing relationships with the royal family. During the queen's seventieth jubilee when Gerald had his 90<sup>th</sup> birthday, his success became apparent. Gerald's handbag was prominently displayed in a video with the queen and Paddington Bear and also in a drone light show. Gerald is not really rich, but he lives a comfortable life.

When I went swimming with Gerald in America a few years ago, a woman who was swimming in the pool gave Gerald some suggestions about growing his business and paying for space in department stores and dealing with the queen. Gerald is normally calm and affable, but upon leaving the pool he could not stop shouting swear words about this woman. How presumptuous for somebody with no real knowledge of the business to give him consulting advice and in particular having him risk his competitive advantage associated with the queen. The implicit idea was that Gerald should aim for the powerhouse square with higher growth (Box 1) and become turn his little company into something like Gucci. Instead of making large investments that would have been required to grow fast and probably fail (Box 1), he saw the surplus capacity coming for his gifts business (box 2) and he got out of the gifts business which left him with a warehouse of useless inventory (Box 3), and he made the moderate investments to change leather goods business to be more on-line focused that arguably made him end up in Box 4. The did not hire McKinsey; he certainly did not make elaborate financial models, and he did not measure his ROIC or his cost of capital. Instead, he made limited and flexible investments that were low risk (he could get out), and he was not afraid to exercise the option

to exit investments. He implicitly used probability analysis in making his investment decisions and he knew what to do in moving from box to box in the competitive strategy graph. I have written this story to suggest that Box 1 may not be the best place aim for or to be (in project finance, the objective is to get a boring investment that insurance companies want); to emphasize that you should be more creative in thinking about valuation analysis than trying to compute the net present value (using probability analysis and considering the flexibility of investments), and that you can assume range in upside cash flows is the same as the range in downside cash flows. I could on and use Gerald as a lesson for managing your career, but I must stay on the subject.



***Figure 8 – Competitive Strategy Graph with Comments Suggesting the Best Place May be Box 4 and Not Box 1***

### **Small Differences in Returns Over Time Can Lead to Really Big Changes in Value**

When comparing GE and Amazon, the criteria used was the growth rate of the assumed investment. If you would have invested in Amazon, an investment of 100 would have given you 80,000. Maybe with this little 100 investment, you could have bought a fancy car or funded your children's education. The example demonstrates that if you see an investment that has a return above 20% (if you are measuring returns with high inflation, this growth rate must be above inflation), you should probably be skeptical. On the other hand, if you bought GE stock, you would be anxious and frustrated and these negative feelings would be reflected in the negative

IRR. So, the question addressed in much of the remainder of this book is using the IRR as a metric to assess all kinds of investment decisions.

In the graph you can see that different growth rates produce dramatic results. For example, the IRR for Amazon of 30.55% does not seem that much more than the IRR of Apple of 26.41%. But this difference leads to accumulation of about 400 for Apple versus more than 800 for Amazon – you get twice as much when you look at the y-axis. The difference between the return of Siemens versus of 7.43% versus .82% for GE means that your money would have grown by 6 times if you invested in Siemens while it would have remained about constant if you invested in GE. The point is that small differences in IRR make big difference in the money you accumulate – especially over the long term (the results would be much less dramatic with shorter lives). Another way of saying this is that the WACC is a really big assumption in valuation analysis if the analysis is based on computing present value. Valuation of a corporation assumes implicitly or explicitly that the company will have an indefinite life – a very long-term perspective.

It is common to make a data table that illustrates the effects of ranges in the cost of capital and the terminal growth on the value of a company. WACC and terminal growth tables where the value skyrockets with lower WACC and with higher terminal value. This is not an accident. Small differences in IRR do produce large differences in value. These tables that show very high variation in results that depend on the cost of capital is a backwards way of saying small differences have a really big impact on value. It is understandable why when talking to people who work in financial analysis, they want to avoid the cost of capital question completely. Note that the graphs above with the IRR had nothing at all about the cost of capital.

We always find the greatest challenge with the ITC story coming from valuation, largely because there is no good comp group for the stock. Accordingly, we focus our efforts predominately on DCF valuation to take into account the large capital spending program over coming years and higher level of free cash generation at the end of the capital investment cycle. Exhibits 4 and 5 look at implied fair values for ITC under different discount rate and terminal value assumptions. Using the two methodologies (terminal multiple and perpetual growth), we are comfortable with a \$46 fair value for the stock before taking into account the incremental value drivers identified in Exhibit 1.

**Exhibit 4: DCF Valuation: Terminal Multiple**

|                          |        | Discount Rate |       |       |       |       |       |       |
|--------------------------|--------|---------------|-------|-------|-------|-------|-------|-------|
|                          |        | 5.70%         | 5.80% | 5.90% | 6.00% | 6.10% | 6.20% | 6.30% |
| Terminal EBITDA Multiple | 9.25x  | 43.82         | 42.87 | 41.94 | 41.02 | 40.11 | 39.22 | 38.33 |
|                          | 9.50x  | 45.64         | 44.67 | 43.72 | 42.78 | 41.85 | 40.93 | 40.03 |
|                          | 9.75x  | 47.46         | 46.47 | 45.49 | 44.53 | 43.58 | 42.64 | 41.72 |
|                          | 10.00x | 49.28         | 48.27 | 47.27 | 46.28 | 45.31 | 44.35 | 43.41 |
|                          | 10.25x | 51.10         | 50.07 | 49.05 | 48.04 | 47.05 | 46.07 | 45.10 |
|                          | 10.50x | 52.92         | 51.86 | 50.82 | 49.79 | 48.78 | 47.78 | 46.79 |
|                          | 10.75x | 54.74         | 53.66 | 52.60 | 51.55 | 50.51 | 49.49 | 48.48 |

Source: Company data, Credit Suisse estimates

**Exhibit 5: DCF Valuation: Perpetual Growth**

|                      |       | Discount Rate |       |       |       |       |       |       |
|----------------------|-------|---------------|-------|-------|-------|-------|-------|-------|
|                      |       | 5.70%         | 5.80% | 5.90% | 6.00% | 6.10% | 6.20% | 6.30% |
| Terminal Growth Rate | 2.50% | 48.33         | 45.18 | 42.22 | 39.43 | 36.80 | 34.33 | 31.98 |
|                      | 2.60% | 50.72         | 47.40 | 44.28 | 41.36 | 38.60 | 36.01 | 33.56 |
|                      | 2.70% | 53.27         | 49.76 | 46.48 | 43.40 | 40.51 | 37.79 | 35.22 |
|                      | 2.80% | 55.99         | 52.28 | 48.81 | 45.57 | 42.53 | 39.67 | 36.98 |
|                      | 2.90% | 58.91         | 54.98 | 51.31 | 47.88 | 44.67 | 41.67 | 38.84 |
|                      | 3.00% | 62.05         | 57.86 | 53.97 | 50.35 | 46.96 | 43.79 | 40.82 |
|                      | 3.10% | 65.43         | 60.97 | 56.83 | 52.98 | 49.40 | 46.05 | 42.92 |

Source: Company data, Credit Suisse estimates

**Figure 9 – Analyst Report with Valuation Demonstrating Extreme Sensitivity to Small Changes in the Discount Rate**

Could show very many examples. Why to they bother with these tables.

# Chapter 3:

## Rate of Return and IRR -- IRR is Not Perfect, but it is Also Not Bull Shit

### No Magic Pill. Instead, Some Suggestions to Improve Your Critical Thinking About Finance

For twenty years I taught corporate valuation and project finance modelling classes at a place called the Amsterdam Institute of Finance. After the second day of the course, students and the staff would meet for drinks, always at the same bar. In these get togethers, staff would tell the same stories about bicycles in Amsterdam and also try to sell their other courses (more exciting than my modelling classes). They would discuss fancy finance professors from famous business schools who would arrogantly talk down to the students (In case you can't tell, I don't teach there anymore). One example I remember is when publicising one of its courses, the institute sent out a mass email proudly quoting Professor Phalippou of Oxford University who had apparently discovered that "IRR is Bull Shit." How could you not sign up for a course with such a prominent Oxford professor who has made such a discovery?

Over the years I have had to listen many times to the tiresome argument as to the use of IRR versus net present value ("NPV"). I always thought that this dispute was meaningless as everybody should know that the IRR and NPV are equivalent decision rules because the IRR is defined as the discount rate in the NPV formula that makes the aggregate NPV equal to zero. But in one of my classes I met a person who represented the polar opposite of Dr. Phalippou. His name is Dennis and he had worked hard as an analyst making various models for different CFO's who would give him difficult modelling requests. Dennis is obsessed with presenting things in a creative and practical manner and does not pay much attention to the theory of finance. As the CFO's he worked for did not trust measures of the cost of capital, Dennis asked about finding decision metrics that do not depend on making an estimate of the cost of capital. After thinking about what Dennis asked, a bulb went off in my head and I realised that the IRR versus NPV debate is in fact much more subtle than I thought. The debate really involves the nuanced question of whether you should start with a discount rate and make investment decisions using the cost of capital as a base or whether you should search for metrics that do not directly depend on something – the cost of capital -- that is fundamentally not measurable.

With all of the business schools, professors and Nobel prizes it is remarkable that the NPV/IRR debate continues, and finance has not come up with a good way to evaluate an investment. I ended the last chapter with the mathematical fact that small differences in the earned or

desired return (compound growth) can make a big difference in the value of a corporation as the time-period for the evaluation of a corporation is indefinite. This is the same way of saying that small differences in IRR are not trivial. I will use the IRR instead of NPV throughout this book as the most reasonable way to measure return (for example as compared the ROIC that McKinsey advocates). My problem with the IRR is not the problem that is often taught -- the mathematical issue that you sometimes it cannot be computed. Problems with the IRR really come from the reinvestment headache described below. I suggest a method that directly computes the risk premium earned on an investment discounted at the risk-free rate as an alternative. I am in no way suggesting that

### **“What is the Business of this IRR Anyway”, and the Re-Investment Rate Headache**

The nice thing about the stock price graphs with Yahoo adjusted close is that we can evaluate results of an investment after the fact. When the dividends are re-invested in the same stock, the growth rate in the investment is the same as the IRR. Wouldn't it be good to make the same kind of evaluation for an investment that pays off in the future. Couldn't we just replace historic cash flow from the stock with future projected cash flow with and determine the growth rate for everything ranging from investing in a stock to making an investment in our education to buying a hydrogen powered car instead of a car with an internal combustion engine. In evaluating any investment from buying a stock to acquiring a company to investing in a hydrogen project to investing in advertising, to paying for your own education to buying a lottery ticket, we are evaluating an uncertain future and the success of the investments depends on some kind of explicit or implicit cash flow projections.

As should be apparent, I have learnt much more from general discussions with people who have endured the torture of attending my classes than by reading finance books and articles. Sometimes the questions the students ask are really instructive. One example that I will not forget as long as I am not senile is when a lawyer from Malaysia asked me “what is all of this business about IRR anyway?” I now regularly ask this question to participants in my courses. The typical answer I receive is that is that the IRR is basically the rate of return. This is like saying that the definition of a person is a human being. But my answer to the question at the time was even worse. From some university class many decades ago, I learned that the IRR is the discount rate number that makes the NPV equal to zero and that was my response which I remember disgusted the lawyer. My answer and vague statements about the IRR being a return do not address the underlying idea of what IRR really measures and why CEO's of companies care so much about the number. For me the best answer is that IRR is the growth rate in your money from making an investment. When you see that everything comes down to compound growth rates, returns and IRR's and that capitalism is driven by growth, you have a big foundation in valuation and many other issues (again, I am not saying that this is necessarily good). But this growth rate has some complications.

The growth rate or IRR you generate by buying, re-investing and selling a stock should mean something to you, just like if you get a raise in your salary. But this is what compound growth rate does. If you could use the IRR to assess an investment, you would not need to make some

kind of NPV calculation; you would not need to measure beta; you would not need to understand the equity market risk premium; you could assess the return relative to the cost of capital.

## Capital Investment and Assessing the Value of Justin Bieber Songs

Before discussing the nuances of project finance analysis and the problems with corporate finance as well as how to integrate project finance ideas into corporate valuation, I begin with a basic capital investment analysis. You can think of this as the decision of a corporation to invest in a new factory or a new hotel. Alternatively, you can ponder the value of getting married or the value of investing in an MBA degree. Later chapters will move to project finance valuation and then discuss how projects can be combined to simulate the value of a corporation.

To illustrate issues associated with basic investment rules, I try to construct as simple and as general investment as I can imagine. I am sometimes forced to listen to the local television shows in the U.S. (that typically promote celebrities and Disney and then have advertisements about drug companies) and I heard about Justin Bieber

selling rights to his songs for US 200 million to the private equity company Blackstone. I assume that upon hearing this story, anybody reading this book would think about how to assess the value of Justin Bieber's songs using IRR, NPV or some better method (I admit that I could not name one of his songs, but I have found that many young people in my classes have no idea who the Beatles are.)

When you think about the value of cash flow from these songs, they may increase in popularity or maybe they will be forgotten. Maybe the songs of Justin Bieber will be like the works of Beethoven and be played for hundreds of years. To simulate the value of Justin Bieber music I

### Justin Bieber nears \$200 mln deal to sell music rights - WSJ

Reuters



Dec 21 (Reuters) - Pop star Justin Bieber is nearing a deal worth about \$200 million to sell his music rights to Blackstone Inc-backed (BXCN) Hipgnosis Songs Capital, the Wall Street Journal [reported](#) on Wednesday, citing people familiar with the matter.

The potential deal includes the Canadian artist's interest in both his publishing and recorded music catalog, according to the report.

Hipgnosis buys song catalogs from artists and earns revenue when their music is streamed online or used in movies or advertising.

have taken five minutes and constructed a financial model. I have assumed different economic lives and different cash flows defined by growth rates as it is reasonable to assume that we are not very sure about the life and the level of the future popularity of the music. When I began writing this chapter, I constructed a more complex model, but I have found that this simple model is more effective. Figure xxx illustrates results of the different lives and cash flow growth using a data table.<sup>10</sup>

### **Net Present Value, the Basis for Valuation is Not Practical Because of Its Dependence on Cost of Capital**

When studying finance at university, you would be taught to measure the value of Justin Bieber's songs by estimating the future cash flow and then using a discount rate to bring the value back to today – the present. If the value of the future songs is larger than the \$200 million paid, the investment is good, and it should be made. There are many problems with the NPV as a decision rule including something called the capital budget constraint and dealing with different asset lives. But the worst problem with NPV is that a small change in the cost of capital that people think of as some kind of variable that can be easily established is there. In fact, if the NPV is very high with 5%, it may be negative at 6%.

To further illustrate problems with the NPV rule I present a little table that contains different scenarios with respect to the remaining life of Justin Bieber's songs. I have made different assumptions about the growth in the value of the songs and different predictions of the remaining life over which people will continue to pay for the music (of course, you could be much more sophisticated). The simulations are summarized in Figure xxx. The Figure demonstrates that if the future cash flow is discounted at a relatively high discount rate, the NPV is low (the 10% case). On the other hand, if the discount rate is low (the 5% case), then almost every scenario except the case where the songs are forgotten after 10 years has positive value relative to the \$200 million invested. The point is that Figure xxx demonstrates how the net present value depends on the cost of capital rate applied. In Figure xxx, the IRR is equal to the discount rate when the net present value is zero. For example, in the left-hand side of the table, the NPV is zero when the remaining life is 100 years, and the growth rate is zero. This implies that the IRR is equal to 10% using the life and growth assumption.

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<sup>10</sup> You can find the spreadsheet associated with this example at [www.edbodmer.com](http://www.edbodmer.com)

| Cost of Capital 10% |                |                |                  | Cost of Capital 5% |                |                |                  |
|---------------------|----------------|----------------|------------------|--------------------|----------------|----------------|------------------|
| Life                | NPV: No Growth | NPV: 3% Growth | NPV: - 1% Growth | Life               | NPV: No Growth | NPV: 3% Growth | NPV: - 1% Growth |
| 10                  | (350)          | (283)          | (371)            | 10                 | (217)          | (119)          | (246)            |
| 15                  | (218)          | (95)           | (253)            | 15                 | 36             | 241            | (22)             |
| 20                  | (135)          | 41             | (183)            | 20                 | 234            | 568            | 146              |
| 25                  | (84)           | 139            | (142)            | 25                 | 390            | 865            | 270              |
| 30                  | (52)           | 209            | (118)            | 30                 | 512            | 1,135          | 363              |
| 35                  | (32)           | 260            | (103)            | 35                 | 607            | 1,380          | 432              |
| 50                  | (8)            | 341            | (87)             | 50                 | 786            | 1,989          | 551              |
| 75                  | (1)            | 380            | (83)             | 75                 | 903            | 2,684          | 616              |
| 100                 | (0)            | 388            | (83)             | 100                | 938            | 3,114          | 631              |
| 120                 | (0)            | 389            | (83)             | 120                | 947            | 3,336          | 634              |

**Figure 10 – Valuation of Cash Flow with Different Lives, Growth and Different Discount Rates Illustrating the Large Effect on Value from Discount Rate Assumptions**

There are also Practical problems with the NPV in terms of ranking investments. Say you have a really big project that results in a quite large positive NPV because the IRR is a smidgeon above the cost of capital. Maybe you could use the NPV of 241 with the 3% growth case using 15 years and 5% cost of capital in the right-hand side of Figure xxx. But this same scenario results in a negative NPV when using the 10% cost of capital. In theory, making the Justin Bieber investment is better than a bunch of small projects with much higher IRR's if you apply the 5% cost of capital. But if you get the cost of capital wrong and increase it a bit, the whole thing reverses, and the big project with positive NPV becomes negative. Further, if the big project has a longer life than the small projects, the NPV for the small projects should include replacement projects and the NPV does not account for the potential replacement of project.

In preparing for teaching, I have read the McKinsey Book a few times. The first time I read the book I thought it was a powerful explanation of how to apply financial ideas. The second time I read it I was much less impressed. The third time I read it I thought it was dangerous in its emphasis on using WACC in evaluating the return on investment and over emphasizing discounting cash flow. One of the things I liked in the first version I read was the statement that analysts tend to overestimate the cost of capital and then compensate for this high cost of capital with over optimistic assumptions. When I looked for this in later versions the statement disappeared.

## Any Suggestion that the Cost of Capital Can be Accurately Measured is Nonsense

The cost of capital consumes three chapters at the end of the book. I have purposely put the cost of capital at the end of the book and not the beginning because it is not reasonable to claim you can compute a The cost of capital is defined as the minimum expected rate of return investor will accept for a given level of risk. This is a mysterious number where you searching for the lowest acceptable number. The minimum return cannot be found on the internet (like you can find credit spreads and interest rates) and it does certainly does not come from a survey of Chief Financial officers tell you (they will give you ridiculously upward biased numbers because they naturally want to earn high returns). The best way I can think about the definition of the cost of capital number is to imagine a bidding scenario. Say you have multiple bidders sitting in a meeting room in Dubai who want to win a contract to construct a solar project. In order to win the bid you must offer the lowest price. Further assume the equipment is mandated in the bid and the estimates of the cost are very similar for different bidders. I mean to construct this example so the only real way to win the bid is to push the rate of return to as low as you possibly can and still earn a return that's acceptable given the level of risk. When you are sitting at the table you may have to make a cell phone call to the CFO to push him down as far as he can go. You need to make the CFO complain, swear and sweat. That minimum level is exactly what the cost of capital is supposed to be.



## Computing the IRR by Hand as the Growth Rate in Cash

**You're too smart for a simple model.** We can compute the expected cash flow on the investment, but there is a problem in making the analysis the same way as the graph for Amazon and GE. The problem is that GE or Amazon have a large portfolio of investments and the rate of return reflects continued re-investment in projects rather than a single project. This problem is that most investments do not allow us to take money and invest it in exactly the same type of investments. This fact that cash flow between when we first take money out of our pocket and then have many periods when we receive or pay money creates a big headache. This is the reinvestment rate headache. The IRR statistic with intermediate cash flow (like dividends) implicitly assumes that we can invest the money at the same rate.<sup>i</sup>

I will be trying to put things together through seeing how the value driver formula with growth, cost of capital and return can translate into the IRR's that investors ultimately earn shown on the graphs with the various stock indices. Say a company is currently hovering around the point

where the cost of capital is the same as the return. Then the company develops a new innovative product and makes capital expenditures to grow. How can the value driver formula be used to gauge the value.

We can prove that the IRR is the growth rate with reinvestment at the IRR itself by setting up a simple little example with an up-front investment, some cash flow received and an assumed lifetime for the investment. When cash is received, we set up an investment account and then allow the cash in the investment account to grow by investing in other projects that receive the same IRR. At the end of the life of the project, you can tabulate the accumulated cash. This is the same as tabulating the amount of money in Amazon or GE where the ending cash is shown on the legend of the graph. When you divide the ending money by the beginning money and raise it to the power of one divided by the life of the project, you get the compound growth rate which is exactly the same as the IRR. We can write  $IRR = (Ending/Starting)^{(1/life)} - 1$ , where Ending is the accumulated cash with re-investment at the IRR itself (no circular references here). This just proves something that most will now, namely that the IRR is the growth rate with a big footnote. The asterisk is that to achieve the growth, the money must be invested at the IRR itself.

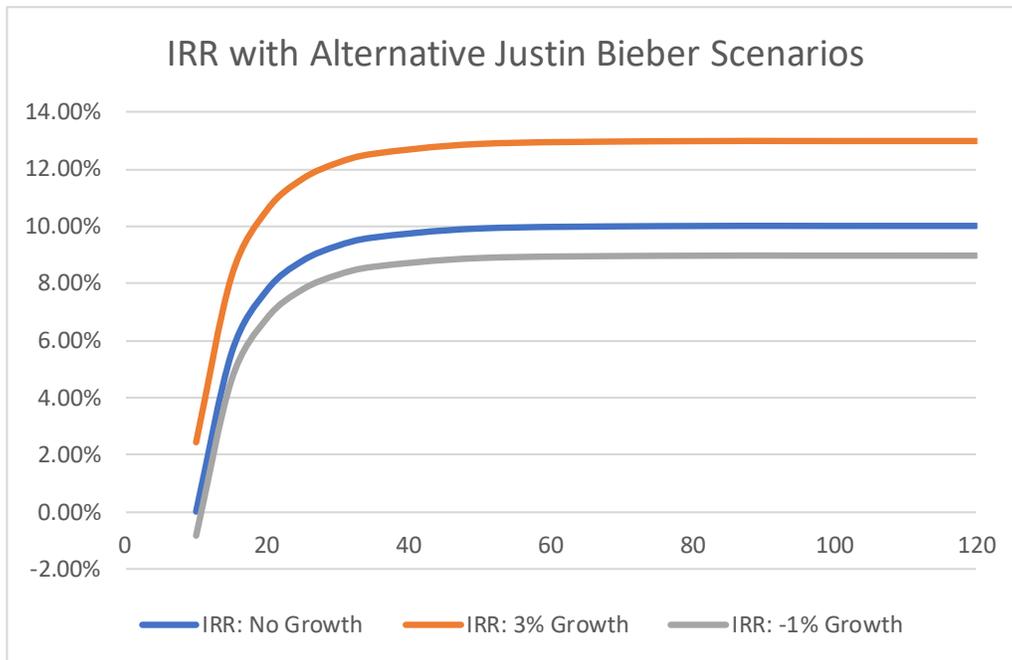
|                       |          | 0          | 1      | 2      | 3        |
|-----------------------|----------|------------|--------|--------|----------|
| <b>Free Cash Flow</b> |          |            |        |        |          |
| Cap Exp               |          | 1,000.00   |        |        |          |
| EBITDA                |          |            | 400.00 | 400.00 | 400.00   |
| Cash Flow             |          | (1,000.00) | 400.00 | 400.00 | 400.00   |
| <hr/>                 |          |            |        |        |          |
| Discount Rate         | 6.00%    |            |        |        |          |
| NPV                   | 65.29    |            |        |        |          |
| IRR                   | 9.70%    |            |        |        |          |
| <b>Cash Balance</b>   |          |            |        |        |          |
| Opening Balance       |          |            | -      | 400.00 | 838.80   |
| Add: Re-investment    | 9.70%    |            | -      | 38.80  | 81.37    |
| Add: Cash Received    |          |            | 400.00 | 400.00 | 400.00   |
| Closing Balance       |          |            | 400.00 | 838.80 | 1,320.18 |
| <hr/>                 |          |            |        |        |          |
| Final Cash            | 1,320.18 |            |        |        |          |
| Initial Cash          | 1,000.00 |            |        |        |          |
| Multiple              | 1.32     |            |        |        |          |
| CAGR                  | 9.70%    |            |        |        |          |

**Figure 11 – Simple Example Demonstrating that the IRR and the Compound Growth Rate are the Same When Money is Re-invested at the IRR Itself**

In this chapter I address issues related to the IRR including the real meaning and a good definition of the IRR; why the equity IRR has become so pervasive; well-known problems with the IRR; bigger problems with alternatives to the IRR; interpretation of high or low IRR's; Oxford Professor stated that IRR is Bull Shit. Maybe he was advocating to use NPV which is no different from IRR. Maybe he is thinking about the well-known problems of re-investment or multiple IRR's. The real issue is coming up with a good alternative and understanding why IRR is computed.

|      |         | Cost of Capital         |          |         |         |           |
|------|---------|-------------------------|----------|---------|---------|-----------|
|      |         | 7% <input type="text"/> |          |         |         |           |
|      | IRR: No | IRR: 3%                 | IRR: -1% | NPV: No | NPV: 3% | NPV: - 1% |
| Life | Growth  | Growth                  | Growth   | Growth  | Growth  | Growth    |
| 10   | 0.00%   | 2.45%                   | -0.82%   | (278)   | (194)   | (303)     |
| 15   | 5.56%   | 8.27%                   | 4.65%    | (83)    | 83      | (131)     |
| 20   | 7.75%   | 10.59%                  | 6.81%    | 56      | 311     | (13)      |
| 25   | 8.78%   | 11.68%                  | 7.81%    | 155     | 501     | 66        |
| 30   | 9.31%   | 12.24%                  | 8.33%    | 225     | 657     | 120       |
| 35   | 9.60%   | 12.55%                  | 8.61%    | 275     | 786     | 157       |
| 50   | 9.91%   | 12.90%                  | 8.92%    | 355     | 1,054   | 210       |
| 75   | 9.99%   | 12.99%                  | 8.99%    | 392     | 1,268   | 230       |
| 100  | 10.00%  | 13.00%                  | 9.00%    | 399     | 1,350   | 233       |
| 120  | 10.00%  | 13.00%                  | 9.00%    | 400     | 1,378   | 234       |

**Figure 12 – IRR versus NPV Demonstrating that IRR is a Better Decision Rule When Using Sensitivity Analysis and Showing that IRR is Above the Risk-Free Rate in Plausible Scenarios**



***Figure 13 – Graph Demonstrating that the IRR Becomes Flat with Longer Life Because of the Re-investment Rate Assumption and Discounting at High Rates***

The classic decision rule for any investment is to first come up with a discount rate that reflects the risk of a project and then compute the net present value. In general, arguments about NPV versus IRR are silly because the IRR is just another way of expressing the NPV (the IRR is the discount rate that makes the NPV equal zero). But the NPV (that accounts for the up-front investment and prospective cash flow) gives you a number that is not useful from a psychological perspective. The number is above zero when the IRR is more than the cost of capital, blah blah blah. The practical contrast between the NPV and the IRR is a bit more interesting and involves two things. First, for the NPV calculation you need a measure of the cost of capital which as I keep repeating is at best a vague number. The idea of presenting the dramatic change in value that results from small changes in cost of capital demonstrates why people do not want to rely on the number. Second, the number given by the NPV is not a practical way to rank investments. Note that I include APV – adjusted present value in this discussion. The APV just uses a different way to compute the cost of capital and does not really add anything.

**Why Doctor Phalippou of Oxford and Others Labelling IRR as Bull Shit is Academic Arrogance**

I read an email from an organization called the Amsterdam Institute of Finance. The Institute was proud of having a course taught by an Oxford professor named Dr. Phalippou. A representative from the Amsterdam Institute suggested that this professor had found something stunning by saying that “IRR is Bull Shit”, as if he has made some kind of big discovery about finance. While I complain a lot about standard investment analysis techniques, the fact is that everybody is going to use the IRR anyway and this suggests that alternatives are difficult to find. Rather than spouting on about the problem with IRR the remainder of this chapter evaluates different alternatives. The alternatives either depend on the cost of capital (e.g. MIRR) which renders the methods subjective for management as most people in finance admit that cost of capital estimates are rubbish or they ignore the timing of cash flows (e.g. the payback period).

The thing that is attractive about the IRR is that we do not have to make any assumptions about the most controversial part of valuation which is the cost of capital. So, when the big boss looks across a whole bunch of different investments; or a private equity firm receives proposals from developers desperate to get money; or you are deciding which stock to buy after you have a very good model with careful evaluation of the terminal value; or you are deciding whether to invest in another child (probably a negative IRR, especially after you add in the cost of carbon emissions), you can compute the IRR and quickly compare the IRR’s across investments. You can rank IRR’s and find the best thing to do (if you have small projects, you can invest in a lot of them). If we could only get around the nasty reinvestment issue. I discuss IRR problems with changing risk, different lives, positive – negative – positive cash flow and high IRR long-term investments in Chapter 3.

I have reviewed Harvard case studies and the kind of analysis that is discussed in expensive MBA programs. The framework for these cases is to start with the cost of capital using the CAPM with some kind of given arbitrary equity market risk premium. When Dr. Phalippou exclaims that IRR is Bull Shit, he is most probably advocating this kind of academic treatment of value that depends on the cost of capital assumption. Like the typical case studies, he probably assumes a cost of capital using a high equity market risk premium. But given the craziness and vagaries of computing cost of capital, any method that depends on cost of capital is rightfully rejected as a preferred method by people who make investment decisions in the real world.

### **Modified IRR (MIRR) is Useless Because the MIRR Ends Up Measuring the Arbitrary Re-investment Rate**

I have struggled with the re-investment rate problem for a long time, and I have largely given up on finding a better alternative than using the IRR itself as the re-investment rate. Winston Churchill’s famous quote that “democracy is the worst form of government besides all the rest” is overused (his quote “the best argument against democracy is a five-minute conversation with an average voter” is much better). After seeing investment analysis in practice and desperately trying to find alternatives to the IRR, it seems like the IRR is like the Churchill quote about being the worst except all the rest. As to the rest, one could imagine many alternatives to IRR including NPV, MIRR, AIRR, MOIC, payback, premium above the risk-free rate and WAROIC.

I computed the XMIRR. Somebody said in fancy language that this is demonstrably better and I got half way through a McKinsey article. Nothing here.

The MIRR is the modified IRR where you put in a re-investment rate that could be the WACC. You can set up an account where the opening balance receives a rate different than the IRR itself. You could assume that the re-investment rate is an estimate of the WACC. If there are no intermediate cash flows (like equity cash flow in a private equity transaction for example), the re-investment rate does not matter. But in more typical situations, the project produces continual cash flow and re-investment income can easily be more than the nominal cash flow itself. The big problem with the MIRR which means it should not be discussed further is shown in the table xxxx. In this table, the cost of capital changes and there is no change in their IRR because the IRR does not depend on the cost of capital. The NPV declines as the cost of capital increases. I defy you to interpret this IRR for projects with different sized projects and with projects that have different lives. Now look at the MIRR row. The MIRR is just matching the cost of capital so this statistic is essentially a copy of the cost of capital. Worse yet, the MIRR goes up when the cost of capital and supposedly the risk goes up.

| Inputs               |       |       | Summary                  |        |
|----------------------|-------|-------|--------------------------|--------|
| Asset Life           | 45    |       | IRR                      | 6.83%  |
| Analysis Flag        | 45    | TRUE  | MIRR                     | 6.14%  |
| Capital Expenditures | 1,000 |       | AIRR                     | 7.52%  |
| Base Cash Flow       | 50    |       | Multiple of Invested Cap | 4.18   |
| Inflation            | 2.50% |       | MOIC - Investment at IRR | 19.54  |
| Apply Replacement    | TRUE  |       | MOIC - Investment ROIC   | 26.14  |
| WACC                 | 6.00% |       | WROIC                    | 7.29%  |
| Long-term ROIC vs Rf | 2.00% |       | Payback Period           | 16.09  |
| Rf                   | 2.50% |       | NPV                      | 133.12 |
| Year                 | 0     | 20    | NPV/Investment           | 13.31% |
| ROIC                 | 6.83% | 8.00% | Premium vs Rf            | 4.54%  |

**Figure 14 – Table Showing Alternatives to the IRR and NPV Including MIRR, MOIC and WROIC**

**Multiple of Invested Capital and Payback Period have the Assume no Re-investment Rate**

Understand that want benchmark that does not depend on the discount rate.

For many transactions it is becoming common to show the multiple of invested capital and if you have not seen this it may seem sophisticated. In fact, it is very simplistic and completely

ignores any income at all from re-investment. The payback period also just accumulates cash flow and counts how many periods (years) it takes to recover the initial investment. The payback period can be a little intuitive if somebody tells you that you get your money back in six years and then all the rest is upside. But the payback period ignores the cost of money, and it does not quantify the upside. The MOIC, like the payback period, ignores any cost of money and it does not directly account for the time-period it takes to get back the investment. The MOIC can be computed for a given time-period and it is then very similar to the payback.

The real problem with the MOIC is similar to the IRR problem in that it does not account properly for the timing of cash flows – the dividends received – over the investment period. If dividends are received almost immediately (like tax equity investments in the U.S.), this is ignored in the calculation. The MOIC is the multiple of invested capital which is simply the total cash inflow divided by the cash outflow for the investment. I also compute an alternative multiple of invested capital that includes re-investment earnings. The payback is the number of periods it takes to payback your investment. The premium above the risk-free rate measures the total cash flow inflow compared over and above the inflow you would get if you invested at the risk-free rate.

### **Weighted Average Rate of Return (ROIC) versus IRR**

An example of trying to find a solution. How to account for the IRR when long-term investment and really high IRR. Seems that the life does not matter. Need to give higher weight to the out year cash flow. The MIRR does not work, the NPV will use a higher discount rate. Could do this with straight line depreciation. If use the IRR itself will get the same number. But if use a different discount rate will get a lower number. Finally, the WAROIC is the return on invested capital year by year computed as the weighted average with the cost of capital. All of these alternative measures either depend on incorporating the cost of capital which people rightly try to avoid (the NPV, the MIRR or weighted average ROIC) or they do not consider any idea about future cash flows being worth less than current cash flow (MOIC, and Payback).

I kind of like the premium versus the risk-free rate. You can get some sort of risk-free rate from publicly available data (it is not at all risk free really, but at least it is objective). Make a series of cases and evaluate the probability of not earning the risk-free rate. How much do you get paid for risk. Adjust for evaluation period – two short term investments versus one long-term investment. Problem is the interpretation.

Now consider the WAROIC. (I do present a weighted average return on invested capital approach using economic depreciation which is better than the IRR.) I also try to reconcile the theory of finance with macroeconomics when discussing the philosophy of cost of capital; country risk premium; credit spreads terminal growth and other issues. A big problem with finance these days is the belief that statistical models (such as the CAPM which are unprovable) can somehow measure the preference human beings have for taking risk.

## A Method that May Have a Bit of Promise - Earned Premium versus Risk Free Rate

Please don't complain about the calculation. The problems highlighted from the methods above are that we do not want to use the cost of capital and we would really like to get around the problem of the re-investment rate. Further there is a problem with the IRR when evaluating long-lived assets (and high returns). This problem is illustrated in table xxx below. In table xxx you can see that with longer lives, doubling the life of an asset results in a very small increase in IRR even though the cash flow has more than doubled. In table xxx, the IRR for a project with a life of 45 is 10.45% while the IRR for a 90-year project has an IRR of 10.69%. This is mathematically correct but not at all intuitive. The change in the cash flow received on the project is shown by the multiple of invested capital which is \_\_\_ for the 45-year life and increases to \_\_\_ for the 90-year project. One way to address this is to compute the premium earned relative to making an equivalent investment in a risk-free asset. I believe this is not a new idea. Compute the cash flow you would receive from using your investment and assuming you get cash flow from the risk-free rate. This should be something like the rate of inflation. Discussion of tax equity. Get the equity out immediately versus a leverage buyout where have to wait.

|                  | 0          | 1        |
|------------------|------------|----------|
| Free Cash Flow   |            |          |
| Cap Exp          | 1,000.00   |          |
| EBITDA           |            | 1,100.00 |
| Cash Flow        | (1,000.00) | 1,100.00 |
| Risk Free Rate   | 2.00%      |          |
| IRR              | 10.00%     |          |
| IRR versus Rf    | 8.00%      |          |
| Investment at RF | 1,020.00   | 1,020.00 |
| Premium          |            | 80.00    |
| Periods          | 1          |          |
| Value of Premium | 78.43      |          |
| Levelised        | 1.02       |          |
| Annual           | 80.00      |          |
| Premium          | 8.00%      |          |

**Figure 15 – Two Period Illustration of Risk Premium Method for Evaluating Investments with PV of Premium and Levelization at the Risk-Free Rate**

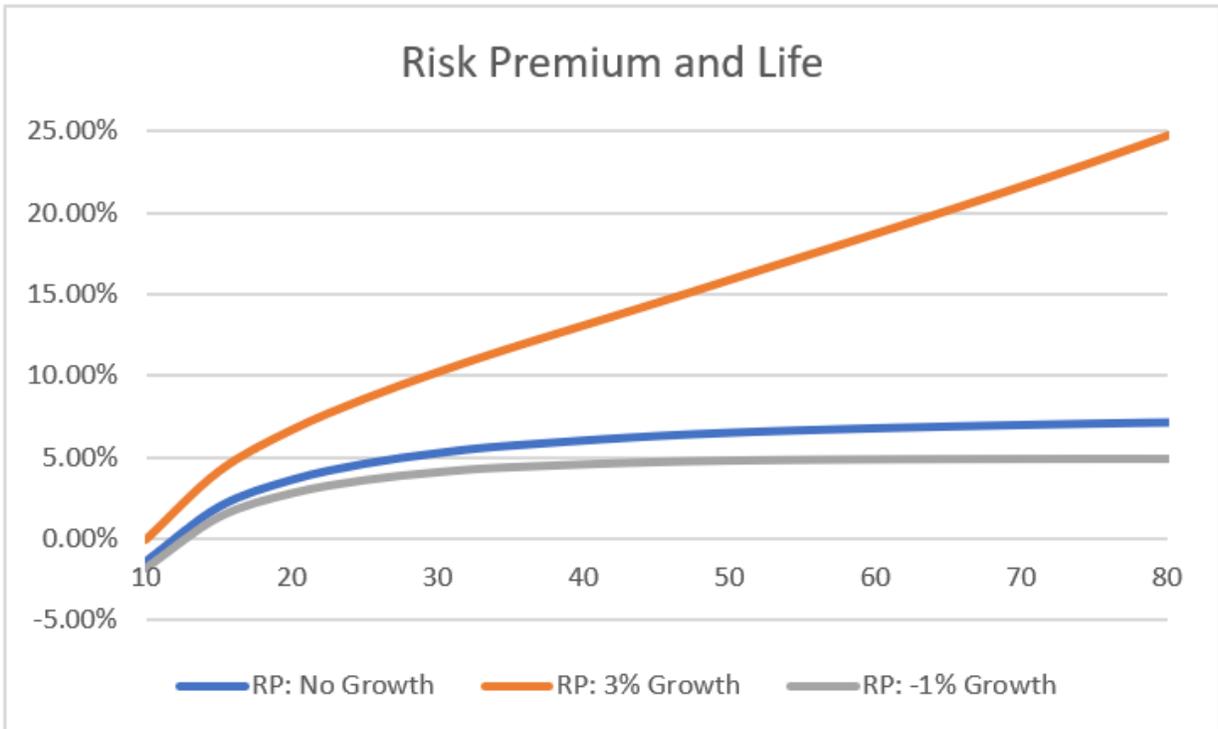
|                  |        | 0          | 1      | 2      | 3      |
|------------------|--------|------------|--------|--------|--------|
| Free Cash Flow   |        |            |        |        |        |
| Cap Exp          |        | 1,000.00   |        |        |        |
| EBITDA           |        |            | 400.00 | 400.00 | 400.00 |
| Cash Flow        |        | (1,000.00) | 400.00 | 400.00 | 400.00 |
| Risk Free Rate   | 2.00%  |            |        |        |        |
| IRR              | 9.70%  |            |        |        |        |
| IRR versus Rf    | 7.70%  |            |        |        |        |
| Investment at RF | 346.75 |            | 346.75 | 346.75 | 346.75 |
| Premium          |        |            | 53.25  | 53.25  | 53.25  |
| Periods          | 3      |            |        |        |        |
| Value of Premium | 153.55 |            |        |        |        |
| Levelised        | 0.35   |            |        |        |        |
| Annual           | 53.25  |            |        |        |        |
| Premium          | 5.32%  |            |        |        |        |

***Figure 16 – Computation of Earned Risk Premium in Three Period Case Where Premium Only Depends on Risk Free Rate and No Cost of Capital Estimate***

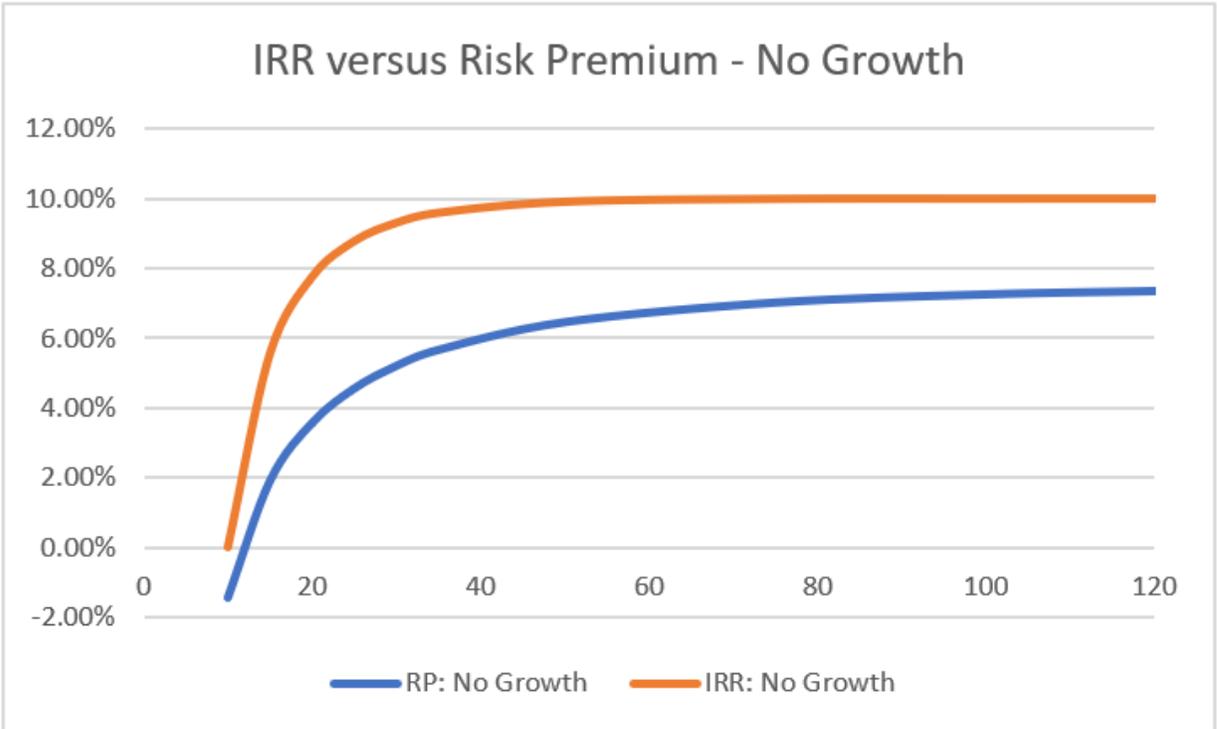
How to calculate. How to Use. Graph or Table of How much Really Means

|     | RP: No<br>Growth | RP: 3%<br>Growth | RP: -1%<br>Growth | IRR: No<br>Growth | IRR: 3%<br>Growth | IRR: -1%<br>Growth | NPV: No<br>Growth | NPV: 3%<br>Growth | NPV: - 1%<br>Growth |
|-----|------------------|------------------|-------------------|-------------------|-------------------|--------------------|-------------------|-------------------|---------------------|
| 10  | -1.43%           | -0.03%           | -1.84%            | 0.00%             | 2.45%             | -0.82%             | (278)             | (194)             | (303)               |
| 15  | 1.92%            | 4.16%            | 1.30%             | 5.56%             | 8.27%             | 4.65%              | (83)              | 83                | (131)               |
| 20  | 3.59%            | 6.70%            | 2.76%             | 7.75%             | 10.59%            | 6.81%              | 56                | 311               | (13)                |
| 25  | 4.57%            | 8.62%            | 3.57%             | 8.78%             | 11.68%            | 7.81%              | 155               | 501               | 66                  |
| 30  | 5.22%            | 10.24%           | 4.06%             | 9.31%             | 12.24%            | 8.33%              | 225               | 657               | 120                 |
| 35  | 5.68%            | 11.72%           | 4.36%             | 9.60%             | 12.55%            | 8.61%              | 275               | 786               | 157                 |
| 50  | 6.47%            | 15.90%           | 4.77%             | 9.91%             | 12.90%            | 8.92%              | 355               | 1,054             | 210                 |
| 75  | 7.03%            | 23.16%           | 4.88%             | 9.99%             | 12.99%            | 8.99%              | 392               | 1,268             | 230                 |
| 100 | 7.27%            | 31.51%           | 4.83%             | 10.00%            | 13.00%            | 9.00%              | 399               | 1,350             | 233                 |
| 120 | 7.36%            | 39.18%           | 4.78%             | 10.00%            | 13.00%            | 9.00%              | 400               | 1,378             | 234                 |

***Figure 17 – Comparison of NPV, IRR and Earned Risk Premium with Different Economic Life and Different Growth Rate***



***Figure 18 – Earned Risk Premium and Life of Project Demonstrating Earned Risk Premium Increases with Economic Life Unlike IRR***



**Figure 19 – Comparison of Earned Risk Premium and IRR with Different Economic Life Demonstrating the Earned Risk Premium Does Not Flatten Out**

# Chapter 4:

## Trying to Find Future Return on Invested Capital is the Holy Grail but Using Financial Statement Analysis Gets You Nowhere

### Stamp Out Chartered Accountancy

Imagine living your life as an accountant. You would get excited about things like the calculation of deferred taxes or LIFO versus FIFO inventory. You may be proud of calculating comprehensive income that uses the calculation of the fair value of derivatives in valuing assets. You may want even to go further and ponder how your numbers are used in the valuation of businesses. This even more exciting activity is called financial statement analysis. In performing financial statement analysis, you could demonstrate how smart financial markets are because the stock price does not increase when a company changes from LIFO to FIFO accounting (please don't worry about this if you have not had a stimulating accounting class and studied this issue). You may even be able to sell a course with a fancy title suggesting that you have an innovative way to analyse accounting data to the Amsterdam Institute of Finance.



Monty Python Accountant.

All of this excitement about accounting makes me think of Monty Python skits about accountants from the 1970's I remember as a teenager that were called Stamp Out Chartered Accountancy (if you have never seen this, I suggest googling it and watching one of the skits). In this chapter you will see that when you study numbers that are developed by arguably necessary bureaucratic accounting rules, all of the numbers created by accountants give a distorted picture of what we really want, namely the earned return earned on investment. The issue is not with comprehensive income, deferred taxes or LIFO inventory that may be

interesting to accountants. The real problem is that you cannot get a reasonable historic series of the return on investment from accounting data. This problem with measurement of return arises from how the capital assets are accounted over time and how this affects the rate of return statistic. capital assets, depreciation, impairment, goodwill and understanding what investment is needed to earn EBITDA.

Chapter 2 and Chapter 3 were supposed to demonstrate that calculation of return is behind a lot of valuation. The theme of evaluating rate of return will continue in our discussion of performance evaluation in Chapter 5, in discussion of multiples in Chapter 6, in developing terminal value in Chapter 7 and throughout the rest of the book. This chapter is about computing returns from financial statements and whether it is possible to derive a reasonable estimate of whether the return can be computed. In order to make valuation we go back to strategy graph in Figure xxx (the return versus cost of capital and growth) and the points I made about additions and economic rent. Given this importance of the rate of return, making a forecast of the rate of return this chapter is all about evaluating and measuring that rate of return.

### **Why Unbiased Return Statistics are Essential from Financial Statement Analysis**

Imagine this. You know the rate of return for current investment projects in a corporation. You have studied the market prospects for the company, the competitive landscape and the cost structure in the industry and you are convinced that the current level of return and growth will decline by a modest amount over the next five years. You have your own idea about the minimum IRR that you will accept for taking risks for the company and that your forecast will be wrong (this is the definition of the cost of capital). In this imagined case you could make a reasonable valuation of the company using the value driver equation introduced in Chapter 2 or better yet, a simple financial model that includes changes in the return. This is the way valuation is supposed to work. But here's the problem. If you do not start with a correct measure of the rate of return and the future return is distorted because of accounting information, you cannot make this analysis. Say the rate of return computed from financial statements is overstated because the assets are old or there has been an impairment write-off and the prospective return is understated because straight line depreciation. You cannot then apply your analysis of the competitive position of the company and its management skills in maintaining economic rent.

I argue that the fundamental goal of financial statement data is computing the return on investment and accounting data badly fails in this respect.

Once we have the return on capital, we can make some kind of prognosis about what will happen in the future to that return. In the end, the most basic objective of financial statement analysis is to get Some of the reasons that the one think you want from the accounts is the rate of return on capital include:

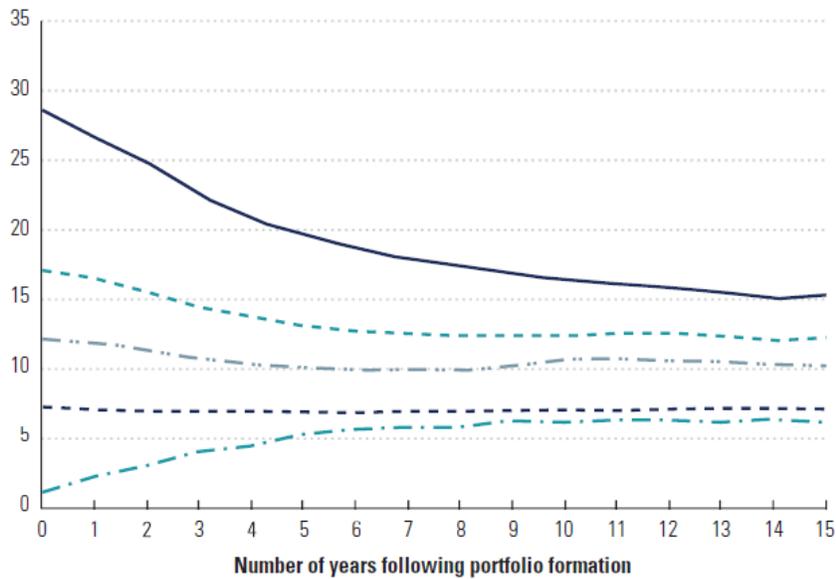
1. Say the rate of return was constant and you want to make a sensitivity analysis of how the investment growth rate affects value. You also have a minimum return criteria in mind. You could then apply the value driver formula  $(1-g/ROIC)/(Required\ Return-growth)$  to derive how much you would pay for an asset. If we want to do this, we need an accurate picture of the past return so that we can assess the future prospects. Without knowing the return, this little exercise will not get you anywhere (Chapter 2).
2. The understanding of P/E and EV/EBITDA multiples depends in part on the changes in the rate of return. For example, if the return is expected to increase, the earnings multiple should be much higher. Further, even if a company grows a lot, if the return is low the multiple should also be low. To evaluate changes in the rate of return you would require reasonable data on both the historic return and the prospective return (Chapter 6).
3. Terminal value calculation and philosophy (Chapter 7) depends on an assessment of whether you believe that current levels of return can be continued and/or when and whether you believe the return will decline. To make judgments about the terminal value you again should have an assessment of current returns relative to the long-run potential.
4. In evaluating individual projects and corporations, I suggest that the first test should be whether the projected return is reasonable given competitive landscape. If the projected return is high, you should ask tough questions about competitors entering the market. This assessment of whether the return is reasonable in part comes from evaluation of historic returns (Chapter 5).
5. A simple way to think about acquisition analysis is to look for companies in your industry that are earning a low return on investment which implies that you as an acquirer can improve the return. If you do not have reliable data on the historic return, this assessment cannot be made.
6. It is one thing to balance the balance sheet in a model. Assessing the reasonableness of a corporate financial model is another matter. I suggest that the way to start making an assessment of a forecast is to compare the projected return on investment with the projected return on investment (not the return on equity). If the return is distorted, this first test cannot be made.

From these points I hope you agree with me that if financial statement analysis cannot be used to evaluate the rate of return, then it is not very useful. One more demonstration of the notion that evaluating the rate of return on invested capital is data presented by McKinsey. Figure xxx taken from the 6<sup>th</sup> edition of their book is supposed to illustrate how returns decline over time but high returns remain high and low returns remain low. (For some reason they do not include goodwill in the analysis even though it represents part of the cash that is invested to purchase a company. I discuss this later). The graph is also meant to illustrate that returns do not completely converge to one another, but instead companies that have been earning high returns continue to earn high returns. This is all very nice and may be true. But if the returns are distorted because of aging assets, impairments, goodwill, asset allocations, and many other things, this graph cannot be based on meaningful data. Furthermore, if you somehow still believe that WACC means anything after completing this book, the returns in Figure xxx

certainly cannot be compared to any kind of WACC number because of the distortions in computing the return.<sup>11</sup> Psychology. Think made a big discovery and cannot admit that the numbers are worthless because of accounting rules. If was true than could get fancy with terminal value. Understand if wrote 800 page books and consulting is centered on the idea. Needs to be propriately because would be such a mess.

**EXHIBIT 6.8 ROIC Decay Analysis: Nonfinancial Companies**

Median ROIC of portfolios (without goodwill),<sup>1</sup> by quintile, %



<sup>1</sup> At year 0, companies are grouped into one of five portfolios, based on ROIC.  
Source: Compustat, McKinsey Corporate Performance Analysis Tool.

***Figure 20 - - Return on Invested Capital in McKinsey Book with ROIC Trends that Does Not Tell You Much Because of Distortion from Age of Plant, and Because of Bias from Goodwill***

**Requirement for Economic Return in Assessing Forecasts**

As an example, consider the forecast made for Air Arabia made by an analysis shown in Figure xxx used to construct a valuation of the stock. The one number that would matter to me would

<sup>11</sup> McKinsey Book 6<sup>th</sup> Edition. Page

be the 10% ROIC in 2016. This number is a lot higher than the historic numbers and bigger than the estimates made for the earlier years (this higher return comes along with a high rate of revenue growth). The 2016 ROIC drives the terminal value which is the biggest number in valuation. In this example, the first question must be what is the story behind the increased return and how can this return be sustained. Not surprisingly, the projected stock price was triple the actual price. The points I am trying to emphasize in this chapter is first the usefulness of looking at the ROIC to test the financial projection and second the problem that this key number is distorted by accounting mechanics.

The reason I suggest using ROIC rather than ROE is that a financial model can easily change the capital structure. For example, if the model builds-up surplus cash or borrows short-term debt with cash flow after capital expenditures, the return on equity will be affected. If a lot of cash goes on the balance sheet and the earnings on the cash is just about zero, then the return on equity will decline because the equity balance increases with the cash and the cash earnings push down the earnings. The ROIC is supposed to be more pure where you can assess

Is it going up because of higher prices. Because of Operating Leverage. But real problem is if it is going up because of lower capital expenditures. Address more important problem of how many capital expenditures in the terminal cash flow later.

| Key Ratios                                 |  | 2011  | 2012  | 2013 e | 2014 e | 2015 e | 2016 e |
|--|--|-------|-------|--------|--------|--------|--------|
| <b>Financial Ratios</b>                    |  |       |       |        |        |        |        |
| <i>Liquidity</i>                           |  |       |       |        |        |        |        |
| Current Ratio                              |  | 2.11  | 1.50  | 2.04   | 1.87   | 0.94   | 0.97   |
| Quick ratio                                |  | 2.10  | 1.49  | 2.03   | 1.86   | 0.94   | 0.97   |
| <i>Margins</i>                             |  |       |       |        |        |        |        |
| Gross Margins                              |  | 13%   | 18%   | 19%    | 20%    | 21%    | 25%    |
| ETIBDA Margins                             |  | 15%   | 19%   | 19%    | 18%    | 23%    | 28%    |
| EBIT                                       |  | 10%   | 13%   | 12%    | 11%    | 13%    | 19%    |
| Net Margins                                |  | 11%   | 14%   | 14%    | 14%    | 16%    | 22%    |
| <i>Profitability</i>                       |  |       |       |        |        |        |        |
| ROE  |  | 5%    | 8%    | 8%     | 8%     | 11%    | 15%    |
| ROA  |  | 4%    | 5%    | 4%     | 4%     | 5%     | 8%     |
| ROIC                                       |  | 4%    | 6%    | 5%     | 5%     | 6%     | 10%    |
| RPK (Revenue Passenger Kilometer) (AED bn) |  | 9.60  | 10.80 | 11.40  | 12.44  | 14.65  | 17.11  |
| ASK(Available Seat Kilometer) (Km.bn)      |  | 11.70 | 13.00 | 13.72  | 14.97  | 17.67  | 20.68  |
| Load Factor                                |  | 82%   | 82%   | 83%    | 83%    | 83%    | 83%    |
| <i>Efficiency</i>                          |  |       |       |        |        |        |        |
| Receivables Turnover                       |  | 62    | 57    | 56     | 56     | 57     | 57     |
| Payables Turnover                          |  | 111   | 105   | 144    | 140    | 135    | 130    |
| Asset Turnover (x)                         |  | 0.34  | 0.37  | 0.31   | 0.29   | 0.35   | 0.39   |

## ***Figure 21 – Example of First Thing to Look for in Analyst Valuation – ROIC versus History in Terminal Period***

### **GE and Amazon Return on Invested Capital**

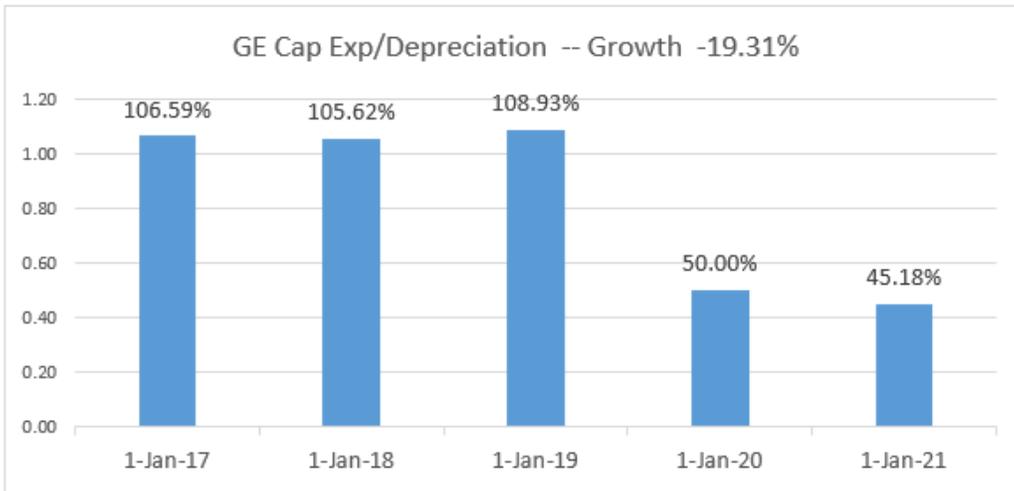
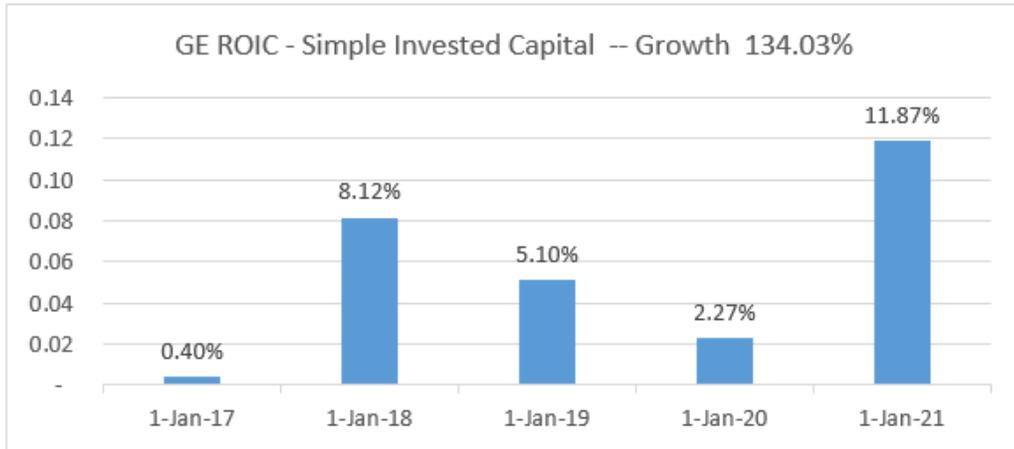
These days you do not need a proprietary database from McKinsey to compute the return on invested capital. I have wasted a whole lot of time over the years in developing files that go to MarketWatch and Yahoo websites to grab data and compute things like the return on invested capital. As an old man I am amazed how you can grab data for companies in Pakistan and Nigeria as well as GE and Amazon. The good thing about getting your own data in excel is that you can make your own adjustments for things like goodwill and non-operating assets. Figure xxx illustrates the Return on Investment for Amazon and GE from my totally non-proprietary database. How can get the data instead of proprietary database with goodwill adjustment and no idea what is there.

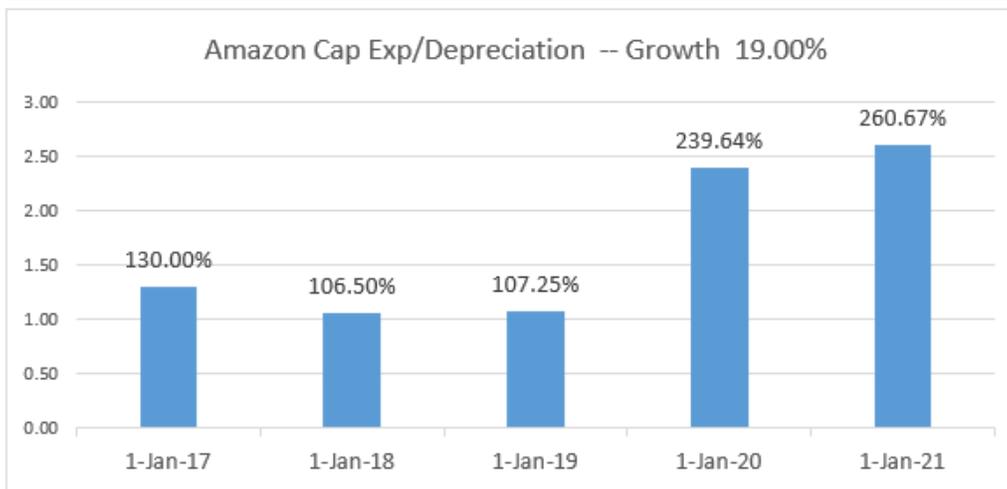
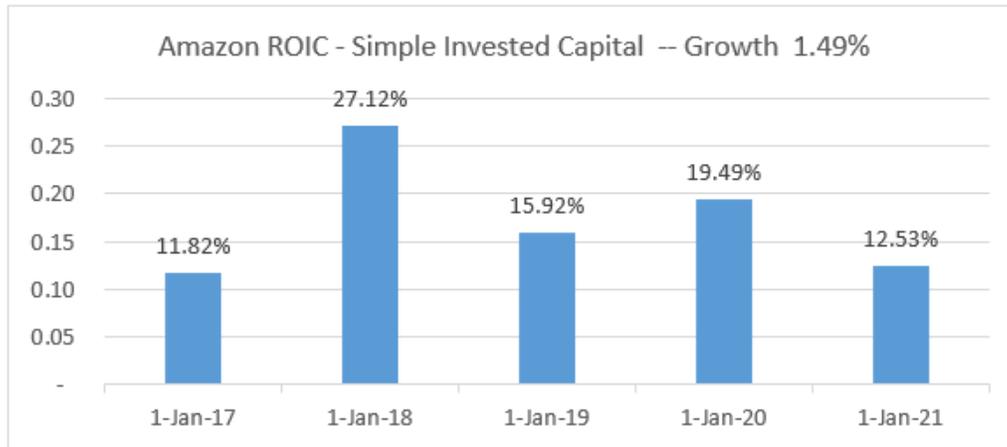
### **Return on Invested Capital and Asset Life**

One reason for the problems with measuring the return on invested capital is the age of assets. If you think about a single asset with cash flow that is received constant over the life, the return on investment increases over time simply because the asset depreciates and the net capital associated with the asset declines to zero. This means that if assets are older for one company than another company, the return on investment will be higher. I was not going to bother with this, but you may have to demonstrate this to consultants. Three scenarios. No replacement and replacement fast.

### **Return on Invested Capital versus Return on Equity**

To illustrate issues with measuring the return on invested capital, Figure xxx and Figure yyy compare the return for GE and for Amazon. The first clear problem with the ROIC is simply





### Computing the Return on Invested Capital for Amazon and GE

In this section I review an analysis what happens if compute return on invested capital. let's use our General Electric and Amazon case and let's keep going back to these cases try to compute the return on invested capital. Amazon did not have kitchen sink quarters like Macys, but GE did. With GE, we can add back impairment write-offs. Even without the impairment problem I evaluate there are important ambiguities with the statistic. In this case, most come from General Electric from taking write-off in assets and from distortions in acquiring companies and revaluing assets and revaluing the event basically the investment when we when we acquire assets. But I also work through more basic questions about what should be included in the NOPAT numerator of invested capital and what should be included in the denominator.

|                                   | 2014           | 2015           | 2016           | 2017           | 2018           | 2019           | 2020            | 2021            |
|-----------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|-----------------|-----------------|
| Historic Terminal Period          | TRUE           | TRUE           | TRUE           | FALSE          | FALSE          | FALSE          | FALSE           | FALSE           |
| Valuation Period                  | FALSE          | FALSE          | FALSE          | TRUE           | FALSE          | FALSE          | FALSE           | FALSE           |
| <b>Financial Statistics</b>       |                |                |                |                |                |                |                 |                 |
| Credit Line                       | 4,580.00       | 4,580.00       | 4,580.00       | 4,580.00       | 4,580.00       | 4,580.00       | 4,580.00        | 4,580.00        |
| Closing Short-term Debt           | 3,020.00       | 3,880.00       | 4,580.00       | 5,022.59       | 5,214.06       | 4,915.47       | 4,452.42        | 3,911.55        |
| Credit Line Exceeded              | FALSE          | FALSE          | FALSE          | TRUE           | TRUE           | TRUE           | FALSE           | FALSE           |
| Cash to Sales                     | 4.41%          | 3.22%          | 3.27%          |                |                |                |                 |                 |
| Operating Cash                    | 190.1          | 233.8          | 279.0          | 345.9          | 401.3          | 433.4          | 459.4           | 486.9           |
| Surplus Cash                      | 89.6           | 17.5           | 25.3           | 0.0            | 0.0            | 0.0            | 0.0             | 0.0             |
| <b>Return on Invested Capital</b> |                |                |                |                |                |                |                 |                 |
| EBIT                              | 623.55         | 684.35         | 853.62         | 1,231.45       | 1,428.48       | 1,525.42       | 1,598.57        | 1,694.49        |
| NOPAT                             | 405.31         | 444.83         | 554.85         | 800.44         | 928.51         | 991.52         | 1,039.07        | 1,101.42        |
| Working Capital                   | 2,287.6        | 2,876.1        | 3,403.3        | 4,185.5        | 4,855.2        | 5,243.6        | 5,558.3         | 5,891.7         |
| Plus Net PPE                      | 3,874.0        | 4,293.3        | 4,654.1        | 4,847.8        | 4,938.8        | 4,875.2        | 4,789.5         | 4,698.6         |
| Less Deferred Taxes               | 351.9          | 360.7          | 406.2          | 539.1          | 603.0          | 636.2          | 669.6           | 713.9           |
| Add: Operating                    | 190.1          | 233.8          | 279.0          | 345.9          | 401.3          | 433.4          | 459.4           | 486.9           |
| <b>Total</b>                      | <b>5,999.8</b> | <b>7,042.6</b> | <b>7,930.2</b> | <b>8,840.2</b> | <b>9,592.3</b> | <b>9,916.1</b> | <b>10,137.5</b> | <b>10,363.4</b> |
| Debit Equity                      | 5,150.0        | 5,860.0        | 6,410.0        | 6,702.6        | 6,744.1        | 6,295.5        | 5,682.4         | 4,991.5         |
| Less: Surplus                     | 939.4          | 1,200.1        | 1,545.5        | 2,137.6        | 2,848.3        | 3,620.6        | 4,455.1         | 5,371.8         |
| <b>Total</b>                      | <b>5,999.8</b> | <b>7,042.6</b> | <b>7,930.2</b> | <b>8,840.2</b> | <b>9,592.3</b> | <b>9,916.1</b> | <b>10,137.5</b> | <b>10,363.4</b> |
| Average Invested Capital          | 5,999.84       | 6,521.24       | 7,486.41       | 8,385.18       | 9,216.25       | 9,754.20       | 10,026.78       | 10,250.43       |
| 14 ROIC                           | 6.76%          | 6.82%          | 7.41%          | 9.55%          | 10.07%         | 10.17%         | 10.36%          | 10.75%          |

**Figure 22 - Return on Invested Capital Calculation for Amazon with Balance Sheet Reconciliation**

The historic ROIC is also important for companies that are expected to experience changes in the rate of return. If you are evaluating a start-up company, you may want to assess the issue of whether the company can really experience very high monopoly profits over the long-run or whether it will be subject to competitive pressure. If the company is currently earning a high return, you need to assess what will be a reasonable industry return and how long will it take for the company to realize that return. Of course, these are extremely difficult questions at the heart of valuation, and I am not suggesting any rule to or any statistical method to evaluate the long-term ROIC. But I do emphasize that if you want to make a presentation of the value of a company, you should first consider the rate of return without biases and you should also make an explicit presentation of your ROIC assumptions relative to historic levels.

If you are reviewing a company that is expected to change its return on capital can think of ROIC as you would think about other statistical data. If you want to ultimately make a projection of the time series, the place to start is to evaluate what happened in the past and then make some adjustments (such as correlation to some other variable). You can then add some judgment using economic or behavioural analysis to adjust your forecast. When you have a time series statistic like the oil prices, or GDP per capita you could examine reasons for underlying trends; evaluate mean reversion and cyclical trends; relate the statistic to other variables; gauge forecasts of the statistic relative to historic data and so forth. I suggest that this is what you are attempting to do in valuation analysis through predicting trends in ROIC. For example, if you believe a company will move to Box 2 -- the “throwing money away” box -- from

Box 1 because of surplus capacity with long-term investments, then value quantification will depend on how far the ROIC falls and for how long.

It sounds like this other than trying to explain some formula now let's get back so what do we do with Amazon and GE. The graph below the tour the table below shows the Amazon return on invested capital assume that all of its cash on the balance sheet is Surplus cash an alternative case when we assume none of the cash on the balance sheet. is so close cash and. The point of this is to illustrate that just this assumption about gives you a very different run and this is without even scratching the surface the other thing we and it's relates to uncertainty about Surplus cash is we have to decide for example do with deferred taxes.

### Rate of Return and HBS Cases

Case study of Burton Sensors. Simple case and not a real company. Assumes that continue to grow without making capital expenditures. Do not include return on invested capital in the case. If computed return on capital it increases. Need to get back to a normal return in the competitive business. Will address this case in terminal value.

Exhibit 4 Comparative Data for Four Publicly Traded Sensor Manufacturers, 2014-2016 (\$U.S. millions)

|                       | TE Connectivity (TEL) |           |           | Ametek (AME) |           |           | Opsens (OPS) |        |        | Cyberoptics (CYBE) |        |        |
|-----------------------|-----------------------|-----------|-----------|--------------|-----------|-----------|--------------|--------|--------|--------------------|--------|--------|
|                       | 2014                  | 2015      | 2016      | 2014         | 2015      | 2016      | 2014         | 2015   | 2016   | 2014               | 2015   | 2016   |
| Net sales             | 12,233.00             | 12,238.00 | 13,113.00 | 3,974.30     | 3,840.09  | 4,300.17  | 5.21         | 9.60   | 17.75  | 41.13              | 66.24  | 53.33  |
| Operating profit      | 1,992.00              | 1,936.00  | 2,201.00  | 944.32       | 841.40    | 931.89    | (5.13)       | (8.49) | (6.38) | (2.20)             | 6.15   | 1.02   |
| Net income            | 2,420.00              | 2,009.00  | 1,683.00  | 590.86       | 512.16    | 681.47    | (2.88)       | (9.28) | (6.54) | (2.10)             | 11.56  | 2.00   |
| Assets                | 20,589.00             | 17,608.00 | 19,403.00 | 6,660.45     | 7,100.67  | 7,796.06  | 12.76        | 16.86  | 27.61  | 44.74              | 59.58  | 59.50  |
| Total debt            | 3,884.00              | 4,070.00  | 4,344.00  | 1,866.12     | 2,062.64  | 1,866.17  | 3.69         | 5.58   | 5.30   | —                  | —      | —      |
| Total liabilities     | 11,004.00             | 9,123.00  | 9,652.00  | 3,405.82     | 3,844.16  | 3,768.43  | 6.87         | 9.55   | 9.64   | 8.68               | 10.68  | 7.22   |
| Shareholders' equity  | 9,585.00              | 8,485.00  | 9,751.00  | 3,254.63     | 3,256.51  | 4,027.63  | 5.89         | 7.31   | 17.97  | 36.06              | 48.90  | 52.28  |
| Operating margin      | 0.16                  | 0.16      | 0.17      | 0.24         | 0.22      | 0.22      | (0.99)       | (0.88) | (0.36) | (0.05)             | 0.09   | 0.02   |
| Profit margin         | 0.20                  | 0.16      | 0.13      | 0.15         | 0.13      | 0.16      | (0.55)       | (0.97) | (0.37) | (0.05)             | 0.17   | 0.04   |
| Shares outstanding    | 405.00                | 366.00    | 355.00    | 239.91       | 232.59    | 230.23    | 60.18        | 66.74  | 80.95  | 6.71               | 6.83   | 6.95   |
| Market capitalization | 24,959.14             | 24,618.77 | 33,490.92 | 12,748.27    | 15,280.00 | 16,940.38 | 51.75        | 108.11 | 90.67  | 51.30              | 191.30 | 114.61 |
| Equity beta*          | 1.30                  | 1.26      | 1.24      | 1.29         | 1.16      | 1.25      | 1.32         | 1.17   | 1.02   | 0.82               | 0.80   | 0.85   |
| EPS                   | 5.98                  | 5.49      | 4.74      | 2.46         | 2.20      | 2.96      | (0.05)       | (0.14) | (0.08) | (0.31)             | 1.69   | 0.29   |
| P/E                   | 10.31                 | 12.25     | 19.90     | 21.58        | 29.83     | 24.86     | NA           | NA     | NA     | NA                 | 16.55  | 57.30  |
| D/Marketcap           | 0.16                  | 0.17      | 0.13      | 0.15         | 0.13      | 0.11      | 0.07         | 0.05   | 0.06   |                    |        |        |

\*Based on previous five years.

Part of the problem is evaluating how to evaluate cash amounts that are on the balance sheet. Invested capital should include cash but not surplus cash. It is generally inefficient to hold cash on a balance sheet – one could say that the cash is sleeping. So, unless there are large balances of cash, it is pretty reasonable to assume that the cash is necessary for ups and downs in revenue collections and required payouts.

When making valuations, students of finance will quickly learn about net debt. Maybe they could be told that cash is like negative debt and that any cash that is not used to manage short-

term liquidity needs could be used to pay down debt. The students learn that a lot of cash and/or short-term investments on the balance sheet make the cash flow less volatile (because of the earnings on the cash and investments). So, for example, when betas are “unlevered”, the surplus cash is supposed to be treated as negative debt. Further, when you compute return on invested capital, the numerator should only include cash flow from operating activities – this means no income on surplus cash. Similarly, the denominator should only include invested capital related to operating activities. This means that if invested capital is computed from equity invested plus debt invested, then any cash or other investments that are not related to operating activities should be subtracted from the other invested capital.

Let's deal with the problem of what to do about how much cash you need how much liquidity do you really need to keep running your business and how much cash is Surplus cash and how much cash is necessary to run the business. Something I have observed and something I have done myself is trying to find a rule somebody else does then having some kind of reference. One example of this is rules on what is surplus cash and what is cash needed for running a business. One example is an arbitrary rule that 2% of revenue is necessary to run the business. Another rule I have heard about is a little fancier where you compute the standard deviation of the ratio of cash to revenues and then put if the ratio is more than one standard deviation away from the average, the average plus the standard deviation is used for the operating cash. It sounds pretty sophisticated, but it is the rule is meaningless. In the case of Amazon and GE, I assume all of the cash is needed for liquidity.

### **Financial Statement Analysis and How Much Does Apple Make when You Buy and iPhone**

For a few reasons which I don't want to write, I have not been able get myself to buy and iPhone. One of the reasons is that I want to know how much Apple would be earning when I would buy the iPhone. To see how much shareholders get when buying an iPhone you could go the Apple's financial statements and compute the return on investment.

I use net debt and the case of Apple to illustrate why one can suggest using return on invested capital as a statistic to evaluate future prospects of a company rather than return on equity or some other measure that measures cash flow after debt.

In the graphs of return on invested capital for GE and for Amazon, understanding that the effects of straight line depreciation in the in the calculation return on invested completely distorts the data. because very problematic issue companies assets that are aging will have a higher return on invested Capital because they also they need to subsequently increase the return on invested capital the return on your does not Paramount write-offs but jump in the invested Capital as we saw in the graph for General Electric now hey.

We have to make some judgments another understand we are trying to look at the core assets of the business a few years ago have billions in cash on its balance sheet I don't know exactly why it was there. But I understand it was about re-patriation. Apple held its cash and they would have labeled this cash.

|  | Years ended           |                       |                       |
|--|-----------------------|-----------------------|-----------------------|
|  | September 26,<br>2015 | September 27,<br>2014 | September 28,<br>2013 |
| Net sales                                | 233,715               | 182,795               | 170,910               |
| Cost of sales                            | 140,089               | 112,258               | 106,606               |
| Gross margin                             | 93,626                | 70,537                | 64,304                |
| Operating expenses:                      |                       |                       |                       |
| Research and development                 | 8,067                 | 6,041                 | 4,475                 |
| Selling, general and administrative      | 14,329                | 11,993                | 10,830                |
| Total operating expenses                 | 22,396                | 18,034                | 15,305                |
| Operating income                         | 71,230                | 52,503                | 48,999                |
| Other income/(expense), net              | 1,285                 | 980                   | 1,156                 |
| Income before provision for income taxes | 72,515                | 53,483                | 50,155                |
| Provision for income taxes               | 19,121                | 13,973                | 13,118                |
| Net income                               | 53,394                | 39,510                | 37,037                |
| <br>                                     |                       |                       |                       |
| Tax Rate                                 | 26.37%                | 26.13%                | 26.15%                |
| NOPAT                                    | 52,448                | 38,786                | 36,183                |
| <br>                                     |                       |                       |                       |
| Cash Income Net of Tax                   | 946                   | 724                   | 854                   |

**Figure 23 - Apple Income Statement with Research and Development and Simple Layout**

|   | September 26, September 27, |                |                     |
|---|-----------------------------|----------------|---------------------|
|   | 2015                        | 2014           | Operating Financing |
| <b>ASSETS:</b>  |                             |                |                     |
| Current assets:                                       |                             |                |                     |
| Cash and cash equivalents                             | 21,120                      | 13,844         | 1                   |
| Short-term marketable securities                      | 20,481                      | 11,233         | -1                  |
| Accounts receivable, less allowances of \$82 and \$86 | 16,849                      | 17,460         | 1                   |
| Inventories   | 2,349                       | 2,111          | 1                   |
| Deferred tax assets                                   | 5,546                       | 4,318          | 1                   |
| Vendor non-trade receivables                          | 13,494                      | 9,759          | 1                   |
| Other current assets                                  | 9,539                       | 9,806          | 1                   |
| <b>Total current assets</b>                           | <b>89,378</b>               | <b>68,531</b>  |                     |
| Long-term marketable securities                       | 164,065                     | 130,162        | -1                  |
| Property, plant and equipment, net                    | 22,471                      | 20,624         | 1                   |
| Goodwill  | 5,116                       | 4,616          | 1                   |
| Acquired intangible assets, net                       | 3,893                       | 4,142          | 1                   |
| Other assets  | 5,556                       | 3,764          | 1                   |
| <b>Total assets</b>                                   | <b>290,479</b>              | <b>231,839</b> |                     |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY:</b>          |                             |                |                     |
| Current liabilities:                                  |                             |                |                     |
| Accounts payable                                      | 35,490                      | 30,196         | -1                  |
| Accrued expenses                                      | 25,181                      | 18,453         | -1                  |
| Deferred revenue                                      | 8,940                       | 8,491          | -1                  |
| Commercial paper                                      | 8,499                       | 6,308          | 1                   |
| Current portion of long-term debt                     | 2,500                       | 0              | 1                   |
| <b>Total current liabilities</b>                      | <b>80,610</b>               | <b>63,448</b>  |                     |
| Deferred revenue, non-current                         | 3,624                       | 3,031          | -1                  |
| Long-term debt  | 53,463                      | 28,987         | 1                   |
| Other non-current liabilities                         | 33,427                      | 24,826         | 1                   |
| <b>Total liabilities</b>                              | <b>171,124</b>              | <b>120,292</b> |                     |
| <b>Total shareholders' equity</b>                     | <b>119,355</b>              | <b>111,547</b> | 1                   |
| <b>Total liabilities and shareholders' equity</b>     | <b>290,479</b>              | <b>231,839</b> |                     |
| Operating   | 32,698                      | 30,273         |                     |
| Financing   | 32,698                      | 30,273         |                     |
| Average Invested Capital                              | 31,486                      |                |                     |
| <b>ROIC</b>   | <b>166.58%</b>              |                |                     |
| Cash net of Debt                                      | 86,657                      | 81,274         |                     |
| Average Cash Less Debt                                | 83,966                      |                |                     |
| <b>Cash Return</b>                                    | <b>1.13%</b>                |                |                     |

**Figure 24 - Apple Return on Invested Capital Calculation with Separation of Non-Operating Assets and Operating Assets**

To illustrate some issues associated with computing return on invested capital as well as other related valuation let's look at a balance sheet look at the figure below to either the cash on the balance sheet for Apple. This time I need to go back a few years to get the historic data long-term historical data can be done by going to the web. I went out Apple have this kind of cash on the balance sheet its earnings on the cash itself were very low but that doesn't reflect that earnings on the cash obviously does not work the overall earnings on the Core Business earnings and making iPhones and getting people to iTunes whatever they do. That cash on the balance sheet therefore if you want to evaluate the return on invested capital and this is a good example of where return on invested Capital. This time we are looking at why ROIC and not ROE. For Apple you would be investing in a lot of cash before and now you would just be investing in the pure company. would be very different than return on Equity you would that Surplus cash you would want to understand just how much cash we needed to run its business.

Now after the tax law changed Apple issue dividends and the cash went down dramatically. This fact that the cash went down dramatically would have increased ROE. If then if you would have left this on in the invested capital in the denominator of our return on invested capital I would have given you a lower denominator and a big increase in the in the return on invested capital of course that's what we don't want. the points and this illustrates the real point of the return on invested capital and that is to compute return from the core earnings that's what we're looking for that's why we harp on return on invested capital and not return on equity.

### **Earnings Forecasts Don't Tell You Much**

You can ponder a case where you have no idea how to project the future rate of return. You could then do what most people would and make a forecast of earnings or earnings per share using some kind of historic growth estimation that includes the earnings guidance made by the company. You may make a careful forecast of two of the three operating factors – the revenues and the expenses. But you would have no idea how to forecast the last part of the big three – the capital expenditures and other investments. Without any idea of how to make capital expenditure forecasts – the required capital expenditure to generate the rate of return, you forecast is most probably meaningless in terms of the ability to think about its value.

### **Goodwill and Sales of Assets**

Goodwill and internal growth versus growth by acquisition.

## **Thinking of ROIC and Project IRR Forecasts for Valuation in Statistical Terms**

In evaluating the value of a corporation and in particular the terminal value, I argue that you should make a forecast of the ROIC and the growth. If you knew the future trends in return on invested capital and the growth, you could use this data to back into the cost of capital if you know the stock price. If you make a forecast with the ROIC rather than the alternatives that use multiples or terminal growth, you implicitly making a capital investment forecast that is consistent with both the growth rate and the return.

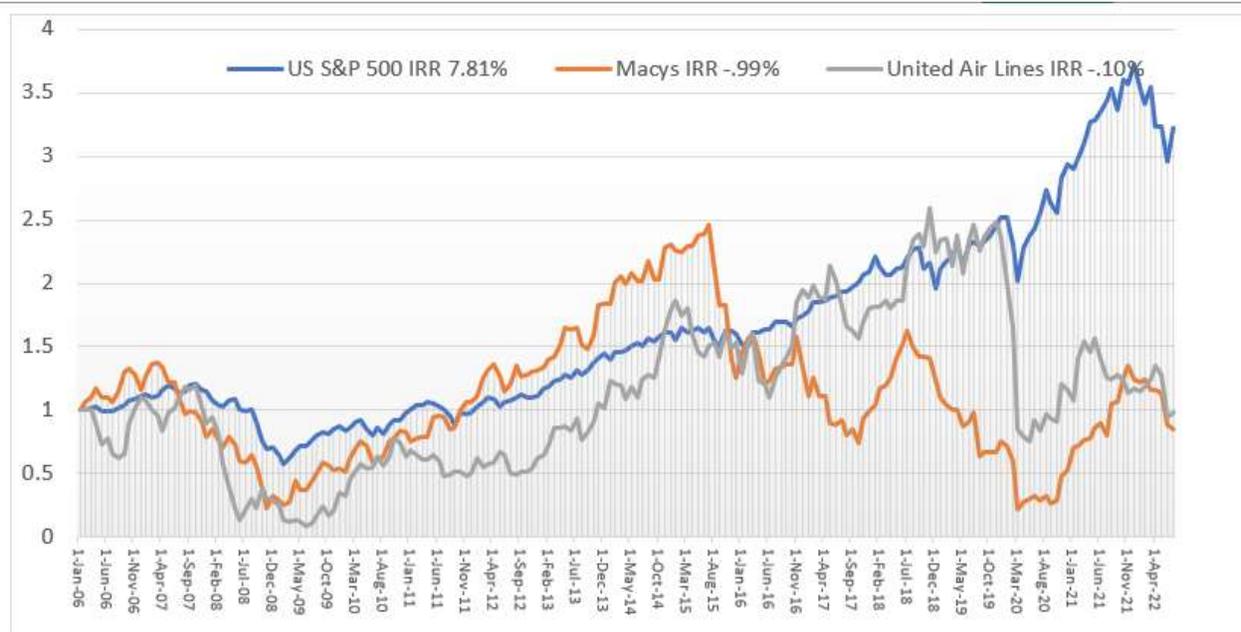
In discussing valuation from discounted cash flow, I have heard people being worried that the terminal value is a large part of the overall value. I hope you see that this is silly as the terminal value is supposed to be a big part of the value of a corporation because any corporate valuation or any multiple implicitly assumes that a company will last indefinitely. Arguably the biggest question in valuation is what will happen to the return on invested capital over the long-term. To make this assessment, an obvious place to start is what has been the return on capital in the past. For a company such as Carlsberg beer, or Flower Foods the company is probably already in a stable equilibrium state, and it may be reasonable to assume that the return on capital is consistent with historic levels. For this, you clearly need an unbiased estimate of the historic return on capital. It is also better if you have a long-term estimate.

In this chapter I discuss the rate of return as a statistic where history can be used as a potential guide and a starting point. The main point is that the rate of return can be very ambiguous to calculate, and it can become a biased or useless measure. If we had good historic data on the rate of return that tell you how much a company has earned in the past and you have some judgement about what kinds of things will happen in terms of competitive position to access prospects for future returns, you could then have a pretty good idea about the valuation of a company. But when you see the way that this all-important statistic is computed in practice, these ideas fall apart. I suggest that spending time looking at investor analyst reports on the rate of return can be a waste of time.

## **Effects of Kitchen Sink Quarters on the Prospective Return on Invested Capital – the Case of Macy's**

Academic papers in finance generally collect a lot of data, write down some kind of fancy formula with an integration sign, and then have an empirical proof of a proposition with some t-statistics. Sometimes rather than evaluating financial issues with this kind of approach, it can be more effective to examine case studies for selected companies. At the onset of COVID and lockdown, I was asked to make a Zoom presentation on the effects of COVID on financial analysis and modelling in a webinar. I decided to look at Macy's (the fancy retail stores in New York and around the U.S.) as an example of a firm that should have been having problems from

on-line competition before COVID and that were aggravated with COVID (I also looked at United Air Lines). Figure xxx shows stock price trends and Figure yyy is a presentation made by Macy's of their return on invested capital.<sup>12</sup>



**Figure 25 – Macy's Adjusted Stock Price and COVID**

<sup>12</sup> To make this graph, go to the database menu of edbodmer.com and select the stock price database. You will then be guided to a page that explains how to make this graph.

**Macy's, Inc.**  
**Return on Invested Capital (ROIC)**  
(\$ in millions)

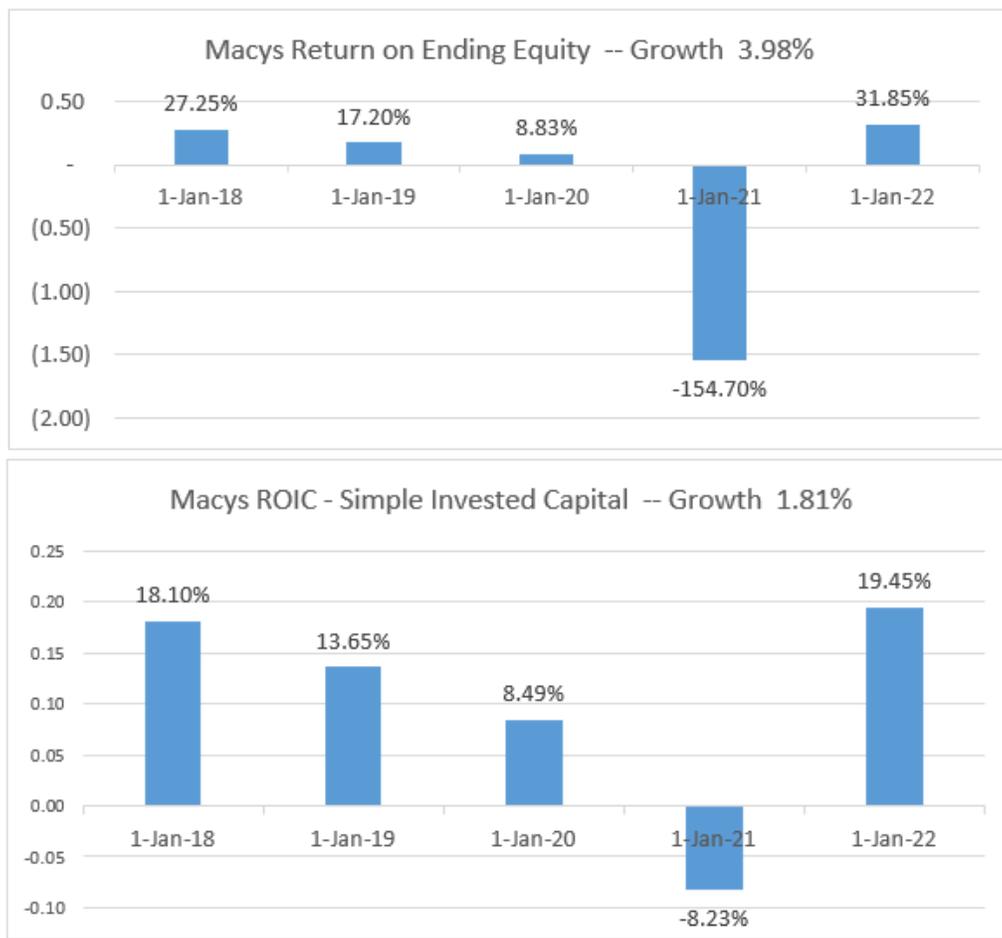
|   | Trailing Four Quarters |                  |
|---|------------------------|------------------|
|   | February 1, 2020       | February 2, 2019 |
| Most Comparable GAAP Ratio:   |                        |                  |
| Net income  | \$ 564                 | \$ 1,098         |
| Property and equipment - net  | \$ 6,633               | \$ 6,637         |
|   | 8.5%                   | 16.5%            |
| Non-GAAP Ratio:   |                        |                  |
| Net income  | \$ 564                 | \$ 1,098         |
| Add back interest expense, net  | 185                    | 236              |
| Add back loss on early retirement of debt   | 30                     | 33               |
| Add back federal, state and local tax expense   | 164                    | 322              |
| Earnings before interest and taxes (EBIT)   | \$ 943                 | \$ 1,689         |
| Add back restructuring, impairments, store closing and other costs  | 354                    | 136              |
| Add back settlement charges   | 58                     | 88               |
| Add back depreciation and amortization  | 981                    | 962              |
| Add back benefit plan income, net   | (31)                   | a                |
| Add back rent expense   |                        |                  |
| Real estate   | 335                    | 327              |
| Personal property   | b                      | 9                |
| Deferred rent amortization  | -                      | 14               |
| EBIT, excluding impact of restructuring, impairments, store closing and other costs, settlement charges, depreciation and amortization, benefit plan income, net and rent expense | \$ 2,648               | \$ 3,225         |
| Property and equipment - net  | \$ 6,628               | \$ 6,655         |
| Add back accumulated depreciation and amortization  | 4,438                  | 4,553            |
| Add capitalized value of non-capitalized leases   | -                      | 2,800            |
| Add capitalized value of variable rent  | 114                    | -                |
| Add lease right of use assets   | 2,241                  | -                |
| Add (deduct) selected balance sheet components:   |                        |                  |
| Receivables   | 265                    | 273              |
| Merchandise inventories   | 5,743                  | 5,664            |
| Prepaid expenses and other current assets   | 551                    | 608              |
| Other assets  | 675                    | 803              |
| Merchandise accounts payable  | (2,183)                | (2,219)          |
| Accounts payable and accrued liabilities  | (2,609)                | (2,917)          |
| Other long-term liabilities   | (371)                  | c                |
| Total Average Invested Capital  | \$ 15,492              | \$ 16,220        |
|   | 17.1%                  | 19.9%            |

Management believes that return on invested capital (ROIC), as defined as EBIT, excluding the impact of restructuring, impairments, store closing and other costs and settlement charges, depreciation and amortization and rent expense, as a percentage to its average invested capital is a useful measure in evaluating how efficiently the Company employs its capital. As computed above, the total average invested capital is comprised of an annual two-point (i.e., end of the previous year and the immediately preceding year) average of gross property and equipment, a capitalized value of non-capitalized leases equal to periodic annual reported net rent expense multiplied by a factor of eight or the right of use assets and a four-point (i.e., end of each quarter within the period presented) average of other selected assets and liabilities. The calculation of the capitalized value of non-capitalized leases is consistent with industry and credit rating agency practice and the specified assets are subject to a four-point average to compensate for seasonal fluctuations.

**Figure 26 – Excerpt from Macy’s Financial Presentations Showing that the Company Supposedly Earned 17.1% ROIC in 2020, the COVID Year**

The stock price trends in Figure xxx demonstrate, not surprisingly, that Macy’s has had problems that arose before COVID from competition from on-line sales. The return has been

below the overall market and the company's adjusted stock price has not returned to pre-COVID levels. But Figure yyy suggests that Macy's has a very high return on invested capital. Figure zzz (from another tool in edbodmer.com – footnote) demonstrates the return on invested capital computed in a simpler way. The whole idea of this little discussion is the real world problems in computing return on invested capital. If you really believed that Macy's was earning a very good return, you would expect the company to try to grow and to have a very high price to book ratio. But if you look at some details, you can get hints about why this statistic is so bad. Specifically the comment "Management believes that return on invested capital (ROIC), as defined as EBIT, excluding the impact of restructuring, impairments, store closing and other costs and settlement charges, depreciation and amortization and rent expense, as a percentage to its average invested capital is a useful measure in evaluating how efficiently the Company employs its capital" you can see that ROIC is affected by restructuring, impairment and other factors that make the denominator of the ratio lower. These factors as well as the fact that the company has not been replacing its assets render the statistic meaningless.



***Figure 27 – Macy’s Return on Equity and Return on Invested Capital After Write-off Demonstrating Rebound After Negative Returns***

If you think that there is some kind of standard formula, or an exact formula to Computing the return on invested Capital, you would be wrong. This is why the next section the next section let's talk about let's talk about the who just a minute continuing there is no standard for me.

By scanning the graphs above you can see that Macy’s had a “kitchen sink” quarter in2020 with the negative 119% return on equity. After the denominator of the return on equity is reduced – net income/equity – the future return statistics are much higher. If you think this new return with the lower denominator can be any kind of indicator of future return statistics, good luck to you. Financial statement analysis should be about using financial statement data to predict the future. Any suggestion that this fundamental aspect of financial analysis can be resolved is gone. Current and historic return data now has absolutely nothing to do with what kind of

return can be earned on new assets. As the rate of return on investment drives value along with growth, we have lost the ability to use historic data in making projections and we have almost no ability to judge what the return on new assets could be. Further, if you would go to the database tool and select other companies in the Dow 30 index, you would find that most have some kind of kitchen sink quarter or other impairment adjustment in the balance sheet that limits any potential for using the balance sheet to predict returns.

Now let's say you want to make a forecast of the net cash flow for Macy's. You could just make a forecast of EBITDA (or EBITDA less working capital changes). You would have to then assess the potential for growth in EBITDA and use this as the starting point for your valuation analysis. But as I have tried to point out, this growth depends directly or indirectly on making capital or other investments (inventory, research, software, education) of some sort. If you had an idea of the return the company could earn on new investments, you could then back-out the investment number. But with the kitchen sink quarter in 2020, the return statistics are now meaningless. We cannot look backwards and get any idea of the potential for returns – you have no historic data to use as a basis for a forecast.

Alternatively, when making a valuation you could perhaps just allow EBITDA to diminish as the stores age (like Sears or Montgomery Wards) and not make new investments. But then you better keep the EBITDA diminution consistent with the capital expenditure assumption. When making your terminal value analysis you would still have to consider capital expenditures. Maybe you could assume that capital expenditures are consistent with historic growth but the real issue is that you do not have a real basis for making a forecast. In contrast, imagine if you had a good idea of what the return on investment really is. You could then use the return in computing the value formula  $\text{Value} = \text{Net Operating Profit} \times (1 - \text{ROIC}/\text{Growth}) / (\text{WACC} - \text{Growth})$ . Perhaps the return is below a reasonable estimate of the cost of capital or the growth is slow.

### **Fancy Name Bridge Between Equity Value and Enterprise Value**

Make some outrageous statements. But also some practical stuff. Market Value. Deferred Taxes.

### **Deferred Taxes in Computing Return on Investment**

More illustration of how to think about computing the return on investment and segregating operations from financing. To illustrate the idea of thinking about items on the balance sheet

rather than using some kind of prescribed formula, I discuss deferred taxes in this chapter. If you think about deferred taxes maybe you easy and say oh I don't want to get into this understandable account. But deferred taxes can be related it's the valuation of derivatives the fair valuation of derivatives that you can see on a balance sheet. In this case the Deferred taxes would clearly not be related core operations. on the other hand some of the Deferred taxes could very well be related to the and this is accumulated defer taxes some of the accumulated defer taxes could be related to could be related to the difference between and the tax depreciation kind of that classic items could be very I'm in the end it with no let's go back to the Deferred taxes can a deferred taxes what you would do is if your Computing invested capital and your

#### ILLUSTRATION OF STABILISATION WITH GROWTH

Computing how much capital is used to generate net operating profit which is the core operating profit which does not include I'm from things like cash Investments that we talked about or doesn't pay any interest expense it's got the non-financing the pure earnings of the corporation agree with that does not include derivative gains from the change in the market value of derivatives or the if these are on the balance sheet. In this case the of the company so you can do this and mechanically you can work through the balance sheet and could compute invested capital in two different ways that's it is to identify financing of a corporation that's related to the Core Business of the assets. So let's go return to the Apple example in the Apple example we had all of that Surplus cash the balance remember you don't have to be an accountant to know that the balance sheet balances you can even be an engineer and I understand that the word balance sheet means to balance the balance sheet.

And if we have a whole lot of cash on the asset side of the balance sheet that's being financed play or explicitly by debt and equity make that cash into a lot of things with that cash we could go on a holiday we can pay for bonuses we could pay dividends we could use it to buy back stock with debt plus cash must be is not related to the Core Business and so you take the debt and the equity and subtract that Surplus cash that's one way to do this and in order to do this mechanically you work through the one next to the Surplus cash.

#### **Separating the Balance Sheet and Finding Core Operating Activities - Mechanics of Computing ROIC**

You make a little column that says invested Capital Computing from Finance alternatively you go right next door and make a second little column next to the balance sheet and say Capital computed from direct Investments that are made to finance the core operations. An example of this calculation in the case of Amazon is shown in Figure xxx below. The Core Business of the asset and when you do that don't include Surplus cash but you do include things like inventories

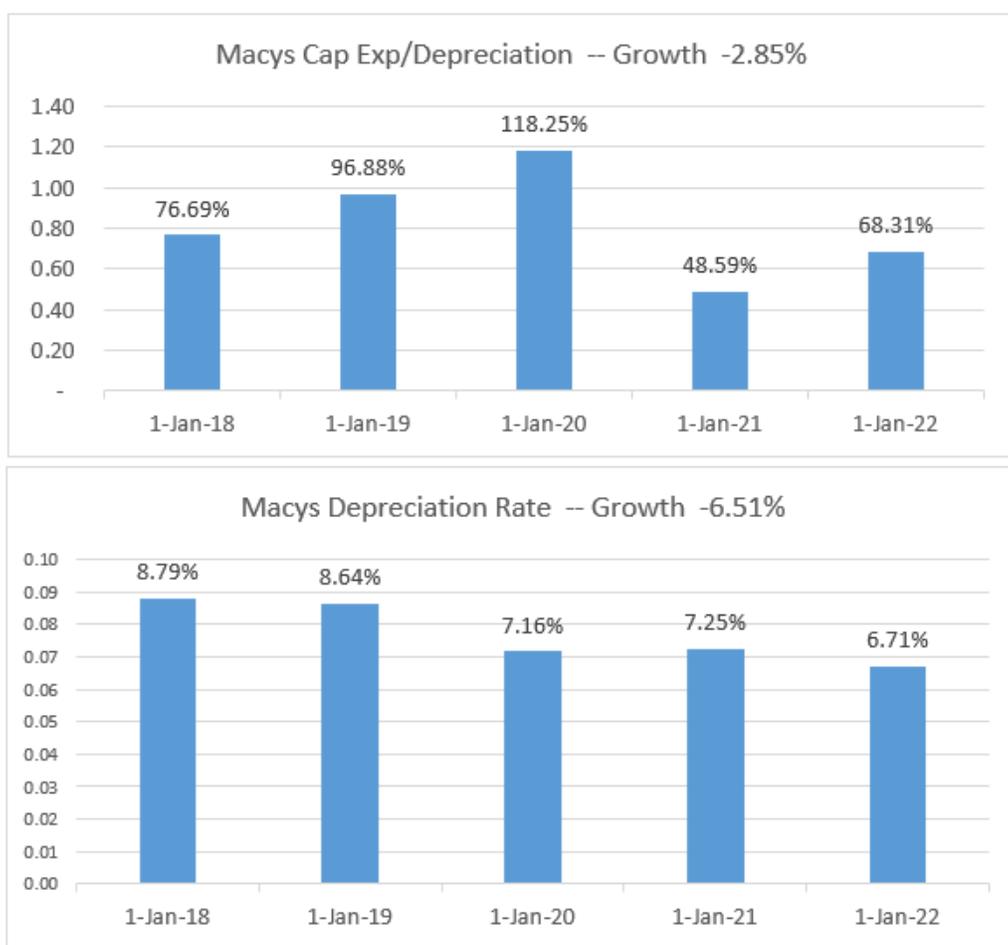
and accounts receivable very importantly the net plant assets the long-term assets of the company things that are related to financing the other business from alterations sprayable and you have to struggle with some deferred taxes and other liabilities and those sorts of items footnote you can see how this works by going to their website and seeing the mechanic okay so the graph below shows the turn on invested Capital overtime for our two companies Amazon and the we show this in two different cases where you use difference different assumptions Surplus cash and other items that's our first ambiguity.

I could complain about the difficulty in segregating ambiguous accounts in the critique of financial statement analysis.

Figure xxx with segregation of income statement and balance sheet

### **Return on invested Capital for Dow 30 Companies**

You might think I am too obsessed with the return on investment statistic but the real issue is about what kind of investment we have to make what kind of growth in that investment we have to make in order in the long run in order to generate cash flow and value. The reason for focus on return on investment is because we should consider both the numerator which is the profit and the denominator which is what kind of investment does it take to get that profit. As already discussed, maybe you go to the internet and you see that you can make enormous profits from buying and selling houses without investing any of your own money. My point is really doubt this We can't just get a profit from doing absolutely nothing improving the environment anything we do.



***Figure 28 – Macy’s Capital Asset and Depreciation Ratios Resulting in Distortions in Return on Invested Capital***

In the next chapter I will put portfolios of investments together to explain why terminal value techniques can be biased. This involves making different assumptions about the growth rate in assets; the age of assets; the accounting for assets; the profitability of different assets and other factors. Constructing a portfolio of assets is a way to prove what the true theoretical value is of a corporation that holds different kinds of portfolios. Please do not think with the current state of accounting and presenting financial information that this is possible in the real world, but it is the information that you would need to really understand value and it can be used to highlight valuation mistakes that occur from ignoring the age of assets, the obsolescence of assets and the risk changes that occur in assets.

Summary of Problems in Measuring ROIC

One day, if companies would report returns, debt capacity and risks for individual projects in a structured manner (whether project financed or not), financial statement analysis and valuation could be significantly improved as analysts could really see where the value of a corporation is coming from (and where it is being squandered). For now, it is helpful to see how projects that are comprise a portfolio to form a corporation are valued. Unfortunately, the way in which ROIC is measured from accounting data has a number of serious problems. Some of the key points in this chapter include:

1. Evaluation of a Corporate Forecast and Returns --return on invested capital (before tax) is driven by the three fundamentals: capital expenditures, revenues and operating expenses and working capital investments. Capital expenditures over the long term can be the difficult thing.
2. When using standard financial statement analysis, return is understated for periods early in the life of a project and overstated in late in the life of a project. In evaluating issues like the terminal value and multiples, the true ROIC which is the project IRR should be found.
3. Why impairment write-offs distort the possibility of making valuation analysis from ROIC and growth.
4. How goodwill and asset write-ups distort return measurement
5. How the value driver formula ( $\text{Value} = \text{Income} \times (1 - \text{growth}/\text{Return}) / (\text{COC} - \text{growth})$ ) can be used in the context of a portfolio of investments

# Chapter 5:

## Finding the True Rate of Return Using Project Finance Concepts

### **McKinsey in Malaysia**

For many years I have been able to teach classes in Malaysia for a company named Tenaga. Each year I listened to complaints from hard working engineers about and how investments that seemed to be obvious could not be made because of the ROIC was less than the WACC. One example was an engineer who came up with a creative idea improving the efficiency of power plant. He was told that the investment could not be made because the ROIC was less than a WACC. The WACC in turn was dictated by consultants at McKinsey (who apparently had read the McKinsey book that I am so obsessed about). Risks of different projects were shoved into the WACC instead of evaluating specific risks for different projects.

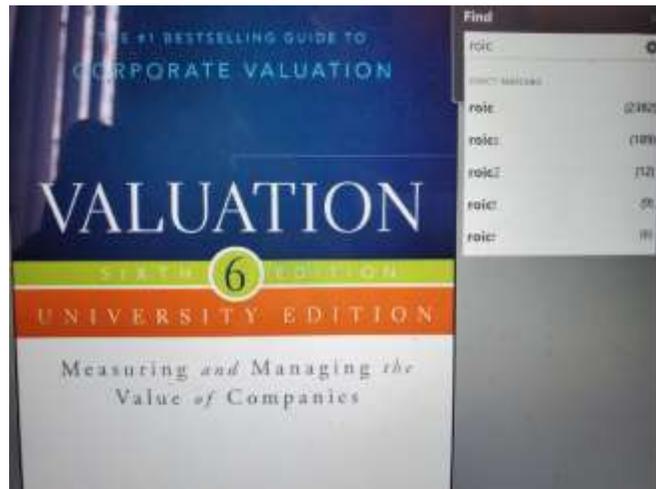
### **WACC – What Absolute Complete Crap**

I now abbreviate WACC with What Absolute Complete Crap. Later could not bid on solar projects. 2382/782 or more than 3 per page including all of the pages with chapter headings. Only 619 WACC's and NOPLAT 1182.

As you now know the ROIC in the initial years is not constant over the life of a plant. This chapter uses project finance to correct the ROIC and derive a sensible performance ratio. To do this we compute the economic depreciation and illustrate how.

### **Project Finance, Project IRR and ROIC**

My idea in this chapter I try and move to some solutions to problems with financial analysis and valuation rather than just moaning about the problems. I suggest that some creative new ways to think about all kinds of financial issues can be found in studying the ideas underlying project finance. I have been able to work on both project and corporate finance modelling classes over the years and the contrast between the two is stark. I suggest that the two branches of finance should be integrated and that teaching of valuation and financial statement analysis should start with project finance instead of the traditional subjects of free cash flow, CAPM, multiples and terminal value. So, in this chapter I move to project finance where the measurement of returns, modelling, risk analysis and valuation is highly structured. In project finance you do not waste time trying to dissect financial statements, there is no terminal value calculation, WACC should not be calculated, and valuation does not use anything like EV/EBITDA multiples. In project finance, everything starts with measurement of different returns and bankers give you answers about risks that can be accepted.

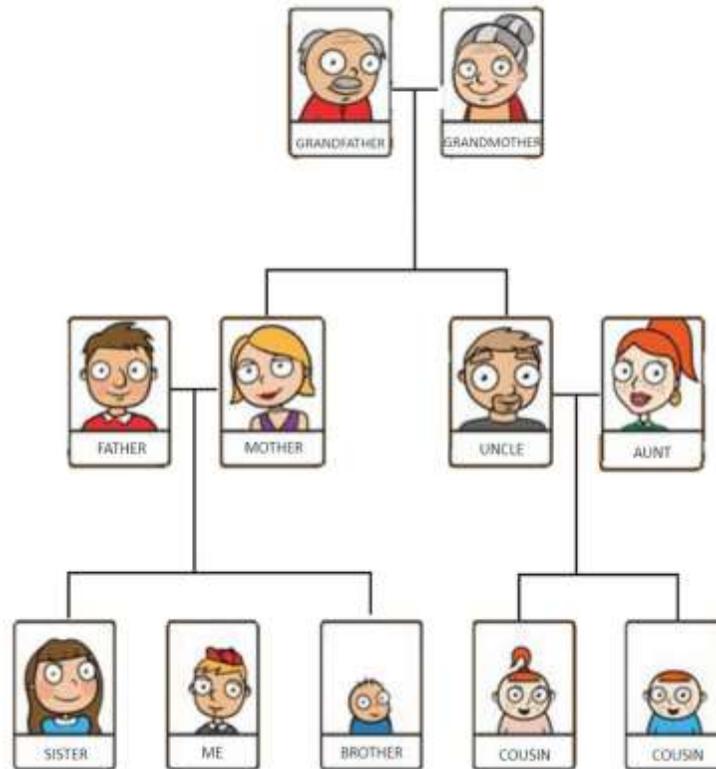


This is the first of three chapters where I try to apply project finance ideas to other areas of finance. I introduce basic project finance concepts and address valuation using the idea that any corporation is a constellation of separate projects before discussing issues with multiples and terminal value calculation. By evaluating the rate of return and the valuation of individual projects, the ROIC can be evaluated in theory, and one see biases in corporate financial statement analysis. In this chapter I begin with fundamental return analysis while in the next Chapter I move to more nuanced valuation issues associated with individual projects related to changes in risks over time and derivation of return requirements from risk assessment made by lenders.

### **Valuation of a Corporation and a Family**

All corporations are made of collections of individual mature assets, new projects, start-up ventures, and many other investments. Similarly, families are made up of many individuals and countries are made up of separate villages, towns, cities, counties and states and .... To understand corporations, families, or countries, you really need delve into what makes up the individual elements. When you look at some kind of aggregate financial statements, you do not get a story of what is really happening to the organization, country, corporation or family. If a corporation is to achieve a high valuation, the rate of return as measured by the IRR on individual projects should be more than some measure of the risk of the projects and the corporation should have the opportunity to make a lot of the high valued projects. To evaluate the future cash flow of a corporation, you are essentially trying to evaluate the returns on existing projects as well as the returns on new projects.

To illustrate the reasons for understanding project finance, consider the family tree diagram in Figure xxx. Let's say the grandmother in Figure xxx for some crazy reason wants to know the value of the family. To really do this, each of the people in the family tree must be valued. But these people have different ages, different risks, different earnings potentials. For example, the one of the young people may be in the teenage development stage and you do not know whether she will have any value at all because she only follows around bad boys. Another boy in the family tree may show a lot of promise but he is just finishing his education and has not earned anything yet. Imagine that you make a spreadsheet for each family member (I have met people in my classes who may do this) and then put add up all of the current earnings as would be the case in financial statement analysis. I assume you are thinking that this would be useless. In valuing a corporation which is analogous to this family, we are using very crude financial statements to evaluate the value of the company.



### **Project Finance and IRR versus Return on Investment**

Not too much because not book on project finance. Why important to value. Demonstrates use of IRR and discovery of project IRR which will be driver of value. Foundation in measuring risk and demonstrates that WACC and Beta not relevant. Value is from equity cash flow and equity discount rates.

In project finance, returns are measured with IRR's. The project return measures the profit – the growth rate over time with no financing (this can also be without tax). The project IRR that is pre-tax is analogous to return on invested capital where you divide the EBIT rather than NOPAT by invested capital. Then you can move to the growth rate after tax. In project finance, you then evaluate the equity IRR that is the driver of what investors care about. The equity IRR is dependent on the financing of the project.

Illustration of very simple project finance analysis for one period and consistency with corporate analysis in one period model.

### **Nuances of Project Finance in Valuation**

A general theme of this book is that you should look further than current methods applied in finance. Some of these ideas include the issue of how to interpret and adjust multiples; how to resolve problems with terminal value; how to come up with alternatives to the CAPM; how to evaluate the true return on invested capital; and how. There are a lot of lessons from project finance including how to deal with development and start-up type risks; how to derive the required return (i.e., the cost of capital) for individual projects; how to consider upsides and capital gains from projects as they progress from high-risk to low-risk projects; how to evaluate financial ratios such as EV/EBITDA and Debt/EBITDA and for individual projects; and how to evaluate the value of projects as a function of their age. All of these issues have implications for the valuation of a corporation even if using the project finance concepts are not directly incorporated into individual terminal value, cost of capital and other valuation formulas.

Why obsessed with project finance. Why discuss. Need risk and cash flow. Need to be more nuanced about risk than CAPM. Want the equity value of a corporation. Could compute the value of corporation. Would not need terminal value, this is the really big deal. Can use to prove value. Again will build this up in a portfolio. Build up value and build up cash flow.

Returns are the centrepiece of value and come from contracts. No terminal value. Debt structuring defines risk and can come up with reasonable estimate. Cover some issues in project finance as a way to think about corporate valuation. Do not discuss general stuff like technical details of contracts, but only present valuation issues to think about. Much less magic potion. Normally teach project finance with diagrams and structuring. That is fine. Discuss here some of the nuances in valuation.

Project Finance addresses risk, return and valuation for individual projects and it is generally treated as a completely distinct subject from corporate finance. Corporate finance covers things like DCF valuation, multiples, CAPM and corporate credit analysis. Project finance deals with debt capacity and debt structure, valuation using IRR, and cash flow from individual projects over their life. This chapter discusses how the two branches of finance should not be divorced from each other and why project finance ideas like risk reduction in assets over distinct periods of their lifetime and using financing structure to evaluate overall risk of an asset can be the foundation for many valuation issues for corporations, start-up businesses, personal finance

affairs, stock valuation and other subjects. The chapter homes in on IRR problems that arise from changing risk; I demonstrate how economic depreciation is an essential idea in understanding valuation and reconciles ROIC and ROE with Project IRR and equity IRR; illustrates how the age and lifetime of assets causes biases in comparative P/E and EV/EBITDA multiples; and discusses how development premiums can be a way of evaluating start-up businesses, research projects and other innovations needed for corporations to survive in the long-term.

It is also instructive to see what the MBA programs do not have. There were no courses in project finance much less do they recognize the nuances in project finance where financing is driven by the economics and the risks of individual projects.

We will also introduce the idea that financing can be a better way to find out about implicit risk and why the ideas of a true hero in finance – Merton Miller – do not apply in project finance. How solar plants work. To introduce mechanical issues with ROIC use a second branch of finance project finance. In project finance project IRR. No terminal value. Most financing comes from debt and lenders credit analysis provides a guide for the investment. Can see the cash flow on a transparent basis. Risk directly evaluated and little or nothing directly about diversifying risk. Most important the investment is made from evaluating financing. After project finance corporate finance becomes extremely frustrating.

### **Project IRR and Return on Invested Capital**

Issues and with depreciation for that analysis we are going to move to project Finance. In project Finance we don't measure return on invested capital. Instead, we measure project IRR and equity IRR. In the next paragraph I'll demonstrate welcome to the true irr of a project if we straighten line straightened out if we correct the depreciation and if we use economic depreciation then find depreciation.

I have been thinking about this since the 1990's. I have looked at betas for companies with merchant risk like Exelon compared to betas for companies with no merchant risk like ConEd. Generally I cannot find anything. I then tried some kind of Monte Carlo simulation to illustrate risks. Again this did not get me anywhere.

So finally, I ask investors what kind of equity IRR they need. I put in much less favourable financing in for the merchant case (cash sweep, shorter tenure, less debt) and then back into the project IRR you would need to achieve the same equity IRR. You could also add a point or two to the equity IRR. Of course one could critique this, but for me it illustrates how project finance structuring is a good way to find a real quantification of the risk of a project.

### **Just What Exactly is an Investment**

Cannot remember the definition of investment. Struggle in thinking how you can generate returns without making some kind of investment. Think differently about investments and do not use an accounting definition that is something like something where the asset lasts longer than a year. This is nothing. The definition of an investment should be something – money, time or pain – that you make and that yields future benefits that are generally uncertain. This can be advertising, inventory, software development, acquiring permits, employee training and many other things. Think of an irritating interview with an actor in a Disney movie talking about the deepness of the themes and the skills of the team making the film. This is an investment.

Imagine a lot of investments. Could compute the value of each one then add them up and get the value of a corporation. Will do this where we add up projects to portfolio.

When you think about economics and try to find how you can receive money without doing anything at all. You could wait for money to come from the sky. You could wait for somebody to die and receive inheritance. Maybe you can trick somebody rich to marrying you. But other than a few things like that, to get something in the future, you have to make an investment. The fundamental question in finance is what kind of return you can earn on your money and how can you find people to invest in your project if you don't have your own money

We are looking for ROIC or IRR. But what is an investment. Again, the definition of investment by accountants, that an investment is where the benefits are longer than one year is worthless. There is a big danger of falling into the trap of believing the definitions. capital expenditures, inventories, advertising, research and development, software development. The simplest way to think about return on investment is to pretend you are operating in Abu Dhabi with no taxes and you have an investment that is all financed by equity. Assume that you are investing 1,000 today and expect to get 1,100 back in a year (there is an equal upside and downside probability). Then the IRR on your investment – whether advertising, inventory, gambling or capital expenditures is 10%. You could also compute the return on invested capital as the amount you get in a year – 1,100, less the allocated cost of your investment – 1,000. This gives you income of 100. And the income 100 divided by the initial investment also gives you 10%.

If you have to wait two years to get back your investment and you get back 550 per year, then things get more complicated and the return on investment falls apart as a statistic. If you go to excel and compute the IRR, your return is now down to 6.60% (you need excel for this). If you allocate the investment of 1,000 over two years giving an allocated cost (depreciation or amortisation) of 500, then the income is 500 per year. But the invested capital on you balance sheet starts at 1,000 and then goes down to 500 in the second year. This gives a return on capital that is lower than the IRR of 6.6% in the first year –5% -- and is higher than the IRR in the second year. Further, the average of the ROIC is not the same as the IRR. The example is illustrated in table xxx.

|                           | 0       | 1     | 2      |
|---------------------------|---------|-------|--------|
| Capital Expenditure       | (1,000) |       |        |
| EBITDA                    |         | 550   | 550    |
| Free Cash Flow            | (1,000) | 550   | 550    |
| IRR                       | 6.60%   |       |        |
| Amortisation              |         | 500   | 500    |
| EBIT (Income)             |         | 50    | 50     |
| Investment End of Period  | 1,000   | 500   | -      |
| ROIC (Income/Initial Inv) |         | 5.00% | 10.00% |

### ***Figure 29 – Simple Two Period Model Demonstrating Difference between IRR and ROIC***

When I discussed the famous finance professors at the start of the book, I perhaps should have been more nuanced. Each of the finance Gods did make important contributions. For example, I am not asserting the Markowitz's ideas that the variability of cash flow can be reduced from diversification. More importantly, the ideas of Merton Miller (that debt is not relevant) have led to use of unlevered cash flow to compute value, adjusting beta for leverage, using ROIC rather than ROE to assess the competitive status and prospects of a company. The latter point is essential for beginning the discussion of how we can evaluate the future value of a company and assess the reasonableness of a forecast. If the company's capital structure has changed in the past or is expected to change in the future because of new debt issues or retirements, if the capital structure implicitly changes in the forecast because of an assumption that the company retains large balances or if any other change such as stock buybacks, the return on equity is affected. These changes in the return are not related to the fundamental things the company really does (a very bad interpretation of Miller's ideas). This is why in the remainder of this chapter I focus on the ROIC and the project IRR rather than the return on equity and the equity IRR.

#### **Analogy of ROIC and Valuation Analysis to Country Analysis with Real GDP and Well Being**

To illustrate how the ROIC can be evaluated and distorted I have tried to think about other performance measures where historic trends, different underlying strategies, distortions and ultimately projections can be made. I thought about various time series like the oil price, but

after racking my brain I came up with GDP per capita. We all know, and I completely agree that GDP is not a very good statistic – divorce lawyers, medical bureaucrats, and abusive prison guards are part of GDP, but they do nothing positive for people. In evaluating the historic economic performance of a company in light of government policy, education and economic structure, we could compare countries in an analogous manner to evaluating the return on investment for corporations. But if the GDP is distorted because of things like changes in the way it is accounted for or changes in the .... , then the GDP per capita statistic becomes impossible to use in analysing the historic performance of the company or in evaluating the future prospects of the country. In the same way, if the ROIC statistic is distorted because of accounting and changes in risk, the Fundamental measure is GDP per capita. Comes from productivity (like ROIC) and population growth. Show GDP growth and show population growth and show GDP per capital for good and bad example. Use Russia and South Korea.

As the graph and business is driven by return on investment, I have tried to think about a statistic that is analogous to the rate of return on invested capital. The best I can think of is GDP to assess the well-being of a country (please to not think in any way I believe that GDP is a good measure of too much, but it is used a lot). Later, I will present data on GDP per capita and make analogies between returns, growth and cost of capita to the GDP of different countries where returns are returns are replaced with productivity, growth is replaced with population growth and value is replaced with income per capita. As you need returns and growth to increase value, to increase income per-capita you need both high productivity and growth.

#### GRAPH OF GDP PER CAPITA

In evaluating the ROI, you want to compare the value of the company to potential for ROI increases or decreases. I had to teach a course in financial statement analysis. I tried to focus the entire class on computing the historic ROIC and ROE and how to interpret these numbers. (The class was not successful as the students wanted to learn some basic accounting issues). To demonstrate why evaluation of ROI is central to valuation and finance, I have made another simple example with different ROI trends. The table below summarizes the scenarios with different trends in ROI relative to the current value. Some scenarios are below the assumed cost of capital and some are high. The table illustrates the theoretical multiple with different ROI trends and growth rates. If the ROI is expected to increase, the P/E or EV/EBIT ratio should be high. If the ROI is low and there is growth, then the value should be low. The idea here is to demonstrate how the evaluation of prospective trends in ROI is central to valuation. But what if the ROI is measured in a distorted manner. I have made some simulations using a model that has different trends in the ROI.

#### **Searching for the Holy Grail – The True ROIC and IRR**

If the ROIC was the same as the IRR and you could have really good data on the individual projects. But the ROIC that you can measure for a corporation is not the IRR that you measure for an individual project. The ROIC can be derived from financial statements but not the IRR on individual projects. For example, GE is in many businesses ranging from electricity generation

asset construction to financial services to making airplane engines. We really want to see the future IRR prospects for each of these businesses to gauge what the value of the company but because of accounting we cannot get anywhere near this data. Could then use the value driver formula and see if market expectations are right. Could then evaluate performance. Could then evaluate whether new investments can really earn. No discussion of terminal value. No discussion of P/E or EV/EBITDA ratios. No discussion of near-term EPS. So much comes down to the ROIC or ROE.

### **Project IRR from Capital Expenditures, Revenues, Operating Expenses and Working Capital**

Standard financial model to forecast earnings. You can think of ROIC as you would think about other statistical data. Cap Exp is the big deal.

$ROIC = (\text{Revenues} - \text{Op Exp}) / \text{Investment}$ . If you project capital expenditure and if it is not consistent with ROIC. Use crazy cap exp to sales which is meaningless. Investment is so important. Capital expenditures to sales may have problems. In sum, the process is a big mess.

In project finance returns are explicitly the criteria (maybe the only criteria). If you could add up portfolio of projects could derive value. Also the risks are carefully defined. One day will provide some kind of asset portfolio.

Why did it take me so long. Get very confused by forecasting process. General process of variable expense and fixed expense. Gross margin. Revenue growth. But what to do about capital expenditures. Capital expenditures are the problem. EPC, O&M and PPA. Capital Expenditure to sales. Capital Expenditures to Depreciation, Growth Rate in Capital Expenditures. Importance of capital expenditures.

### **Straight Line Depreciation Distorts Return on Investment for a Single Asset**

The return on investment, whether the return on equity or return on invested capital compares investment to the money that comes to investors. The money that comes to investors begins with EBITDA which measures real cash. If this was where the return on investment stops, there would be no big accounting issues. But the money that comes in is after depreciation expense, impairment expense, interest expense and taxes. The problem is that depreciation is distorted and leaves ROI to be a mess. If a company has old assets, the ROI will be very high relative to the true earnings because of the manner in which depreciation is computed. But DA is a problem, so EBIT is a problem, and it is the basis for computing ROIC and even ROE. Depreciation is the change in value. Can only make it allocate the total value if the IRR is used to make value. NPV at IRR is the value of a project. At the first year, the NPV at the IRR gives you the total value. This value declines to zero over the life of the project.

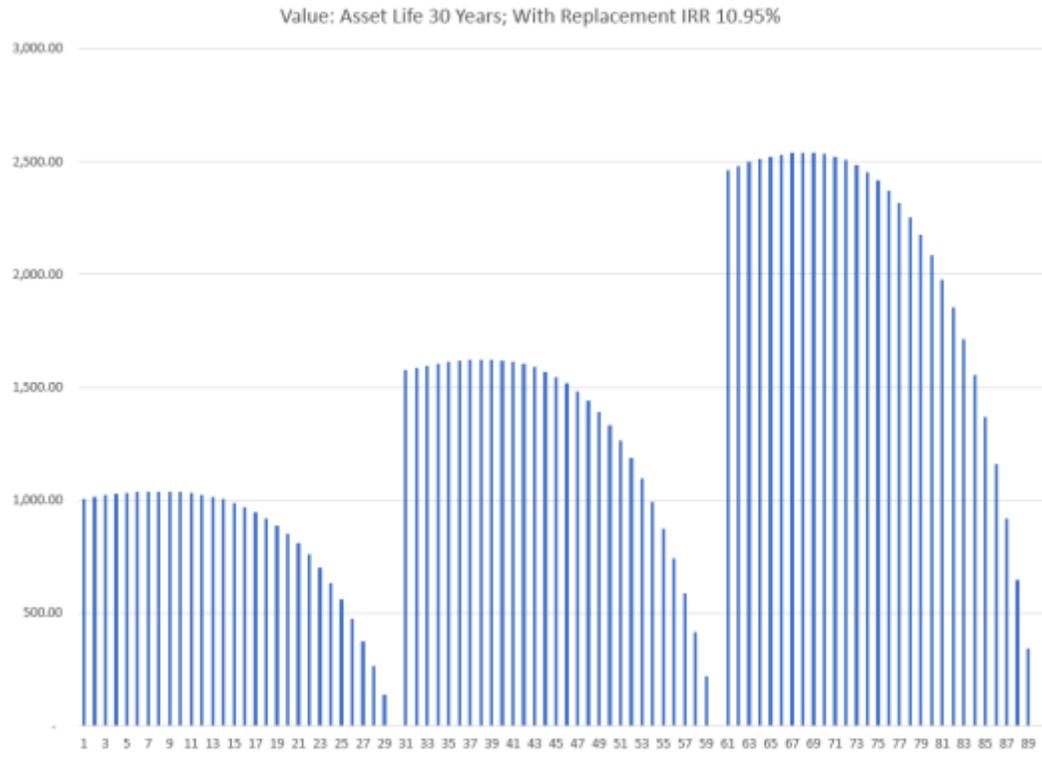
Not only straight-line depreciation, but the also the economic life of a project. If you could find this true return you could then measure the long-term portfolio of projects. To demonstrate problems in the calculation of ROIC, move to project finance. If you have ever worked on project finance, you may be thinking that ROIC is virtually never computed as a part of transactions and how formulas related to the IRR can translate directly into the ROIC if depreciation is accounted for properly. We will see how IRR and ROIC are growth rates and value comes from cash flow growing at a faster rate than the cost of capital.

**Economic Depreciation and IRR/ROIC Reconciliation**

Start with the time series of value over the life of an asset. Figure xxx shows the trend in value for three cycles of an asset. The calculation is simple, the EBITDA is flat and the EBITDA less taxes drive at the value. If assets are lumpy like this, then the present value goes down and up when the assets are replaced. Can see a lot from this. EV/EBITDA and price to earnings completely change over the life of an asset. Value is not constant. Return on investment is not constant. Value goes down as plant ages simply because there is less cash flow. Value does not go down on a straight-line basis because the discount rate is not zero. The pattern of value decline is driven by the Why need the true ROIC on investments. There is a true IRR. This is the project IRR in project finance. Value for a single asset does not change on straight line basis.

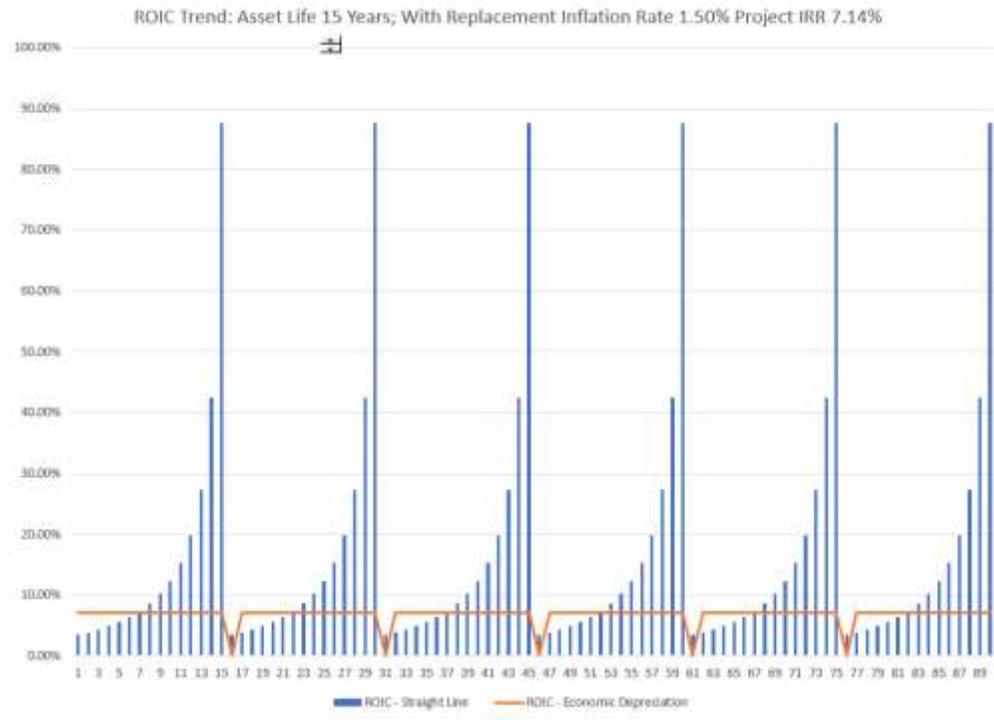
|                        | 0     | 1         | 2         |
|------------------------|-------|-----------|-----------|
| NPV at IRR             | 1,000 | 516       | -         |
| Change in Value        |       | 484       | 516       |
| EBITDA                 |       | 550       | 550       |
| Economic Depreciation  |       | 484       | 516       |
| <u>EBIT - Economic</u> |       | <u>66</u> | <u>34</u> |
| ROIC (Economic)        |       | 6.60%     | 6.60%     |

***Figure 30 – Two Period Model Demonstrating Economic Depreciation Calculation from Progression in Value Computed Using the IRR and Depreciation as the Change in Value***



***Figure 31 – Value of Assets Using Project IRR with Replacement of Assets and Growth (Used as the Basis for Computing Economic Depreciation)***

Graph does not show what happens if you have productive assets that are fully depreciated. Keep coming back to the conclusion that financial statement analysis is utterly worthless.



**Figure 32 – Difference between ROIC Computed Using Straight Line Depreciation and ROIC Computed Using Economic Depreciation in Case with Multiple Assets**

### Effect of Growth Rate and Plant Age on Rate of Return

You can use the idea of economic depreciation to illustrate the bias in rate of return from companies with different growth rates. I have made a simple simulation where there is investment build-up with different growth rates. In the first case, the return is 10% and the growth rate is 4%. The true rate of return is computed with economic depreciation and the this rate of return over time is compared to the rate of return computed from straight line depreciation. There is a second graph where the depreciation rate does not reflect the true economic life. The average age is shown along with the accumulated depreciation to the value of the investment.

Alternative graphs is shown for different growth rates and different asset lives.

Work through economic depreciation with different scenarios. Use an oil example with declining balance (you can use the VDB function in excel). Criticize a lot and must include

accountants. Had to teach a class in financial statement analysis. It thought it should be about how to arrive at the ROIC so that we can assess performance and potential to earn future ROIC. Straight line depreciation, deferred taxes, R&D expense all make computing the ROIC impossible from accounting. The class failed by the way. I also tried to contrast project and corporate finance.

## Performance Measurement with Return Computed Using Economic Depreciation

Figure xxx illustrates how you can use economic depreciation for evaluation the performance and more importantly the prospective return after a change in the performance. The top shows the return without any adjustment. In this case with economic depreciation is the same as the IRR. To compute this you compute the value of the plant at the IRR. Then you compute the change in this value. Because you use the IRR and not another rate, the value is the same as the capital expenditure. This is the basic idea that the NPV using the IRR is equal to zero or, without the initial capital expenditure, it is the capital expenditure.

The second part of figure xxx shows what happens when you use the same depreciation. Note there is no impairment. In this case the ROI goes down for three years. Now, you may want to evaluate the potential future return. You want to do this because you may want to assess new investments. You may not have a model and want to evaluate the future prospects of the project. The 6.88% IRR does not mean anything to you anymore. This was for the initial investment. The actual has come down and you have some history. At the end of the day did your IRR would be 6.86%. But you do not know what will happen in the future. Is the 4.61% a better way to evaluate future prospects. If the reduction in cash flow continues you will earn something like 4.5%. It is true that you could compute the reduction.

| Base Case    |       |    |         |       |       |       |       |       |       |       |       |       |       |
|--------------|-------|----|---------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
|              |       |    | 0       | 1     | 2     | 3     | 4     | 5     | 6     | 7     | 8     | 9     | 10    |
| EBITDA       | 100   | 0% | 100     | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   |
| Cap Exp      | 1,000 |    | 1,000   |       |       |       |       |       |       |       |       |       |       |
| Cash Flow    |       |    | (1,000) | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   |
| IRR          | 7.75% |    |         |       |       |       |       |       |       |       |       |       |       |
| Value        |       |    | 1,000   | 978   | 953   | 927   | 899   | 869   | 836   | 801   | 763   | 722   | 678   |
| Depreciation |       |    |         | 22    | 24    | 26    | 28    | 30    | 33    | 35    | 38    | 41    | 44    |
| EBIT         |       |    |         | 78    | 76    | 74    | 72    | 70    | 67    | 65    | 62    | 59    | 56    |
| ROI          |       |    |         | 7.75% | 7.75% | 7.75% | 7.75% | 7.75% | 7.75% | 7.75% | 7.75% | 7.75% | 7.75% |

| Performance     |       |  |         |       |       |       |       |       |       |       |       |       |       |
|-----------------|-------|--|---------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
|                 |       |  |         |       |       |       |       |       |       |       |       |       |       |
| Base EBITDA     |       |  | 100     | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   |
| Reduction       |       |  |         |       |       | 30    | 30    | 30    | -     | -     | -     | -     | -     |
| Adjusted        |       |  | 100     | 100   | 70    | 70    | 70    | 70    | 100   | 100   | 100   | 100   | 100   |
| Cap Exp         |       |  | 1,000   |       |       |       |       |       |       |       |       |       |       |
| Total Cash Flow |       |  | (1,000) | 100   | 100   | 70    | 70    | 70    | 100   | 100   | 100   | 100   | 100   |
| IRR             | 6.88% |  |         |       |       |       |       |       |       |       |       |       |       |
| Plant Balance   |       |  | 1,000   | 978   | 953   | 927   | 899   | 869   | 836   | 801   | 763   | 722   | 678   |
| Depreciation    |       |  |         | 22    | 24    | 26    | 28    | 30    | 33    | 35    | 38    | 41    | 44    |
| EBIT            |       |  |         | 78    | 76    | 44    | 42    | 40    | 67    | 65    | 62    | 59    | 56    |
| ROI             |       |  |         | 7.75% | 7.75% | 4.61% | 4.52% | 4.42% | 7.75% | 7.75% | 7.75% | 7.75% | 7.75% |

**Figure 33 – Illustration of Using Economic Depreciation and Economic ROIC to Evaluate Decline in Performance Showing that If the Decline Continues the IRR will be Approximately 4.5% and the 6.88% return on the Overall Project is Less Relevant**

| Base Case       |       |         |       |       |       |       |       |       |       |       |       |       |
|-----------------|-------|---------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
|                 |       | 0       | 1     | 2     | 3     | 4     | 5     | 6     | 7     | 8     | 9     | 10    |
| EBITDA          | 100   | 0%      | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   |
| Cap Exp         | 1,000 | 1,000   |       |       |       |       |       |       |       |       |       |       |
| Cash Flow       |       | (1,000) | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   |
| IRR             | 7.75% |         |       |       |       |       |       |       |       |       |       |       |
| Value           |       | 1,000   | 978   | 953   | 927   | 899   | 869   | 836   | 801   | 763   | 722   | 678   |
| Depreciation    |       |         | 22    | 24    | 26    | 28    | 30    | 33    | 35    | 38    | 41    | 44    |
| EBIT            |       |         | 78    | 76    | 74    | 72    | 70    | 67    | 65    | 62    | 59    | 56    |
| ROI             |       |         | 7.75% | 7.75% | 7.75% | 7.75% | 7.75% | 7.75% | 7.75% | 7.75% | 7.75% | 7.75% |
| Performance     |       |         |       |       |       |       |       |       |       |       |       |       |
| Base EBITDA     |       |         | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   | 100   |
| Reduction       |       |         |       |       | 30    | 29    | 28    | 27    | 26    | 25    | 23    | 22    |
| Adjusted        |       |         | 100   | 100   | 70    | 71    | 72    | 73    | 74    | 75    | 77    | 78    |
| Cap Exp         |       | 1,000   |       |       |       |       |       |       |       |       |       |       |
| Total Cash Flow |       | (1,000) | 100   | 100   | 70    | 71    | 72    | 73    | 74    | 75    | 77    | 78    |
| IRR             | 5.38% |         |       |       |       |       |       |       |       |       |       |       |
| Plant Balance   |       | 1,000   | 978   | 953   | 927   | 899   | 869   | 836   | 801   | 763   | 722   | 678   |
| Depreciation    |       |         | 22    | 24    | 26    | 28    | 30    | 33    | 35    | 38    | 41    | 44    |
| EBIT            |       |         | 78    | 76    | 44    | 43    | 42    | 40    | 39    | 37    | 36    | 34    |
| ROI             |       |         | 7.75% | 7.75% | 4.61% | 4.62% | 4.63% | 4.64% | 4.66% | 4.67% | 4.69% | 4.72% |

**Figure 34 - Using Economic ROIC and Economic Depreciation to Evaluate Continued Decline in Performance**

# Chapter 6: Multiples such as P/E, EV/EBITDA and Debt/EBITA are Useless Even If a Banker Waves a Magic Wand and Gives You a Number

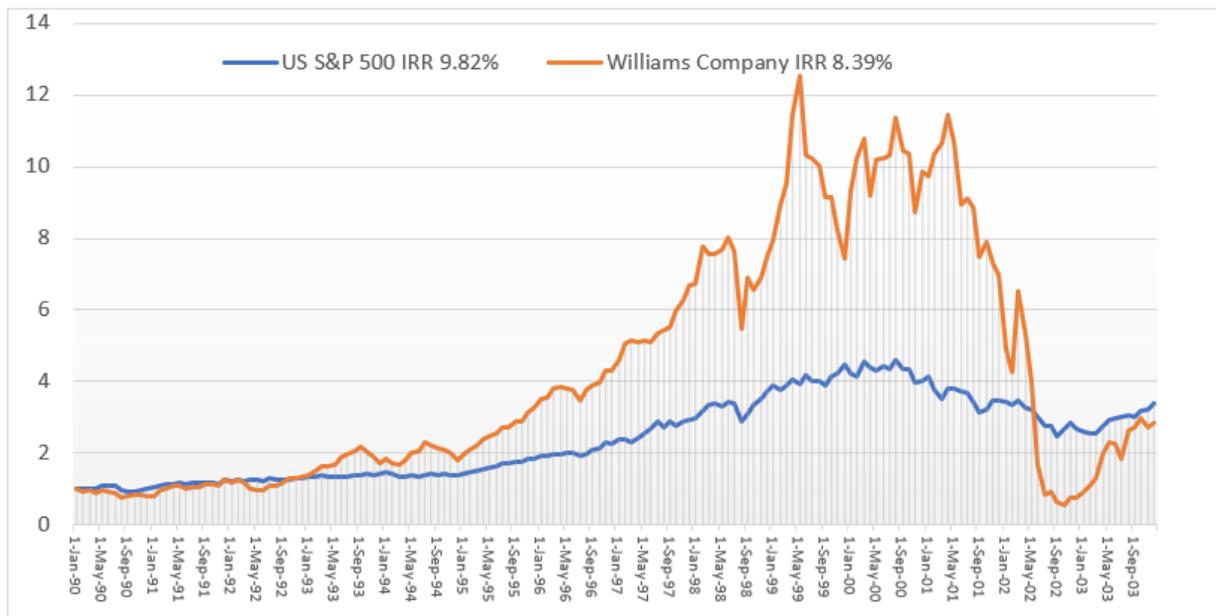
## No Rate of Return on Invested Capital in MBA Cases and Project Finance

I have reviewed the kind of case studies that are taught in prominent MBA programs (finance courses, private equity courses, investment courses), and I was surprised. First, none of the cases suggest directly or indirectly for students to compute the return on investment much less the project IRR in understanding the foundation of valuation analysis and its connection to corporate strategy. Second, in the valuation cases, students seem to be taught that the only way to compute cost of capital is using the CAPM (or maybe the arbitrage pricing model) and they are given an equity market risk premium number that is much higher than the real growth in the economy (they are never asked to question the number, nor the absurdity of high cost of capital numbers). Third, any analysis of terminal value in the case studies -- the elephant in the room of valuation -- are either based on simple (and very flawed) constant growth models or unadjusted comparative multiples. Fourth, the MBA programs continue to teach financial statement analysis without emphasizing the search for the true ROIC or IRR which is the number you want as the starting point of your valuation. These were topics that I was taught many decades ago and the lack of progress is remarkable.

For example, there was an old case study about a telecommunication venture before the dot com bubble of 2000-2001. The dot com bubble is now ancient history, but at the time the internet was a relatively new thing and anything that had anything to do with investing in the internet received a high valuation. I remember a natural gas pipeline company named Williams that put fibre optic cables next to its pipes and called itself a Williams Telecom company. As shown in the graph below, the company experienced a very high stock price and then experienced a dramatic decline after it was clear that there was a dramatic overcapacity -- anybody could do something like Williams and there was no special competitive advantage. It was a classic example of moving from the power-house square -- box 1 -- to the throwing money away square -- box 2. Now back to the case study. There was no discussion of the true

competitive advantage or the potential for making a high return in this case study. Instead, students were instructed to waste time on the CAPM, the terminal value, comparative companies and the prospects for and IPO.

The company As discussed in Chapter 2, the ROIC statistic is essential for many reasons. Some of the reasons include: (1) calculating value using value driver formula –  $Value = E1 \times (1 - g/ROIC)/(WACC - g)$ ; (2) evaluating the current performance of management relative to, competitors and other potential business lines as part of competitive strategy; (3) Understanding trends in ROIC and potential risks from increased competition and supply from around the world (China); and (4) considering whether the level of ROIC is adequate relative to the risk that is taken. A central idea of the discussion in this chapter is the idea that the true return on investment is the project IRR which is the starting point of project finance analysis. Furthermore, the project IRR can be established over time by use of economic depreciation rather than traditional accounting depreciation.



**Figure 35 – Crash in Williams Telecom Value After Surplus Capacity from Move to Telecommunications – Danger of Box 1 to Box 2**

If you waste your time watching boring financial television programs or take a basic course in finance, you will hear a lot about the P/E ratio, the EV/EBITDA ratio, and the Price to Book Ratio. These statistics that are called multiples are the centre of evaluation of leveraged buyouts; they are used in assessing benchmarking stock prices of companies; they are used as

inputs for computing terminal value; and some can be used to assess the performance of management. Alternative multiples are used to measure the risk and value of debt including Debt to Capital, Debt to EBITDA, and Debt Service Coverage. The debt ratios directly or indirectly are used to measure the risk of default on debt through establishing credit ratings.

**Bankers can wave their magic wand and suggest the correct multiples to use. You can pay a lot for an advisor.**

I begin using a Harvard case study of an acquisition in the proposed acquisition of the railway industry. The table below shows the PE ratio and the EV/EBITDA ratio for all companies in the industry. One would think that companies in this industry are very stable and very similar with similar multiples. But when we look at the PE and the EV to EBITDA ratios there is a wide range. Note that the PE ratio varies between X and Y. Note that the EV to EBITDA ratio is between Y and Z.

It would be ridiculous to simply take the average ratio or the median ratio without understanding why these ratios are different. Differences in value theoretically come from resources, the rate of return on investment, the growth rate, and cost of capital. When we dig a little deeper we may explain why these ratios are different. First, note the lower ratio for the company that has a higher return. Other possible reasons for the difference in the ratios may be the upcoming required capital expenditures, the growth rates, or the businesses. If we have a good idea about the return on investment including trends in the rate of return we should be able to work through differences in the multiples. We will see that there are important differences between the interpretation of an EV/EBITDA multiple and a PE multiple.

**Exhibit 18: Comparable Public Companies**Source: <https://www.sec.gov/Archives/edgar/data/724606/000119312>

| Company                          | EV / EBITDA |       | P / E |       |
|----------------------------------|-------------|-------|-------|-------|
|                                  | 2017E       | 2018E | 2017E | 2018E |
| <b>Fast Casual</b>               |             |       |       |       |
| Chipotle                         | 25.9x       | 18.8x | 54.8x | 37.1x |
| Shake Shack                      | 14.8x       | 11.7x | 66.8x | 53.0x |
| Wingstop Inc.                    | 24.7x       | 21.2x | 44.2x | 36.3x |
| Potbelly                         | 7.7x        | 7.0x  | 30.2x | 26.2x |
| Zoe's Kitchen                    | 16.0x       | 12.8x | NM    | NM    |
| Habit Restaurants                | 10.2x       | 8.6x  | 60.0x | 54.5x |
| Freshii                          | 26.5x       | 18.5x | 42.0x | 28.8x |
| Noodles & Company                | 8.1x        | 7.2x  | NM    | NM    |
| <b>Multinational QSR</b>         |             |       |       |       |
| Domino's                         | 20.2x       | 17.7x | 35.4x | 29.7x |
| McDonald's                       | 13.6x       | 13.3x | 21.0x | 19.6x |
| Starbucks                        | 14.8x       | 13.0x | 26.4x | 23.3x |
| Yum! Brands                      | 15.5x       | 15.0x | 23.4x | 20.3x |
| Restaurant Brands <sup>(1)</sup> | 13.5x       | 12.5x | 29.7x | 22.9x |

***Figure 36 – Excerpt from HBS Case Study on LBO for Panara Bread Demonstrating Large Difference in both P/E Ratio and EV/EBITDA Ratio for Companies in the Same Industry***

### Bidding for Hertz: Leveraged Buyout

#### Comparable Company Analysis (\$ millions)

| Company <sup>(1)</sup>  | Stock Price<br>(8/15/05) | Equity<br>Value | Enterprise<br>Value (EV) <sup>(2)</sup> | LTM Financials |         |                  | Price Earnings |       | Enterprise Value/LTM |        |
|-------------------------|--------------------------|-----------------|---|----------------|---------|------------------|----------------|-------|----------------------|--------|
|                         |                          |                 |   | Revenue        | EBITDA  | EBITDA<br>Margin | 2005E          | 2006E | Revenue              | EBITDA |
| <b>Car Rental</b>       |                          |                 |   |                |         |                  |                |       |                      |        |
| Amerco                  | \$58.01                  | \$1,236         | \$1,929                                 | \$2,047        | \$298   | 14.60%           | 19.1           | 15.7  | 0.94                 | 6.47   |
| Cendant                 | \$20.54                  | \$22,117        | \$26,417                                | \$20,454       | \$3,119 | 15.20%           | 14.6           | 12.3  | 1.29                 | 8.47   |
| Dollar-Thrift           | \$32.30                  | \$846           | \$661                                   | \$1,481        | \$107   | 7.20%            | 15             | 13.7  | 0.45                 | 6.18   |
| <b>Equipment Rental</b> |                          |                 |   |                |         |                  |                |       |                      |        |
| United Rentals          | \$18.49                  | \$1,440         | \$4,212                                 | \$3,013        | \$785   | 26.10%           | 10.8           | 8.7   | 1.4                  | 5.37   |
| Ashtead Group           | \$2.04                   | \$675           | \$1,567                                 | \$1,144        | \$246   | 21.50%           | 16.9           | 11.8  | 1.37                 | 6.37   |
| Atlas Copco             | \$18.02                  | \$10,942        | \$11,823                                | \$6,270        | \$1,495 | 23.80%           | 16.8           | 15.2  | 1.89                 | 7.91   |

<sup>(1)</sup> Cendant held Avis and other travel-related businesses. RSC Equipment Rentals was a division of Atlas Copco.

<sup>(2)</sup> Enterprise Value for car and truck rental represents the value of the operating company, such that the associated multiples represent the multiples for the operating company. Similarly, EBITDA for car rental represents adjusted EBITDA. Dollar Thrifty Automotive Group, Inc.'s enterprise value is less than equity value because all of its debt is fleet-based (there is no operating company debt) and because Dollar Thrifty has \$185 million in excess cash.

Source: Consortium internal documentation on LBO.

## **Figure 37 – Example from HBS Case Study of Data Sources (No Return on Invested Capital; No EV/EBITDA Ratio; P/E Ratio Has Wide Fluctuations)**

Another example is shown below. In this case the multiples should be very similar as the industry is stable.<sup>13</sup>

### **Explaining Multiples to your Mother (who is not interested in finance)**

Explain to your mother and usefulness when multiples are really low.

The multiples and ratios are easy to criticize, but most of the complaints you hear simply suggest that the multiples are simplistic, and the companies are not directly comparable. In real world if you have some multiples for comparable companies, the real world is to blindly use the multiples. But the multiples are not studied in the context of implied changes in returns and growth, or the distortions created by accounting. The comparative multiples also do not account for the effect of the age of assets on the return and the requirement for new investment.

<sup>13</sup> 216-057 Canadian Pacific's Bid for Norfolk Southern

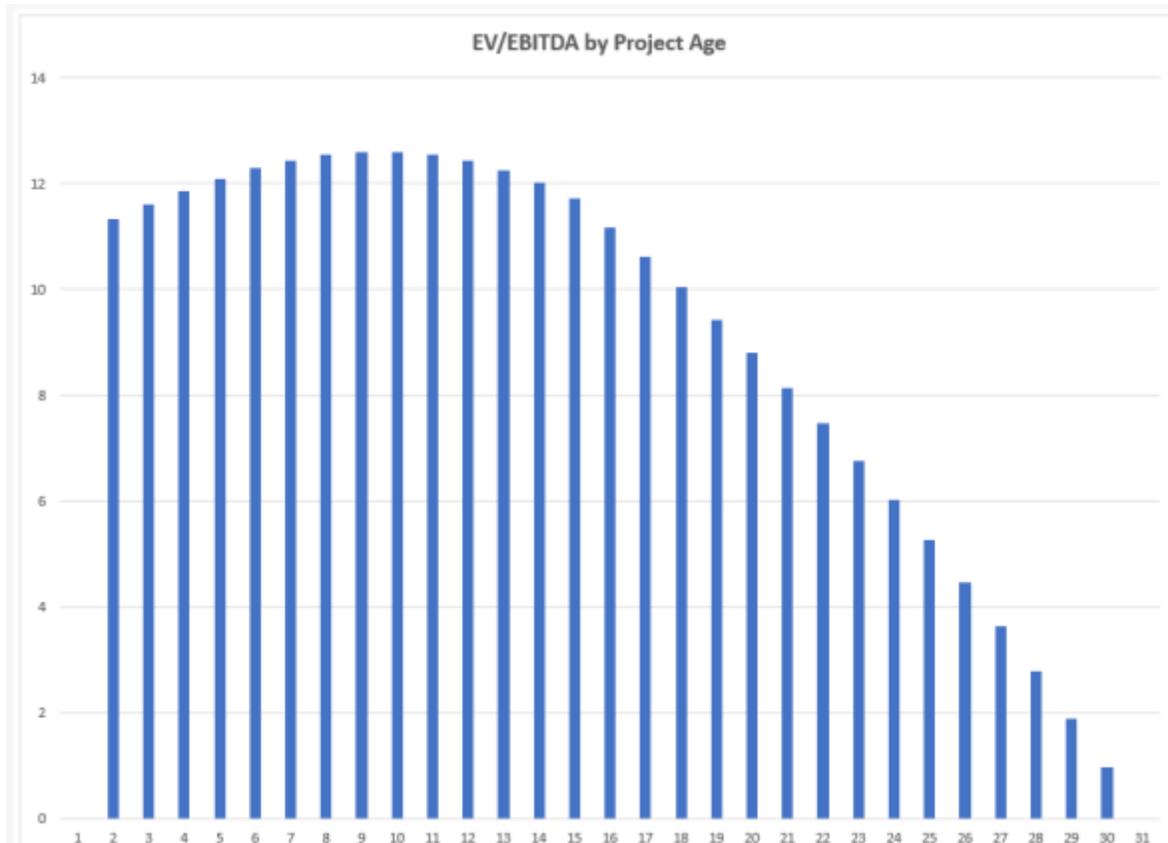
In this chapter I hope to provide methods of thinking about how you can adjust multiples to receive to remove distortions. For example, if you have two companies in an industry -- one is the company you were valuing company. The other two are comparison companies. If one of the companies earning a higher rate of return and the company being valued while the second comparable company is earning a similar rate of return. Then you could see a ... the company earning the high rate of return and derive and adjusted multiple assuming that company would earn a similar rate of return. This may sound a little complicated but unless adjustments are made, the whole idea of you suppose can give you.

### **Multiples are Distorted even if Returns and Growth were Stable**

If things worked. Simple case. Could find the cost of capital. If had the return on capital (remember the last discussion). If different returns and different growth for different companies. Could derive the multiple for the company in question. Could derive the cost of capital for each company.

### **Multiples and Project Finance**

Kind of things that are obvious once you make a very simple analysis. Demonstrates something that also should be obvious, namely that companies with older assets should have lower EV/EBITDA.



***Figure 38 – EV to EBITDA for a Single Investment with Changing Risk and Decline from Lower Cash Flow with Shorter Remaining Life***

**Constant Return and Different Growth – Multiples Affected by Different Growth Prospects**

When young investment bankers put their value presentations together an analysis of comparative multiples, they do not show the return and growth prospects next to each comparative company. To compare one company that may have different growth prospects than other companies, the multiples will be different because of the different growth. For example, if the company being valued has a relatively low growth potential while the comparative companies have higher growth prospective, using the comparative sample with higher growth will overstate the value of the company being valued. It can be argued that this is the typical problem with terminal value where multiples are used in comparative analysis. Table xxx illustrates comparative multiples for a case study developed by Kellogg business school. Note the extremely wide variation in both the P/E and the EV/EBITDA multiples. Maybe you

could throw out some extreme companies; compute the median; select a couple of the companies with a little discussion. But in the end, we all know it will be rubbish.

### Illustration of Using Multiples – GE Case Study

No fancy new things here. History presented – and long-term history. Return and growth the central parts of Comparison

All comes down to two variables – ROE and P/E ratio. Alternatively ROE and growth.

My father got this and used to spend time sorting it out.

IRR connected which is called annual return

| GENERAL ELECTRIC NYSE-GE   |        |                 |  |       |       |       |       |        |       |       |       |       |       |       |       | RECENT PRICE          | 27.48 <sup>G</sup> | P/E RATIO                         | 16.1 (Trailing: 15.1 Median: 15.0) | RELATIVE P/E RATIO | 0.83   | DIVD YLD | 3.5%   | VALUE LINE |        |        |        |                                   |        |  |  |     |
|--|--------|-----------------|--|-------|-------|-------|-------|--------|-------|-------|-------|-------|-------|-------|-------|-----------------------|--------------------|-----------------------------------|------------------------------------|--------------------|--------|----------|--------|------------|--------|--------|--------|-----------------------------------|--------|--|--|-----|
| TIMELINESS   | 3      | Lowered 4/18/14 | High:  | 37.8  | 37.3  | 38.5  | 42.2  | 38.5   | 17.5  | 19.7  | 21.7  | 23.2  | 28.1  | 27.9  | 26.3  | Target Price          | Range              |                                   |                                    |                    |        |          |        |            |        |        |        |                                   |        |  |  |     |
| SAFETY   | 3      | Lowered 3/13/09 | Low:   | 28.9  | 32.7  | 32.1  | 33.9  | 12.8   | 5.7   | 13.8  | 14.0  | 18.0  | 20.7  | 23.7  | 23.4  | 2018                  | 2019               | 2020                              |                                    |                    |        |          |        |            |        |        |        |                                   |        |  |  |     |
| TECHNICAL  | 3      | Lowered 2/21/14 | <b>LEGENDS</b><br>..... 10.5 x "Cash Flow" p sh<br>- - - - Relative Price Strength<br>Options: Yes<br>Shaded area indicates recession  |       |       |       |       |        |       |       |       |       |       |       |       |                       |                    |                                   |                                    |                    |        |          |        |            |        |        |        |                                   |        |  |  |     |
| BETA   | 1.15   | (1.00 = Market) | <b>2018-20 PROJECTIONS</b><br>Price High 45 (+65%) Low 30 (+10%)<br>Gain Ann'l Total Return 16% 6%<br><b>Insider Decisions</b><br>M J J A S O N D J<br>to Buy 0 0 1 0 0 0 0 0 0 0<br>Options 0 0 0 0 0 0 2 0 0 0<br>to Sell 0 0 0 0 0 0 1 0 0 0<br><b>Institutional Decisions</b><br>2Q2014 3Q2014 4Q2014<br>to Buy 866 848 925<br>to Sell 818 838 846<br>Hd's (M) 535388054076585498474<br>Percent shares traded 12 8 4 |       |       |       |       |        |       |       |       |       |       |       |       |                       |                    |                                   |                                    |                    |        |          |        |            |        |        |        |                                   |        |  |  |     |
| <b>1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016</b>   |        |                 |  |       |       |       |       |        |       |       |       |       |       |       |       | © VALUE LINE PUB. LLC | 18-20              |                                   |                                    |                    |        |          |        |            |        |        |        |                                   |        |  |  |     |
| 11.33  | 13.07  | 12.69           | 13.21  | 13.33 | 14.44 | 14.28 | 15.90 | 17.30  | 17.32 | 14.70 | 14.15 | 13.93 | 14.16 | 14.52 | 14.76 | 15.15                 | 15.35              | Revenues per sh                   | 18.10                              |                    |        |          |        |            |        |        |        |                                   |        |  |  |     |
| 1.77   | 2.06   | 2.14            | 2.12   | 2.24  | 2.38  | 2.56  | 2.90  | 3.28   | 2.81  | 2.07  | 2.13  | 2.28  | 2.44  | 2.65  | 2.60  | 2.65                  | 2.75               | "Cash Flow" per sh                | 3.65                               |                    |        |          |        |            |        |        |        |                                   |        |  |  |     |
| 1.07   | 1.29   | 1.41            | 1.51   | 1.55  | 1.61  | 1.72  | 1.99  | 2.20   | 1.78  | 1.03  | 1.15  | 1.31  | 1.52  | 1.64  | 1.65  | 1.70                  | 1.80               | Earnings per sh <sup>B</sup>      | 2.60                               |                    |        |          |        |            |        |        |        |                                   |        |  |  |     |
| .49  | .57    | .64             | .73  | .77   | .82   | .91   | 1.03  | 1.15   | 1.24  | .61   | .46   | .61   | .70   | .79   | .88   | .92                   | 1.00               | Div'ds Decl'd per sh <sup>C</sup> | 1.40                               |                    |        |          |        |            |        |        |        |                                   |        |  |  |     |
| .21  | .26    | .29             | .24  | .97   | 1.24  | 1.38  | 1.62  | 1.79   | 1.52  | .81   | .92   | 1.20  | 1.45  | 1.34  | 1.35  | 1.40                  | 1.45               | Cap'l Spending per sh             | 1.60                               |                    |        |          |        |            |        |        |        |                                   |        |  |  |     |
| 4.32   | 5.08   | 5.52            | 6.39   | 7.87  | 10.47 | 10.43 | 10.93 | 11.57  | 9.93  | 11.00 | 11.20 | 11.01 | 11.82 | 12.98 | 12.73 | 13.75                 | 14.75              | Book Value per sh <sup>D</sup>    | 17.70                              |                    |        |          |        |            |        |        |        |                                   |        |  |  |     |
| 9854.5   | 9932.0 | 9925.9          | 9969.9   | 10063 | 10586 | 10484 | 10277 | 9987.6 | 10537 | 10663 | 10615 | 10573 | 10406 | 10061 | 10064 | 10050                 | 10050              | Common Shs Outst'g <sup>E</sup>   | 10000                              |                    |        |          |        |            |        |        |        |                                   |        |  |  |     |
| 35.9   | 40.1   | 30.8            | 20.7   | 18.1  | 20.5  | 20.5  | 17.3  | 17.2   | 15.7  | 13.0  | 14.4  | 13.9  | 13.3  | 14.7  | 15.7  | 15.7                  | 15.7               | Avg Ann'l P/E Ratio               | 15.0                               |                    |        |          |        |            |        |        |        |                                   |        |  |  |     |
| 2.05   | 2.61   | 1.58            | 1.13   | 1.03  | 1.08  | 1.09  | .93   | .91    | .94   | .87   | .92   | .87   | .85   | .83   | .82   | 82                    | 82                 | Relative P/E Ratio                | .94                                |                    |        |          |        |            |        |        |        |                                   |        |  |  |     |
| 1.3%   | 1.1%   | 1.5%            | 2.3%   | 2.7%  | 2.5%  | 2.6%  | 3.0%  | 3.0%   | 4.4%  | 4.6%  | 2.8%  | 3.4%  | 3.5%  | 3.3%  | 3.4%  | 3.4%                  | 3.4%               | Avg Ann'l Div'd Yield             | 3.7%                               |                    |        |          |        |            |        |        |        |                                   |        |  |  |     |
| <b>CAPITAL STRUCTURE as of 12/31/14</b><br>Total Debt \$272.2 bill. Due in 5 Yrs \$170.0 bill.<br>LT Debt \$200.4 bill. LT Interest \$11.0 bill.<br>(61% of Cap'l)<br>Leases, Uncapitalized \$900 mill.<br>Pension Assets-12/14 \$60.7 bill.<br>Obligation \$86.3 bill.<br>Pfd. Stock None<br>Pfd. Div'd None<br>Common Stock 10,064,909,484 shares<br>MARKET CAP: \$277 billion (Large Cap) |        |                 |  |       |       |       |       |        |       |       |       |       |       |       |       | 149702                | 163391             | 172738                            | 182515                             | 156783             | 150211 | 147300   | 147359 | 146045     | 148589 | 152400 | 154200 | Revenues (\$mill)                 | 181000 |  |  |     |
|  |        |                 |  |       |       |       |       |        |       |       |       |       |       |       |       | 30.6%                 | 32.5%              | 35.1%                             | 31.1%                              | 25.4%              | 26.8%  | 30.3%    | 27.7%  | 26.5%      | 26.7%  | 27.0%  | 27.3%  | Operating Margin <sup>A</sup>     | 30.0%  |  |  |     |
|  |        |                 |  |       |       |       |       |        |       |       |       |       |       |       |       | 8538.0                | 9158.0             | 10278                             | 11492                              | 10636              | 10013  | 9185.0   | 9346.0 | 9762.0     | 9283.0 | 9300   | 9600   | Depreciation (\$mill)             | 10500  |  |  |     |
|  |        |                 |  |       |       |       |       |        |       |       |       |       |       |       |       | 18275                 | 20666              | 22468                             | 18089                              | 11434              | 12623  | 14880    | 16065  | 16882      | 16600  | 17085  | 18090  | Net Profit (\$mill)               | 26000  |  |  |     |
|  |        |                 |  |       |       |       |       |        |       |       |       |       |       |       |       | 17.4%                 | 16.1%              | 15.5%                             | 5.5%                               | --                 | 7.4%   | 27.4%    | 14.4%  | 8.5%       | 13.0%  | 25.0%  | 25.0%  | Income Tax Rate                   | 25.0%  |  |  |     |
|  |        |                 |  |       |       |       |       |        |       |       |       |       |       |       |       | 12.2%                 | 12.6%              | 13.0%                             | 9.9%                               | 7.3%               | 8.4%   | 10.1%    | 10.9%  | 11.6%      | 11.2%  | 11.2%  | 11.7%  | Net Profit Margin                 | 14.4%  |  |  |     |
|  |        |                 |  |       |       |       |       |        |       |       |       |       |       |       |       | 184959                | 235281             | 244405                            | 254715                             | 316579             | 314972 | 272131   | 283910 | 245855     | 297289 | 303000 | 317000 | Working Cap'l (\$mill)            | 330000 |  |  |     |
|  |        |                 |  |       |       |       |       |        |       |       |       |       |       |       |       | 212281                | 260804             | 319015                            | 330067                             | 338215             | 360681 | 315832   | 312668 | 251789     | 200400 | 205000 | 210000 | Long-Term Debt (\$mill)           | 220000 |  |  |     |
|  |        |                 |  |       |       |       |       |        |       |       |       |       |       |       |       | 109354                | 112314             | 115559                            | 104665                             | 117291             | 118936 | 116438   | 123026 | 130566     | 128159 | 138000 | 148000 | Shr. Equity (\$mill) <sup>D</sup> | 177000 |  |  |     |
|  |        |                 |  |       |       |       |       |        |       |       |       |       |       |       |       | 7.1%                  | 6.7%               | 6.4%                              | 5.6%                               | 4.6%               | 3.9%   | 4.8%     | 4.8%   | 5.6%       | 5.5%   | 6.5%   | 6.5%   | Return on Total Cap'l             | 8.0%   |  |  |     |
|  |        |                 |  |       |       |       |       |        |       |       |       |       |       |       |       | 16.7%                 | 18.4%              | 19.4%                             | 17.3%                              | 9.7%               | 10.6%  | 12.8%    | 13.1%  | 12.9%      | 13.0%  | 12.5%  | 12.0%  | Return on Shr. Equity             | 14.5%  |  |  |     |
|  |        |                 |  |       |       |       |       |        |       |       |       |       |       |       |       | 8.2%                  | 9.1%               | 9.5%                              | 5.4%                               | 2.1%               | 6.6%   | 7.2%     | 7.2%   | 6.9%       | 6.0%   | 6.0%   | 5.5%   | Retained to Com Eq                | 7.0%   |  |  |     |
| CURRENT POSITION   |        |                 |  |       |       |       |       |        |       |       |       |       |       |       |       | 2012                  | 2013               | 12/31/14                          |                                    |                    |        |          |        |            |        |        |        |                                   |        |  |  | 54% |
|  |        |                 |  |       |       |       |       |        |       |       |       |       |       |       |       | 51%                   | 50%                | 51%                               | 69%                                | 79%                | 38%    | 43%      | 45%    | 46%        | 53%    | 54%    | 56%    | All Div'ds to Net Prof            | 54%    |  |  |     |

***Figure 39 – Computation of Value Using P/E Ratio where the Forecast of Earnings Included Increase in Return on Capital to 8% from 5.5% and P/E Ratio of 15 that Resulted in Price Forecast of \_\_\_ While the Actual Price Declined to \_\_\_***

By using the basic valuation formula –  $\text{Value/Income} = (1-g/\text{ROI})/(\text{CoC} - g)$  you can see why different companies have different multiples. If the cost of capital is held constant across comparative companies and the return is greater than the cost of capital, then companies that are expected to grow faster will have a higher multiple. Alternatively, if the ROI is below the cost of capital, then lower growth increases the multiple. Therefore, instead of simply listing multiples as in the table xxx, you should put the returns, the expected returns and the expected returns next to the multiples. You could in theory make adjustments for different returns and different growth rates to the multiples to attempt to resolve the differences.

To illustrate issues with comparative multiples and use of multiples to evaluate potential differences in value I have constructed a simple model. I have made some different scenarios with different returns and growth rates (in this case I hold returns and growth rates constant over time) that are shown in Table xxx. If the returns change over time because of expected profits or changes in the age of assets or large capital expenditures or write-offs, this assumption of a constant return cannot be made and the analysis. As discussed in the last chapter, you are searching for the true return and if you cannot find it you cannot really evaluate multiples. The non-replacement of capital expenditures and write-offs is at least one reason why, if you look at the Dow 30, many of the companies have extremely high returns that cannot be assumed to continue indefinitely. For these Dow 30 companies, the earned return is nowhere near the economic return.

Constant Return Cases

|                 |   | Base     | High<br>Return | Low<br>Return | Return<br>=COC | Return<br>below<br>COC |
|-----------------|---|----------|----------------|---------------|----------------|------------------------|
| ROIC            |   | 7.00%    | 8.00%          | 6.50%         | 6.00%          | 3.00%                  |
| Growth          | 7 | 2.00%    | 2.00%          | 2.00%         | 2.00%          | 2.00%                  |
| Cost of Capital | 6 | 6.00%    | 6.00%          | 6.00%         | 6.00%          | 6.00%                  |
| Current Return  |   | 5.50%    | 7.00%          | 4.50%         | 6.00%          | 3.00%                  |
| Future Return   |   | 5.50%    | 7.00%          | 4.50%         | 6.00%          | 3.00%                  |
| Book Value      |   | 1,000.00 | 1,000.00       | 1,000.00      | 1,000.00       | 1,000.00               |
| Initial Income  |   | 55.00    | 70.00          | 45.00         | 60.00          | 30.00                  |
| Value formula   |   | 982.14   | 1,312.50       | 778.85        | 1,000.00       | 250.00                 |
| Value/Earnings  |   | 17.86    | 18.75          | 17.31         | 16.67          | 8.33                   |

**Figure 40 – Simulated Value to Earnings Ratio with Returns that are the Same as in the Future Demonstrating that Value Driver Formula Results in Correct Multiple**

In this case with constant returns and cost of capital, you can apply formula  $\text{Value} = \text{Income} \times (1-g/\text{Return})/(\text{CoC} - g)$  and it works. Figure xxx shows the earnings multiple with different growth rates using the base assumptions in Table xxx. When the return is above the cost of capital, you want to reduce the growth. Importance of the case where the return = cost of capital. If you knew this and if the return and cost of capital are constant, then  $\text{P/E} = 1/\text{Cost of Capital}$  or  $\text{Cost of Capital} = 1/\text{P/E}$ . Note also that if there is no growth the Cost of capital =  $1/\text{P/E}$ . This has big implications. If you can find companies with no growth you can get an approximation of the cost of capital. If you are working on M&A cases and believe you can increase growth for a company earning a high rate of return, this is the value of the synergies.

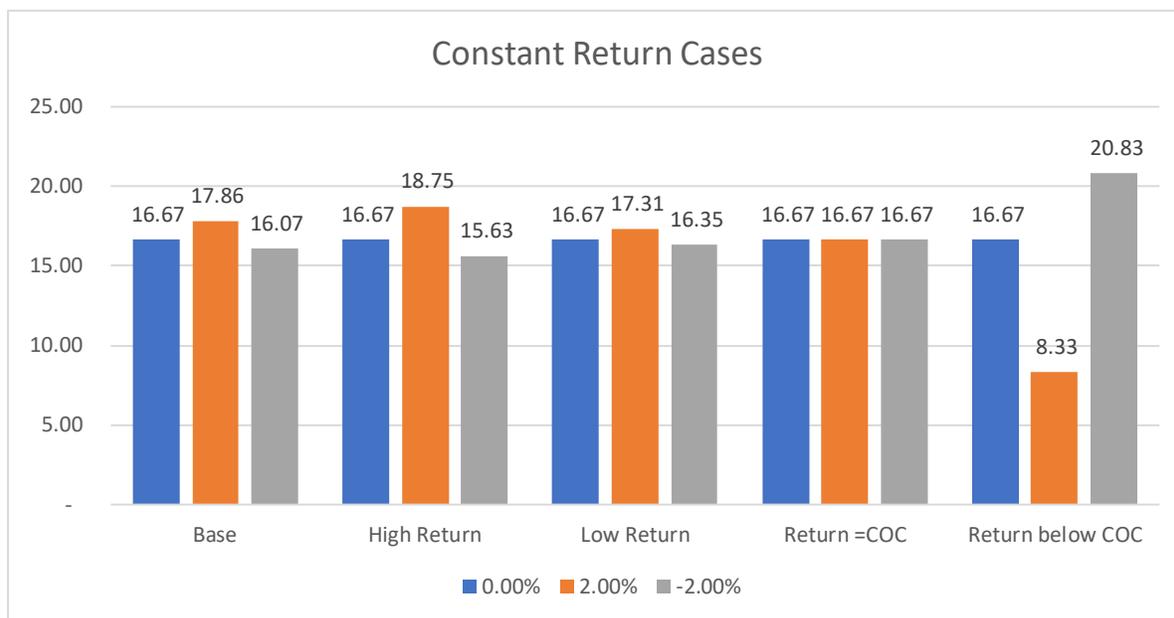
Note that income can be expressed as book value x current Return

Therefore,  $\text{Value} = \text{Book Value} \times \text{Current ROE} \times (1-\text{growth}/\text{ROE})/(\text{Cost of Capital}-\text{growth})$

If the future ROE = Current ROE, the  $\text{Value} = \text{Book Value} \times (\text{ROE}-\text{Growth})/(\text{COC} - \text{Growth})$

In theory the multiples such as the P/E ratio could be adjusted for differences in growth. This could be presented in an analogous manner un-levering and re-levering betas. One could imagine a table with a list of the return on investment and sales growth. Then there could be a column that would show the adjusted P/E multiple. I have not bothered to try this, but one

wonders why fancy investment bankers who make presentations of un-levering and re-levering betas could not develop something similar.



***Figure 41 – Earnings to Value Ratio with Different Returns and Growth Rates Demonstrating Effect of High Growth Versus Low Growth in the Context of Different Returns***

### **Changing Return and Growth – the Value Driver Formula Falls Apart**

If companies stayed completely stable earning constant returns, and we knew that would occur, then valuation and financial analysis would be boring. We could then back out the cost of capital from multiples and the value of a company could be defined precisely using growth rate estimates and the value driver formula. But when the rate of return and growth changes, the value driver formula does not give you an accurate number. Further, there is no magic way the ROE converges from the existing level to the new level. When you put a changing ROI into the formula, the growth rate in income that results is not the growth rate that is input. You can think of the growth rate as the growth rate in investment or capital expenditures. The resulting growth rate will be higher if the return-on-investment increases. McKinsey does not mention this in their book.

We can look to Amazon and GE again to see how changes in value are driven by changes in the return and growth. Given the dramatic changes in stock prices of both companies, it is clear that the changes and growth were not easy to forecast. The growth and the return are shown on the figure xxx below. Indeed, the real essence of people who make valuations is to make forecasts of these items.

The effect of changing returns are show in Table xxx and Figure xxxx. The calculated multiple in the table is computed from making a model of cash flow with an interpolated rate of return that is shown in table xxx. Table xxx shows that when the returns decline the value driver formula over-states the valuation of multiple. On the other hand, when the return is increasing the, true multiple is higher than the multiple computed from the simple value driver formula. In Figure xxx, the computed value is shown in blue while the simple value driver formula that falls apart in orange.

|                    | 0                                | 1        | 2          | 3        | 4        | 5        | 6        | 7        | 8        | 9        | 10       |
|--------------------|----------------------------------|----------|------------|----------|----------|----------|----------|----------|----------|----------|----------|
| Scenario           | Increasing Return 4.50% to 7.00% |          |            |          |          |          |          |          |          |          |          |
| Inputs             |                                  |          |            |          |          |          |          |          |          |          |          |
| Return             | 4.50%                            | 7.00%    |            |          |          |          |          |          |          |          |          |
| Growth             | 1.00%                            | 1.00%    |            |          |          |          |          |          |          |          |          |
| Payout             | 77.78%                           | 85.71%   | =(1-E6/E5) |          |          |          |          |          |          |          |          |
| Cost of Capital    | 6.00%                            |          |            |          |          |          |          |          |          |          |          |
| Model              |                                  |          |            |          |          |          |          |          |          |          |          |
| Return             | 4.50%                            | 4.92%    | 5.37%      | 5.87%    | 6.41%    | 7.00%    | 7.00%    | 7.00%    | 7.00%    | 7.00%    | 7.00%    |
| Payout             | 77.78%                           | 79.66%   | 81.38%     | 82.95%   | 84.39%   | 85.71%   | 85.71%   | 85.71%   | 85.71%   | 85.71%   | 85.71%   |
| Opening Book Value |                                  | 1,000.00 | 1,010.00   | 1,020.10 | 1,030.30 | 1,040.60 | 1,051.01 | 1,061.52 | 1,072.14 | 1,082.86 | 1,093.69 |
| Add: Income        |                                  | 49.16    | 54.24      | 59.84    | 66.02    | 72.84    | 73.57    | 74.31    | 75.05    | 75.80    | 76.56    |
| Less: Dividend     |                                  | 39.16    | 44.14      | 49.64    | 55.72    | 62.44    | 63.06    | 63.69    | 64.33    | 64.97    | 65.62    |
| Closing Book Value | 1,000.00                         | 1,010.00 | 1,020.10   | 1,030.30 | 1,040.60 | 1,051.01 | 1,061.52 | 1,072.14 | 1,082.86 | 1,093.69 | 1,104.62 |
| Terminal Value     |                                  |          |            |          |          |          |          |          |          |          |          |
| Total Cash         |                                  | 39.16    | 44.14      | 49.64    | 55.72    | 62.44    | 63.06    | 63.69    | 64.33    | 64.97    | 65.62    |
| Growth Rate        |                                  |          | 10.33%     | 10.33%   | 10.33%   | 10.33%   | 1.00%    | 1.00%    | 1.00%    | 1.00%    | 1.00%    |
| Value              | 1,151.14                         |          |            |          |          |          |          |          |          |          |          |
| Formula Value      | 771.43                           |          |            |          |          |          |          |          |          |          |          |
| PE Ratio - Correct | 23.42                            |          |            |          |          |          |          |          |          |          |          |
| PE Ratio - Formula | 15.69                            |          |            |          |          |          |          |          |          |          |          |

**Figure 42 – Simulation Model for Value to Earnings Ratio with Changing Returns and Changing Growth Demonstrating the Value Driver Ratio Cannot Be Applied to Evaluate Multiple**

|                   | Reducing<br>Return<br>7.00% to<br>6.50% | Reducing<br>Return<br>8.00% to<br>7.00% | Increasing<br>Return<br>4.50% to<br>7.00% | Return<br>=COC<br>6.00% | Increasing<br>Return<br>3.00% to<br>7.00% |
|-------------------|---|---|---|-------------------------|---|
| ROIC              | 6.50%                                   | 7.00%                                   | 7.00%                                     | 6.00%                   | 7.00%                                     |
| Growth            | 1.00%                                   | 1.00%                                   | 1.00%                                     | 1.00%                   | 1.00%                                     |
| Cost of Capital   | 6.00%                                   | 6.00%                                   | 6.00%                                     | 6.00%                   | 6.00%                                     |
| Current Return    | 7.00%                                   | 8.00%                                   | 4.50%                                     | 6.00%                   | 3.00%                                     |
| Future Return     | 6.50%                                   | 7.00%                                   | 7.00%                                     | 6.00%                   | 7.00%                                     |
| Book Value        | 1,000.00                                | 1,000.00                                | 1,000.00                                  | 1,000.00                | 1,000.00                                  |
| Initial Income    | 70.00                                   | 80.00                                   | 45.00                                     | 60.00                   | 30.00                                     |
| Value formula     | 1,184.62                                | 1,371.43                                | 771.43                                    | 1,000.00                | 514.29                                    |
| Value/Earnings    | 16.92                                   | 17.14                                   | 17.14                                     | 16.67                   | 17.14                                     |
| Transition Period | 5                                       | 5                                       | 5   | 5                       | 5   |
| Corrected Value   | 1,108.87                                | 1,217.53                                | 1,151.14                                  | 1,000.00                | 1,116.27                                  |
| Corrected P/E     | 16.08                                   | 15.63                                   | 23.42                                     | 16.67                   | 31.41                                     |

***Figure 43 – Table with Effects of Changing Returns on the Value/Earnings Ratio Demonstrating the Error From Using the Value Driver Formula in Different Cases (Most Extreme Case is Increase in Return from 3% to 7%)***

#### **Understanding the ratio of capital expenditures to depreciation**

Capital expenditures and depreciation are part of the computation of invested capital that, together with the assumed return, drives income. The income in turn drives cash flow that determine value. The ratio of capital expenditures relative to depreciation is important in projecting cash flows that result from assumed return on investment. For example, as the capital expenditures to depreciation ratio is driven by growth and the lifetime of investment, if

you change the assumed growth you can use the capital expenditure ratio to compute normalised cash flow.

I have been naïve by thinking people at investment banks must have some sophisticated way to compute stable ratios of capital expenditure to depreciation and the depreciation ratio on net plant. With this calculation, instead of applying some kind of arbitrary and simple valuation approach like the growth model or multiples or even the value driver formula.

Eyes will probably glaze over, but if you do not know to make a table of growth and depreciation and capital expenditure you will go wrong. In the NS/CP case the Harvard Professor Ben Esty (a very nice man), suggested that the terminal capital expenditure to depreciation should be \_\_\_\_.

Need a round of stabilization – move until work through the life of the plant. You must compute the retirements and the replacement of retirements. Unfortunately this means the future ratio depends on historic growth as well as future growth.

Need to make an explicit or implicit forecast of capital expenditures. Any cash flow subtracts capital expenditures. If you do not have a reasonable estimate of capital expenditures everything will fall apart.

|      |    | Growth |       |       |       |       |
|------|----|--------|-------|-------|-------|-------|
|      |    | 1.32   | 2.00% | 3.00% | 4.00% | 5.00% |
| Life | 5  | 1.06   | 1.09  | 1.12  | 1.15  |       |
|      | 10 | 1.12   | 1.18  | 1.23  | 1.28  |       |
|      | 15 | 1.19   | 1.27  | 1.34  | 1.41  |       |
|      | 20 | 1.27   | 1.36  | 1.45  | 1.54  |       |
|      | 25 | 1.36   | 1.46  | 1.57  | 1.68  |       |
|      | 30 | 1.45   | 1.57  | 1.69  | 1.82  |       |
|      | 35 | 1.54   | 1.67  | 1.81  | 1.95  |       |
|      | 40 | 1.67   | 1.82  | 1.97  | 2.12  |       |

**Figure 44 – Capital Expenditure to Depreciation with Different Economic Life and Different Growth Demonstrating the Rate of Replacement is High with High Growth and Long Life, while if the Life is Short Like Inventory, the Replacement Ratio is About 1.0**

## Effect of Projected Growth Rates that are Different from Historic Growth Rates

Assume that you start your multiple analysis or terminal value in year 20, after the life has stabilized. In case 1 assume that the historical growth rate was high. In case 2 assume that it was low. You get different ratios of capital expenditure to depreciation.

## EV/EBITDA calculation and Stable Capital Expenditures

They won't even do it for P/E ratios where you use income after depreciation. EV/EBITDA is more complicated because you have to come up depreciation yourself.

|      |    | Growth |       |       |       |       |
|------|----|--------|-------|-------|-------|-------|
|      |    | 5.50%  | 6.00% | 6.50% | 7.00% | 7.50% |
| Life | 5  | 7.66   | 8.43  | 9.18  | 9.91  | 10.62 |
|      | 10 | 10.87  | 11.88 | 12.85 | 13.78 | 14.67 |
|      | 15 | 13.44  | 14.60 | 15.70 | 16.74 | 17.72 |
|      | 20 | 15.56  | 16.82 | 18.00 | 19.10 | 20.12 |
|      | 25 | 17.34  | 18.68 | 19.90 | 21.03 | 22.09 |
|      | 30 | 18.88  | 20.25 | 21.51 | 22.66 | 23.73 |
|      | 35 | 20.21  | 21.62 | 22.89 | 24.06 | 25.13 |
|      | 40 | 21.38  | 22.81 | 24.10 | 25.28 | 26.35 |

***Figure 45 - Table Demonstrating Effect of Asset Life on the EV/EBITDA Ratio***

## What Drives Differences in the EV/EBITDA Ratio

All agree that multiples affected by cost of capital and growth. I wonder if you asked the following questions to investment bankers what their response would be. To answer the questions, start with a basic case.

Start with a simple one – taxes. If higher tax rate will EV/EBITDA be higher or lower. The answer is that it will be higher. Need more cash flow EBITDA for the same level of income. So the EV is lower from the payment of taxes, but the EBITDA does not change because it does not have taxes in it.

|      |    | WACC   |       | 5.50% |       |       |
|------|----|--------|-------|-------|-------|-------|
|      |    | ROIC   |       |       |       |       |
|      |    | Growth |       |       |       |       |
|      |    | 5.50%  | 6.00% | 6.50% | 7.00% | 7.50% |
| Life | 5  | 4.14   | 4.67  | 5.19  | 5.69  | 6.18  |
|      | 10 | 5.86   | 6.60  | 7.31  | 8.00  | 8.66  |
|      | 15 | 7.29   | 8.19  | 9.04  | 9.86  | 10.63 |
|      | 20 | 8.51   | 9.53  | 10.49 | 11.39 | 12.23 |
|      | 25 | 9.57   | 10.68 | 11.72 | 12.68 | 13.58 |
|      | 30 | 10.48  | 11.67 | 12.77 | 13.78 | 14.72 |
|      | 35 | 11.29  | 12.54 | 13.69 | 14.74 | 15.71 |
|      | 40 | 12.00  | 13.31 | 14.50 | 15.58 | 16.58 |

**Figure 46 - Example of How Variables Affect the EV/EBITDA Ratio - The Case of Working Capital**

EV/EBITDA is also driven by the life of the plant as shorter life means that you have to replace sooner and will have a higher level of investment for the same EBITDA. A dramatic Effect of Plant Life on EV/EBITDA.

Big problem is the EBITDA ratios. Understand why they are used because no distortion from depreciation. Both EV/EBITDA and Debt/EBITDA distorted. Second issue is trends in ROI and growth (already introduced). Age of assets. Depreciation life of assets. Use current income that is affected by depreciation.

Effect of working capital – receive higher return for the same level of EBITDA (the EBITDA is not affected by the working capital change). Changed days revenues from 10 to 90.

|      |    | WACC 5.50% |       |       |       |       |
|------|----|------------|-------|-------|-------|-------|
|      |    | ROIC       |       |       |       |       |
|      |    | Growth     |       |       |       |       |
|      |    | 5.50%      | 6.00% | 6.50% | 7.00% | 7.50% |
| Life | 5  | 19.74      | 21.63 | 23.52 | 25.41 | 27.31 |
|      | 10 | 22.26      | 24.30 | 26.31 | 28.31 | 30.29 |
|      | 15 | 24.34      | 26.47 | 28.55 | 30.59 | 32.62 |
|      | 20 | 26.09      | 28.28 | 30.40 | 32.48 | 34.51 |
|      | 25 | 27.61      | 29.83 | 31.98 | 34.07 | 36.11 |
|      | 30 | 28.94      | 31.19 | 33.35 | 35.45 | 37.50 |
|      | 35 | 30.11      | 32.39 | 34.56 | 36.66 | 38.71 |
|      | 40 | 31.17      | 33.46 | 35.65 | 37.75 | 39.80 |

Use project finance valuation again to demonstrate problems. EV/EBITDA with

### Computing Adjusted Multiples Like Re-Levered Betas

This is not as easy as un-levering and re-levering betas.

The process of using multiples generally involves finding a few comparable companies and then throwing out values that seem out of line. But the multiples are not adjusted for companies that have different return or growth nor for the relationship between return and growth. Some of the new stuff in this chapter for you to think about includes:

1. The value driver formula:  $\text{Value/Earnings} = (1-g/\text{Return})/(\text{Cost of Capital} - g)$  is not useful in assessing the P/E multiple because of changes in the return.
2. Use of project finance for a single asset demonstrates problems with multiples for corporations where the assets are aging, and investment is not re-invested.

3. Dividing the value driver formula into existing and future return does not solve the problem and there is no magic convergence of existing return to the future return.
4. To understand the EV/EBITDA ratio stable ratios of depreciation to capital expenditures, net plant depreciation rate should be established.
5. How can you compute imputed multiples that adjust for changes in return; different growth rates; different returns; age of plants and other things that drive the different multiples.
6. When comparing the valuation multiples, provision should be made for the age of the assets and distortions created by straight line depreciation.
7. The EV/EBITDA and Debt to EBITDA ratio depend to a large extent on lifetime of assets which drives capital expenditure requirements and ignoring the age of assets in using EV/EBITDA leads to distortions
8. The price to book ratio or EV/Invested capital ratio can be used to evaluate performance and cost of capital in an effective manner.
9. The DSCR gives you an evaluation of risk that is more effective than other measures of risk measurement.

# Chapter 7:

## The Sin of Simplistic Terminal Value Formulas in Valuation – the Elephant in the Room of Corporate Finance

### When Somebody Talks about Three Statement Financial Models You Should Throw-up

For a while an engineer named Max called me every day. We had made a deal where Max would tell me about hydrogen and I would explain financial modelling to him. Max listened to me a bit, but he did not completely trust me. So, he went to a website and took a course in how to build a three-statement financial model. After working on a model for Amazon (the company, not the river), he asked for help on balancing the balance sheet. Now as a modeller, I do understand the ecstasy of balancing the balance sheet. But I asked him where the presentation of long-term growth and return on investment was in his model from the corporate finance institute. It was nowhere. He was able to balance the balance sheet but could not present the historic return on investment relative to the projected return on investment. Nor could he show me a nice

presentation of the assumed growth rate and whether the implicit assumptions meant that absolutely everything that you bought – from houses to cars to financial modelling courses – would be from Amazon.



The key output from this three statement financial model should have been the company value. But this calculation used a simple terminal growth and applied the terminal growth to cash flow that was not normalized. There was no way to evaluate whether the expenditures for warehouses, trucks or other things was sufficient to support the assumed long-term growth. You could not see whether the economic return on investment was reasonable compared to other possible ways to buy things. Even though Amazon may be very efficient, other companies can sell things on-line and other stores can still realize a margin from selling stuff in stores. So making some kind of implicit assumption that Amazon can earn a really high return may not be reasonable.

## Overview of Terminal Value Methods

### When You meet the CEO, you Better not Tell Him or Her that Your Company will End Soon

Let's say you are an employee of Amazon. Jeff Bezos calls you to his office and asks you how long do you think Amazon will last. You probably should say that it will last for ever or maybe more properly say that it is on-going. That is a long time. If you computed the duration like the duration on a bond, it would have a very long life. When computing value you could split cash flow from the first five years and compute the value from year six until forever. One would think the value of the second piece would be much bigger.

This chapter and the next address what can be done to assess the value of second piece. In part the long-term value is the continuing advantage you have from developing existing assets. But it also depends a lot on whether you believe future generations of management can do the things like forced obsolescence mentioned in Chapter 2 to earn economic profit. Now assume you don't even know what return you are assuming in the second piece. You may be assuming a higher return or a lower return than has been earned in the past. Given how important this assumption is, how you can make a forecast where you don't even know what you have assumed. But this is the case with using the constant growth method or, as pointed out in the last chapter, the multiples.

Given the intuition that Amazon valuation it is not surprising that it is a popular company to use in teaching financial modelling and valuation. Amazing that people have no idea what the implicit ROIC is in terminal value. Either in growth rate or in multiple do not know explicitly know what the assumption is. Heard stories where the capital expenditure is less than the depreciation and growth rate is positive.

Incredibly bad, and nobody will probably use my suggestions. But hopefully make you think. Second chapter uses a couple of examples.

### INSERT TERMINAL VALUE AS RELATIVE TO TOTAL VALUE

#### What You Are Really Measuring with Terminal Value – The Ability of Management to Continue Earning Economic Rent

May want to stop all economic profits – earnings above the cost of capital.

Before working through terminal value methods that can account for return on invested capital, growth and the changing risk. When presenting basic discounted cash flow analyses, we would use a constant growth rate. I would show how, because the discount rate is used in the terminal value:  $TV = \text{Cash Flow} \times (1+g)/(WACC-g)$ . This is on top of the cash flow and the terminal value being discounted by the WACC. The other method is to use the terminal value from multiplying the EV/EBITDA ratio.

Recall the keep calm and carry on box. Have low risk here.

### **Remarkably, Financial Models do Not Explicitly Consider Rate of Return in Terminal Value**

I have reviewed a model that is taught by the Corporate Finance Institute that shows you how to be proud of yourself for creating a three-statement financial model. Remarkably, the return on invested capital is not presented and there is no comparison between historic and projected returns. Instead, there is a valuation using a constant growth model where the assumed capital expenditures do not change with the alternative growth rates. Looked at case studies used in an MBA program. Provide spreadsheets with history and forecast. No calculation of ROIC or even ROE. No comparison of history and forecast.

If ROIC declines because of increased capital expenditure instead of trends in income, you can set this up in a schedule using a flag or a percentage. In one extreme, all of the change in return results from the change in income. In the other extreme all of the change in return comes from changes in the capital expenditures.

INSERT PICTURE OF CFI MODEL Output from model

Problems with Traditional Terminal Value – EV/EBITDA as Terminal Value

### **Proofs of Terminal Value**

Prove that what is wrong. More difficult to find a good method. The idea of proofs. Don't know what will happen in two years much less three hundred years. But we can make a simulation.

| Theoretical Value           |               | Value Driver Basic                                   | Value Driver Sudden | Value Driver Fade Period |
|-----------------------------|---------------|--|---------------------|--------------------------|
| <b>Value of Corporation</b> | <b>184.21</b> | <b>184.21</b>  | <b>184.21</b>       | <b>184.21</b>            |
| Driver (g or ROIC)          |               | 3.00%  | 10.00%              | 10.00% - 10.00%          |
| Price to Book               | 1.84          |  |                     |                          |
| Price to Earnings           | 18.42         |  |                     |                          |
| Explicit Period             | 10            |  |                     |                          |
| Fade Period                 | 6             |  |                     |                          |
| Cost of Capital             | 6.80%         |  |                     |                          |
| Terminal Period             | 12-Jan-34     | Value Driver Basic = Income * (1-g/ROI)/(k-g)        |                     |                          |
| End of Post Terminal        | 12-Jan-40     | Value Driver Basic = Capital * ROI * [1-g/ROI]/(k-g) |                     |                          |
| Cash Flow                   | 6.80          |  |                     |                          |
| Cash Flow x (1+g)/(WACC-g)  | 184.21        |  |                     |                          |



**Figure 47 – Theoretical Value from Long-term Growth with Constant Growth and Constant Return, Value is  $CF \times (1+g)/(WACC-g)$**

**Gordon’s Method**

What would assume in the constant growth method. Of course the TGR. But also the level of investment necessary to maintain the growth, the level of investment necessary to replace assets, the level of investment to grow, the implied rate of return, the change in risk associated with moving around the competitive strategy boxes.

After working through the terminal growth method sometimes called the Gordon's method. I admit I am biased. It is a good example of I have to talk about disgusting which the growth with method is named the Gordon. If you could find it found a little book written by a man named Gordon subjective was to increase cost of capital estimates so utility companies could get higher rates. He basically came up with a formula that's cost of capital value of a stock is the dividend / stock price. More specifically the future dividend if you're using an annual cost of capital, it would be the if you're using a quarterly it would be the next quarter's dividend. I suppose you would have to an annual eye quarter dividend 1 plus the number raised to the 4th power. If you have this value formula it's extremely simple to reverse the formula and derive the cost of capital so in utility cases where companies have a pretty record of continual record of dividend is compute the dividend yield Kylie has the growth rate estimate of the cost of capital.

Stable Period Adjustment to Growth Method   

|                             | Theoretical Value | Growth Rate   | Value Driver Basic                                     | Value Driver Sudden | Value Driver Fade Period |
|-----------------------------|-------------------|---------------|--|---------------------|--------------------------|
| <b>Value of Corporation</b> | <b>183.72</b>     | <b>155.43</b> | <b>181.79</b>  | <b>181.79</b>       | <b>181.79</b>            |
| Driver (g or ROIC)          |                   | 2.50%         | 10.00%   | 10.00%              | 10.00% - 10.00%          |
| Price to Book               | 1.84              |               |  |                     |                          |
| Price to Earnings           | 18.37             |               |  |                     |                          |
| Explicit Period             | 10                |               |  |                     |                          |
| Fade Period                 | 6                 |               |  |                     |                          |
| Cost of Capital             | 6.80%             |               |  |                     |                          |
| Terminal Period             | 12-Jan-34         |               | Value Driver Basic = Income * (1-g/ROIC)/(k-g)         |                     |                          |
| End of Post Terminal        | 12-Jan-40         |               | Value Driver Basic = Capital * ROIC * (1-g/ROIC)/(k-g) |                     |                          |
| Cash Flow                   | 5.85              |               |  |                     |                          |
| Cash Flow x (1+g)/(WACC-g)  | 139.53            |               |  |                     |                          |

Flat Constant Return Case  
Lower Terminal Growth Case



**Figure 48 – Gordon Method versus Other Approaches from Growth Rate Method (155) without Stable Period Adjustment**

How can somebody have there be dang attributed to this simple formula that basically is a perpetuity formula that adds the fact that the growth rate learning and growth are the same thing. Writing a whole book about this simple formula. That's fine it. I got off track.

The capital asset pricing model became more was that should we fight over the estimation of key the growth rate or should we fight over the estimation of beta in the Caravan by the way. By the way this is completely wrong because the equity Market risk premium much more controversial item in the model.

Other things remarkable the way people tell value is that if there was a cyclical in industry there would not be a big effort to use the return on invested capital for a typical year rather than a high or next year or lower. the further north there was also never attempt that I saw I just captain of the ratio of the capital expenditures to depreciation for changes in the terminal growth. In other words, if there's a higher terminal growth rate higher, there should be associated capital expenditures ratio to depreciation should be higher. We can use a user defined function to derive the capital expenditures and depreciation to derive different numbers and make things more automatic expected terminal growth rate.

| Time Line   | Driver 1 | Driver 2 | Driver 3 | Cost of Cap | 8      | 9      | 10     | 11     | 12                         | 13     | 14     |
|---|----------|----------|----------|-------------|--------|--------|--------|--------|----------------------------|--------|--------|
| Holding Period                                      | 10       |          |          |             | TRUE   | TRUE   | TRUE   | FALSE  | FALSE                      | FALSE  | FALSE  |
| Exit Period   | 10       |          |          |             | FALSE  | FALSE  | FALSE  | TRUE   | FALSE                      | FALSE  | FALSE  |
| Rate of Return Earned on Capital (Equity of Total)  |          |          |          |             | 10.00% | 10.00% | 10.00% | 10.00% | 10.00%                     | 10.00% | 10.00% |
| Growth Rate   |          |          |          |             | 4.00%  | 4.00%  | 4.00%  | 2.50%  | 2.50%                      | 2.50%  | 2.50%  |
| Dividend Payout (Money Extracted)                   |          |          |          |             | 60.00% | 60.00% | 60.00% | 75.00% | 75.00%                     | 75.00% | 75.00% |
| Opening Balance                                     |          |          |          |             | 131.59 | 136.86 | 142.33 | 148.02 | 151.73                     | 155.52 | 159.41 |
| Add: Net Income                                     |          |          |          |             | 13.16  | 13.69  | 14.23  | 14.80  | 15.17                      | 15.55  | 15.94  |
| Less Cash Flow (Dividend or Income - Cap Exp + Dep) |          |          |          |             | 7.90   | 8.21   | 8.54   | 11.10  | =IF(\$F\$13,V12*W8,V12*V8) |        |        |
| Closing Balance                                     |          |          |          | 100.00      | 136.86 | 142.33 | 148.02 | 151.73 | 155.52                     | 159.41 | 163.39 |
| Change in Investment                                |          |          |          |             | 5.26   | 5.47   | 5.69   | 3.70   | 3.79                       | 3.89   | 3.99   |
| Cash Flow Growth                                    |          |          |          |             | 4.00%  | 4.00%  | 4.00%  | 30.00% | 2.50%                      | 2.50%  | 2.50%  |
| Income Growth                                       |          |          |          |             | 4.00%  | 4.00%  | 4.00%  | 4.00%  | 2.50%                      | 2.50%  | 2.50%  |
| NPV of Dividends: True Value                        | 183.72   |          | 6.80%    |             |        |        |        |        |                            |        |        |
| Price to Earnings                                   | 18.37    |          |          |             |        |        |        |        |                            |        |        |
| Price to Book                                       | 1.84     |          |          |             |        |        |        |        |                            |        |        |
| Net Income and Dividend                             |          |          |          |             |        |        |        |        |                            |        |        |
| Terminal Period Cash Flow Before Change             |          | Term g   | 8        |             |        |        | 8.54   |        |                            |        |        |
| Value over Explicit Period                          | 49.99    |          | 6.80%    |             | 7.90   | 8.21   | 8.54   |        |                            |        |        |
| Growth Rate Multiplier (1+g)/(k-g)                  | 23.84    | 2.50%    | 6.80%    |             |        |        | 203.57 |        |                            |        |        |
| NPV of Terminal - Growth                            | 105.44   |          | 6.80%    |             |        |        |        |        |                            |        |        |
| Total Value   | 155.43   |          |          |             |        |        |        |        |                            |        |        |

**Figure 49 – Illustration of Normalization Adjustment with Implied Dividends and Re-investment from Growth Rate. Normalization Uses Re-investment from Future Terminal Growth and Not Current Level of Growth**

Now show the adjustment for normalisation where the future growth.

|                             | Theoretical   |               | Value Driver   |               |                 |
|-----------------------------|---------------|---------------|--|---------------|-----------------|
|                             | Value         | Growth Rate   | Basic  | Sudden        | Fade Period     |
| <b>Value of Corporation</b> | <b>182.90</b> | <b>182.90</b> | <b>182.90</b>  | <b>182.90</b> | <b>182.90</b>   |
| Driver (g or ROIC)          |               | 2.50%         | 10.00%   | 10.00%        | 10.00% - 10.00% |
| Price to Book               | 1.83          |               |  |               |                 |
| Price to Earnings           | 18.29         |               |  |               |                 |
| Explicit Period             | 10            |               | Flat Constant Return Case                            |               |                 |
| Fade Period                 | 6             |               | Lower Terminal Growth Case                           |               |                 |
| Cost of Capital             | 6.80%         |               |  |               |                 |
| Terminal Period             | 12-Jan-34     |               | Value Driver Basic = Income * (1-g/ROI)/(k-g)        |               |                 |
| End of Post Terminal        | 12-Jan-40     |               | Value Driver Basic = Capital * ROI * (1-g/ROI)/(k-g) |               |                 |
| Cash Flow                   | 5.85          |               |  |               |                 |
| Cash Flow x (1+g)/(WACC-g)  | 139.53        |               |  |               |                 |



**Figure 50 – Growth Method with Future Dividend Driven by (1-Terminal G/Future ROE) Rather than Current ROE**

**Use of Value Driver Formula in Terminal Value**

You can impress people with the formula and application is not very difficult all you have to do is add one more variable in your terminal analysis. Your terminal analysis should all already include the weighted average cost of capital the terminal growth rate.

Please note I just cost of capital weighted average cost of capital tax treatment in the weighted average cost of capital in subsequent chapters. So wouldn't it be why don't we just add for the turn on invested capital in addition to the growth rate.

Then we have all three formulas or something. Mechanically, all we have to do is compute a multiple. The multiple of the no cap and the value the formula below recounts this formula it's simply

$$\text{Enterprise Value} / \text{NOPAT} = (1 - G / \text{ROIC}) / (\text{WACC} - G).$$

We could then easily compute NOPAT which is necessary to compute the free cash flow anyway. You need to multiply the NOPAT by one minus the tax rate. We can compute NPOAT, and we can just multiply NOPAT. There is no requirement for making assumptions about capex to depreciation about making adjustments to the capital you just have NOPAT, and we have the multiple.

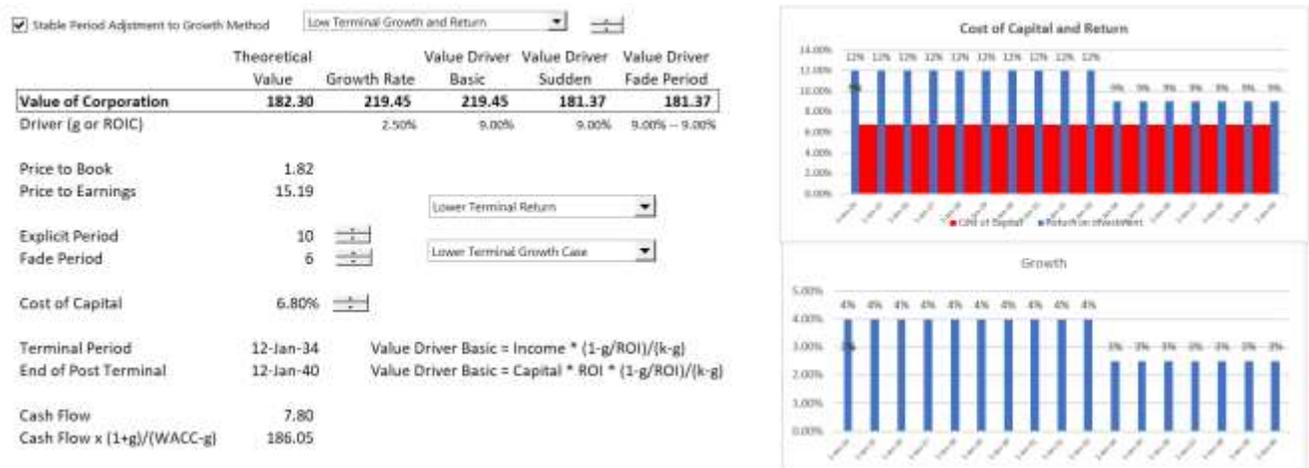
## Use of Value Driver Formula in Terminal Value

You can impress people with the formula and application is not very difficult all you have to do is add one more variable in your terminal analysis. Your terminal analysis should all already include the weighted average cost of capital the terminal growth rate.

Please note I just cost of capital weighted average cost of capital tax treatment in the weighted average cost of capital in subsequent chapters. So wouldn't it be why don't we just dad for the turn on invested capital in addition to the growth rate.

Then we have all three formulas or something. Mechanically, all we have to do is compute a multiple. The multiple of the no cap and the value the formula below recounts this formula it's simply

$$\text{Enterprise Value} / \text{NOPAT} = (1 - G / \text{ROIC}) / (\text{WACC} - G).$$



**Figure 51 – Difference Between Application of Value Driver Formula with Gradual Change in Return and Immediate Change in Return**

## Normalizing Adjustments in Terminal Value

Start with idea of normalizing cash flow in the terminal period. If you are making a long-term forecast, you need to make things consistent. If you make a long-term forecast, you need to not distort things. This is a minimum. I start with this and then move to the key question of capital expenditures.

In computing terminal value, there should be adjustments that correspond to the assumed long-term terminal growth rate. A typical normalized cash flow adjustment is working capital. Because of the changing growth rate the working capital should be adjusted. The investment required to grow the cash flow includes the terminal higher. Work through the investment in inventories or the investment in accounts receivable. Let's take an extreme example. Let's say the terminal growth rate is 0 the historic growth rate was 10%. The last period cash flow is affected by the investment in working capital. The proof of the working capital adjustment is illustrated in Table xxx.

In making the working capital adjustments, you could evaluate accounts receivable to revenues and inventories to cost of goods sold, and accounts payable to expenses etc. Growth rate is reduced to zero good working capital becomes stable. But the historic EV/EBITDA including a 10% growth and included an increase in working capital this investment for example in inventories is not needed play changes to a zero Growth Company. The most important is how to use a model to make a proof of something.

INSERT TABLE OF WORKING CAPITAL ADJUSTMENT AND EXISTING AND FUTURE CAPITAL EXPENDITURE

### **Fraud of Explicit Cash Flow Periods and Adjusted IRR**

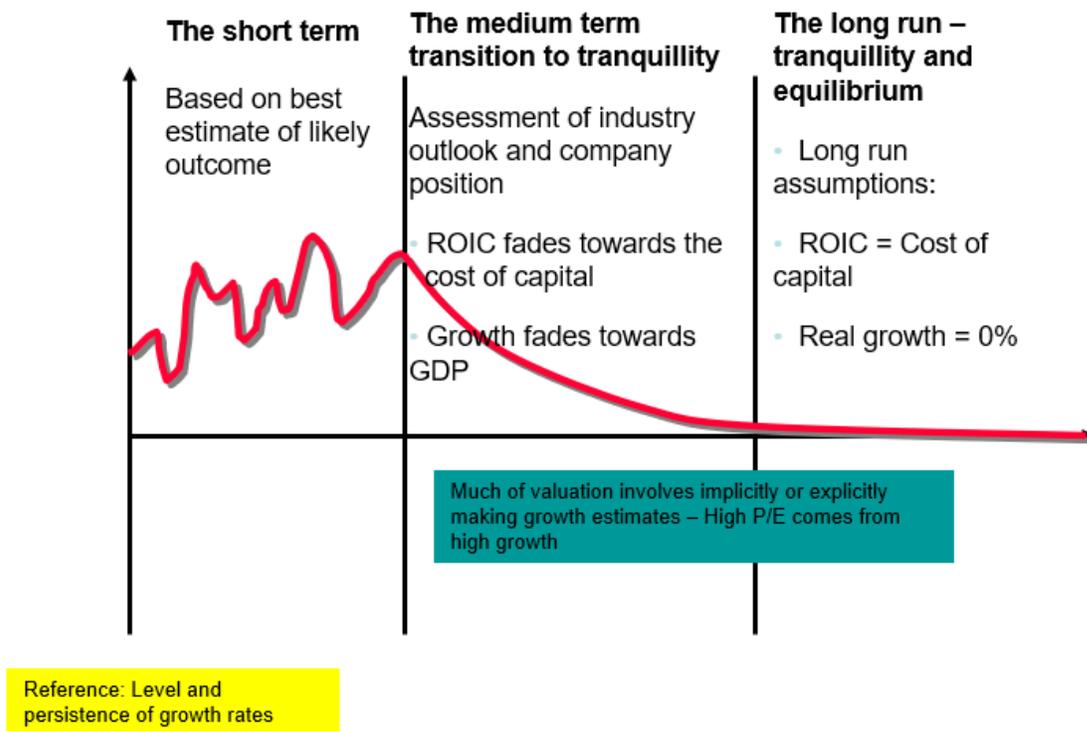
There is an idea in valuation that companies and business ventures have a life cycle and eventual become obsolete. This idea is behind all sorts of terminal value ideas in valuation where constant growth rates, continuing capital expenditures and normalized income are used, comes from the general ideas shown in Figure xxx. The notion shown in Figure xxx is that you can make some kind of short-term forecast (perhaps with some kind of company guidance). This is the first fraud. We all know that company guidance can be irrelevant to the valuation of a corporation that is supposed to last indefinitely. The second idea is that the business activity will have a real growth of zero (the growth is at the rate of inflation). This is the second fraud. Why not a negative growth rate or assume that the company can continue to make people addicted. The third point is that the return will go down to the cost of capital as other companies enter the business. This is the fourth fraud. Why would a company continue making investments if it is only earning the cost of capital. The final fraud is the biggest one. How could you be so crazy as to suggest that you know when a company will suddenly achieve some kind of mystical equilibrium where everything suddenly becomes very boring (but the cost of capital does not change.)

All of this does point out a whole lot of problems with valuation. But now I will be a hypocrite. Some of the ideas like that fact that nothing can keep growing for very long-term periods at really fast growth rates is reasonable. This is simply because when you grow you get bigger (think about your stomach). There is some limit to growth because otherwise you will explode.

So, assuming some kind of gradual reduction in growth is reasonable (although when and how this occurs is a crazy notion). McKinsey claims to have found evidence that growth does slow but who knows what they really did. The general notion that companies cannot maintain high returns indefinitely is also reasonable. Here McKinsey suggests that there is less evidence, but this is probably because they are not looking at anything close to the correct measure of a return with economic depreciation, adjustment for impairment write-offs, goodwill and economic versus depreciation lives.

REDO THIS GRAPH

1. Earnings guidance
2. Your Own Judgment
3. Getting to Stable ROI with Correct Cap Exp
4. Philosophy of Return above minimum required return



***Figure 52 – Conceptual Graph of Fade Period and Eventual Equilibrium with No Economic Profit and No Real Growth, Creating No Value***

Resolve the fraudulent issues with flexible sensitivity. In terms of the IRR you could apply a re-investment rate that gradually moves down if it is currently high (note I do not say that this movement is the cost of capital.) So, the AIRR is like the MIRR, but you assume the re-investment rate gradually converges to a number closer to the cost of capital. This is consistent with two economic ideas that drive the philosophy of valuation. Introduced here because I will use the idea elsewhere. The main reason I introduce this and make up a name, is that I will introduce analogous concepts when discussing the terminal value. Note that I do not suggest that anybody will every use this method.

### **Capital Expenditure to Depreciation**

How important it is to come up with investment to support the future expenditures. Maybe repeating too much that just forecasting earnings without the investment required to sustain the growth is an absurd exercise. When you make a forecast of return on invested capital, you

are implicitly making a capital expenditure forecast. If you make an assumption about capital expenditures separate from the cash flow or income, you have no idea what kind of return assumption you are implicitly making.

The real issue is evaluating capital expenditures and making sure that the capital expenditures are consistent with the growth rate in EBITDA. I begin by discussing the general use of capital expenditures to depreciation. The main point is that even if one is careful with capital expenditures to depreciation you do not know what the implicit return on invested capital is. For purposes here, I will pretend that investments in development, research, software and other items are correctly accounted for.

|                               | Est.     | Projected (period ending 12/31) |          |          |          |          |          |
|-------------------------------|----------|---------------------------------|----------|----------|----------|----------|----------|
|                               | 2015     | 2016                            | 2017     | 2018     | 2019     | 2020     | 2021     |
| <u>Income statement items</u> |          |                                 |          |          |          |          |          |
| Revenue                       | \$10,649 | \$10,698                        | \$11,175 | \$11,671 | \$12,191 | \$12,557 | \$12,871 |
| Growth rate (%)               |          | 0.5%                            | 4.5%     | 4.4%     | 4.5%     | 3.0%     | 2.5%     |
| Operating expenses            | \$6,548  | \$6,397                         | \$6,570  | \$6,808  | \$7,049  | \$7,139  | \$7,440  |
| Depreciation [1]              | \$1,049  | \$1,091                         | \$1,135  | \$1,180  | \$1,227  | \$1,300  | \$1,313  |
| EBIT                          | \$3,052  | \$3,210                         | \$3,470  | \$3,683  | \$3,915  | \$4,118  | \$4,118  |
| Operating ratio               | 71%      | 70%                             | 69%      | 68%      | 68%      | 67%      | 68%      |
| <u>Balance sheet items</u>    |          |                                 |          |          |          |          |          |
| Capital expenditures          | \$2,365  | \$2,070                         | \$1,910  | \$1,930  | \$1,930  | \$1,949  | \$1,969  |
| Net working capital [2]       | (\$192)  | (\$128)                         | (\$134)  | (\$140)  | (\$146)  | (\$151)  | (\$154)  |

Source: Compiled from UBS Global Research, Norfolk Southern Corporation, October 28, 2015; and casewriter estimates.

[1] Because the expected useful life of a railroad's fixed assets was very long (up to 40 years) and depreciation was based on historical cost, the ratio of Cap Ex to Depreciation was typically greater than one. Historically, the average ratio of Cap Ex to Depreciation for Norfolk Southern was about 1.5. The historical ratio of Cap Ex to Depreciation of 1.5 was expected to hold during the period after 2021.

### ***Figure 53 – Suggested DCF Analysis in HBS Case – Note the Capital Expenditure to Depreciation of 1.5 Relative to the Capital Expenditures in the Historic Data***

I illustrate valuation created by cash flow from not normalizing the Investments sustain the capital expenditures. In my classes I noticed something even worse. I can remember a man 15 or 20 years ago told me that his management instructed him to use a ratio of the depreciation expense to capital expenditures of 1.0 in the normalized cash flow. I was a little bit impressed with this because at least there was some attempt to address the question of what level of capital expenditures is appropriate in valuation and at least there was not But in the last chapter in working through the issue of straight-line depreciation (remember the graph with

the ROIC starting low and getting really high), we demonstrated that even if there is no future growth, the capital expenditures must grow to simply replace the prior plant.

Figure xxx shows the amount of capital expenditures that are necessary to replace plant where straight line depreciation is used and also where the lifetime in depreciation reflects the economic lifetime of assets. The figure demonstrates that capex to depreciation ratio should be well above 1.0 even with no growth. Figure xxx illustrates the errors in valuation of a company through errors in ratio of capital expenditures to depreciation. The zero future growth case where we only have enough to replace our address again just to try to think through some of these issues once you get the issues. The modelling here is simple and this type of simple model can be effective.

Once we have established depreciation to the capital expenditure ratio for a case where there is no growth now let's move to a case where there is growth. When beginning to work through Pepsi in the room volume, I would propose and suggest making proofs proving one method works and one method an example of this is the working capital adjustment discussed above . We could make a very long term model supposed to simulate or it's supposed to simulate going concern

then we have simulation of what happened for example when the growth changes from to 0% we can first simulate the actual value of the company. This is a benchmark. Next can try different terminal value techniques and attempt to understand whether the terminal value techniques the correct value incorrect value. The analysis in table XXXX above does exactly.

We have established ratio of capital expenditures to depreciation of 0% would imply that you should use a ratio of capital expenditures to depreciation that is higher than 1.0 if the nominal growth rate is above zero. Then you are replacing assets the ratio of capital expenditures bro and be higher to reflect the grow simulation up results.

Now back to the terminal value discussion so, it's really not showing you how things look and by how things work I mean what happens if growth rate changes to return changes all of the items I have already discussed. It also did not discuss distortions the measurement of the rate of return.

When I read the book the current time I had a negative opinion I thought this book is talking about how wonderful companies are that are able to charge Monopoly profits and it was essentially a worshipping Monopoly. Sorry again about the rambling. I thought the book was the ultimate look In Praise of capitalism being afraid of learning did the first version of the book on the statement that and because they have overstated the car to get the value increase Value Inn pay for both domestic or something.

That was aggressive credit that statement does not subsequent versions. I had been as we work through the history personal history of terminal value I thought wouldn't doesn't it isn't it a

little fancier either Use multiples all the problems in multiples in the last chapter. To use the Gordon's growth method I have just have just tried to recruit some problems. Wouldn't it be better to use this value driver for me.

### **Why Simple Application of the Value Driver Formula Does Not Work**

You may be yelling at me that I keep telling you what is wrong and not exactly how to fix things. But the nice little value driver formula is does not provide an answer to the crucial terminal value problem. This time I am not even talking about information going into the formula – the ROIC, the WACC and the growth. The formula itself cannot handle the key issue of how things will change in the future. Comment on the McKinsey crap that ROIC is stable. This is like their statement on synergies. If you are reading this still, I hope you can make it.

Now doesn't that sound if it sounds too good to be true well unfortunately it really is. There is a lot wrong with simple value driver formula.

The NOPAT can be computed as the level of invested capital multiplied by the return on invested capital. We have an implicit return on invested capital if that's the capital over from the detail explicit controls. And then we invested capital and here is the problem we have no idea about how we do difference capitals work in the formula. This is another enormous problem with our very famous McKenzie book.

Explicit discussion there was no proof about kind of return on invested capital you were actually making.

We could then easily compute NOPAT which is necessary to compute the free cash flow anyway. You need to multiply the NOPAT by one minus the tax rate. We can compute NPOAT, and we can just multiply NOPAT. There is no requirement for making assumptions about capex to depreciation about making adjustments to the capital you just have NOPAT, and we have the multiple.

Stable Period Adjustment to Growth Method    Higher Return, Lower Growth

|                             | Theoretical Value | Growth Rate   | Value Driver Basic                                   | Value Driver Sudden | Value Driver Fade Period |
|-----------------------------|-------------------|---------------|--|---------------------|--------------------------|
| <b>Value of Corporation</b> | <b>154.87</b>     | <b>268.53</b> | <b>214.89</b>  | <b>139.80</b>       | <b>155.06</b>            |
| Driver (g or ROIC)          |                   | 2.50%         | 6.00%  | 6.00%               | 013% - 006%              |
| Price to Book               | 1.55              |               |  |                     |                          |
| Price to Earnings           | 11.91             |               |  |                     |                          |
| Explicit Period             | 10                |               |  |                     |                          |
| Fade Period                 | 6                 |               |  |                     |                          |
| Cost of Capital             | 6.80%             |               |  |                     |                          |
| Terminal Period             | 12-Jan-34         |               | Value Driver Basic = Income * (1-g/ROI)/(k-g)        |                     |                          |
| End of Post Terminal        | 12-Jan-40         |               | Value Driver Basic = Capital * ROI * (1-g/ROI)/(k-g) |                     |                          |

Lower Final Terminal Return Est  
Decreasing Growth Case



**Figure 54 – Simulation of Alternative Terminal Value Methods Demonstrating Computation of Value Driver with Fade Period Compared to Theoretical Value**

### Implicit Return on Invested Capital Assumption

Re write the formula for value with some substitution.

$$\text{NOPAT} = \text{ROIC} \times \text{Invested Capital}$$

$$1/\text{ROIC} = (\text{NOPAT}/(\text{WACC}-G) - \text{Value}) / (\text{NOPAT} \times G)$$

$$\text{Value} = \text{Current ROIC} \times \text{Invested Capital} \times (1-\text{Growth}/\text{Other ROIC})/(\text{WACC} - \text{Growth})$$

The issue here is the ROIC in the first part of the equation and the ROIC in the later part of the equation. I had to go back and try to understand if there was some kind of magic and some kind of elegant and some kind of a justifiable progression return on invested Capital to the new return on invested capital . When I work through this analysis there were clear logical problems. Begin with the case where the growth is zero. In this case, the formula becomes.

$$\text{Value} = \text{ROIC} \times \text{Invested Capital} \times /(\text{WACC})$$

When this time the second ROIC goes away and it is assumed that the ROIC is always equal to current ROIC. There is no flexibility in evaluating what happens to the ROIC

I doubt that that results that you want to if you input the ROIC less WACC in the formula.

Now if we go growth rate is very high. We could never in the formula make the growth rate higher than or equal to WACC because the denominator goes to 0 . But if we make the growth rate relatively high then there is a larger subtraction for the Growth/ROIC.

I used the interpolation process again I back into the number of years It takes for the current return to progress from the existing return. The incremental return with different growth rates. Now this might be a nice graph, and maybe you could try some sort of theory that would somehow go along with his change in the ROIC. To make this graph

### **Interpolation of ROIC – Need Trend in Invested Capital**

I suggest that trying to come up with some kind of economic explication that's all a lot of crap. Instead why don't you interpolate of time over which you believe the return on investment.

You cannot anymore use the value driver formula and you need to make a little if you want to get fancy could make an automatic function in Excel called an user-defined function okay I think you there now that's more progression terminal value thinking and Analysis with some creativity rather than trying to find a magic formula

when we look at the Dow 30 return on invested capital for most companies is enormous apples invested Capital balance sheet. Is the debt and Equity is blank by car it still has some Surplus where is the operating profit the heavy toll on my income tax rate notice that the tax rate is pretty low is in the figure XXX .

For Nike turn on invested capital is except a list of the return on invested capital is presented below.

I have attempted to write hey program automatically goes to publicly available data get the data into excel and allows you retrieve the data compute cost of capital from the data evaluate the multiples from the data comes from MarketWatch and finance.yahoo. The amazing thing is that you can get the data for just about any company in the world,

### **Corporate Finance Process – Cash Flow Forecast and Ridiculous Terminal Value**

You can make growth rate forecast –  $CF \times (1 + g) / (WACC - g)$  or you can use multiple. Multiples must reflect specific growth, cost and return. By the time you get this right, use an alternative method. When use the growth rate method, you do not even know what implicit assumptions you are making.

## **Problems with Using the Ratio of Capital Expenditures to Depreciation**

Example of capital expenditure to depreciation of 1.0. Use for forecast. Examples – very simple to derive return from the capital expenditure to depreciation. Examples of bad capital expenditures to depreciation. Alternative methods.

Basic idea, if the return changes, the cap exp is higher relative to the depreciation. If you use the historic level, you do not know what kind of assumption you are making. Show some scenarios.

If the return is changing you can do two things. The first is to change the income level and maintain the growth in capital expenditures. Simple example is shown below where the return changes and there is a growth assumption. The second is where the income grows and the capital expenditures are used to change the rate of return. This is shown in the second simple example. Note the same/different valuation.

Discuss the introduction. How to compute stable capital expenditures for a corporation. Examples of capital expenditures (investment) to depreciation. Recall that need investment to make money. Show how to compute and then show what is wrong.

What is depreciation rate. No idea about what assumption making with respect to return on invested capital. Example if higher growth than will have higher cap exp to depreciation.

## **Problems with Traditional Terminal Value – Terminal Growth without Normalization**

How can possibly not change capital expenditures and working capital investment when change the growth rate.

## **Problems with Traditional Terminal Value – Terminal Growth with Normalization**

When change, still do not know the implied ROIC. Need to derive.

## **Problems with Traditional Terminal Value – Value Driver without Adjustment**

Problems with Traditional Terminal Value – Sudden Movement of ROIC and Growth to Long-term Values

Problems with Traditional Terminal Value – Gradual and Explicit Movement of ROIC and Growth to Long-term Values

### Case 1 – Stable Returns, Stable Growth and Constant Age

Portfolio model with UDF. With and without economic depreciation. Value of portfolio of assets. Include the quantity of production and production of capital expenditures. Use the Burton Sensors case.

### Case 2 – Slower Capital Expenditure and Increasing ROIC

### Case 3 – Effect of Age of Plant and Measuring ROIC with Straight Line Depreciation

### Case 4 – Effect of Changing Growth in Measuring ROIC and Terminal Value

#### Points in this chapter

1. Terminal value and Growth Rate – Have No Idea of What ROIC
2. For corporations, ROE and ROIC will be high when investment or re-investment is low and the plants are ageing
3. ROE is a bad statistic for gauging future performance for a corporation because of things like stock buybacks and changes in leverage
4. ROIC is a bad static for gauging future performance because is distorted because of plant age, plant write-offs and vagaries in computing ROIC
5. Terminal Value
6. Ambiguities in basic measurement of Corporate ROIC and Evaluating Future ROIC
7. Corporate analysis and ROIC versus ROE for evaluating future cash flow
8. Incorrect terminal value – no stable cash flow
9. Incorrect terminal value – don't know implicit assumption for EV/EBITDA
10. Terminal value with basic McKinsey formula
11. Terminal value formula with Corrected formula

# Chapter 8

## Terminal Value Cases – Philosophy Instead of Bureaucrat Application of Formulas

### Value of Beethoven's Music

Way back in Chapter 3 I discussed the value of Justin Bieber's music. This may be a radical idea for some young people, but I would suggest that if some private equity company in 1815 could have monetized Beethoven's music, it should be worth even more than Justin Bieber's songs.

Pondering the value of Beethoven's music is a way you could think about terminal value. I am no music expert, but I submit that the joy in listening to this music has not diminished or converged to some kind of boring and stable value where there is nothing special left (where the economic return converges to the cost of capital). The hypothetical (disgusting) private equity company monetizing Beethoven's music hopefully would make you think about how silly it is to apply the same terminal value formula to different situations. To demonstrate



some alternative ways to think about terminal value this chapter applies some practical cases.

### Foolish Consistency is the Hobgoblin of a Petty Mind

Fraud to say that know the future. Different possible premium. Different possible investment strategies. Different possible surplus capacity.

MOVE OR DELETE NEXT PARAGRAPH

If you're working in the real world go to the website download data for your company's now you can get companies from all over the world. Go back to our companies with the extremely high return on invested capital. They have had a kitchen sink quarter kitchen sink is when you might take a lot of impairment studies or other write-offs when you do that take the right off your return on invested capital. It might also be the case Michael Jordan advertisement is the biggest investment for Nike and those do not show up at capital and capital expenditures for inventory investment or other sorts of investments in cash flow statement it might be the case that other companies such as Coca-Cola consistently have a Federal expenditures to depreciation.

The capital expenditures to depreciation is less than one if a company is not replacing its assets are older with a lower investment Capital base and I'm very high computed return new assets. Let's say has a valuable brand Nike or let's say company that has made Harry Potter film has very high profit and that we don't need any more new capital expenditures for the food . First question is predict my suggestion throughout the that it's almost impossible best way to make a big cash flow without making the investment.

Will Nike at some point made some kind of investment to start their business and some executive decided to pay Michael Jordan to make the advertisements somebody paid some artists to make the picture of Michael Jordan those were Investments and the return big return on that the existing investment. It's really hot and very bad investment should be a capital asset and that investment economic depreciation arrived at a to Thrivent the rate of return that rate of return enormous. But of course don't have account to get done is my point is we don't have to apply formula explicitly we cannot because of accounting because it wouldn't make sense we need to make some judgments about probability of being maintained or value or decreased in value . Testing

I would have any expertise at all whatsoever in any kind of fashion at all but when we make our valuation, we could we need to pick creatively I have a much more open mind been simply applying a formula even if it's a beautifully elegant formula. Let's take the case of Coca-Cola.

GE Case Study of Terminal Value Amazon case study

### **Berton Sensors Harvard case study on sensors.**

Introduction case study rehab valuation dad except the current ROIC and perhaps make an adjustment for the normalized ROIC adjustments for normalizing the terminal value.

once we have a procedure for terminal value in a more sophisticated and rigorous manner I will now work through some selected case studies and examples.

Examples illustrate that you cannot just apply a nice little terminal value but that for this elephant in the room you often need to have some creativity. Alternative ways in order to come up with these alternatives I work through some selected case studies.

The first case study General Electric and illustrates analysis of changing ROIC and application of the interpolated formula

The second case study on what not to do and it uses the case of Air Arabia and distortions in the terminal value

The third case study of Norfolk Southern and Canadian Pacific HBS case and it illustrates the first thing is using ratio of capital expenditures to depreciation and the second thing is using the implied return on invested capital when using the Gordon's growth.

The fourth case study call Burton Sensors simple case written up by Harvard issues associated with change return on investment. The terminal value forever funny and just exclude life of the company how could you offer volume

The fifth part is a series of case studies discussing general issues. This case study is a survey of a few of them for the Dow 30. Is a case study of applying the interpolated return on invested Capital technique using Amazon as an example. Some percentage of the total value of the company.

New section.

The theoretical model compute cash flow given the return, best way to achieve the return given the growth rate in the investment.

This example will be extended and modified for changes in changes in growth and numerous complications that arise when using EBITDA have a provision for depreciation on Capital assets, nor taxes that must be paid nor working capital Investments that must be met.

All of the examples that are technical you can Associated spreadsheets and detailed documentation of the associated spreadsheets on the website.

Change in Return on Investment and Growth

**Chapter on Terminal Value Case Studies**

The general point of the chapter is being more creative when evaluating terminal value and don't using a simple formula.

If you're working in the real world go to the website download data for your company's now you can get companies from all over the world. Go back to our companies with the extremely high return on invested capital. They have had a kitchen sink quarter kitchen sink is when you might take a lot of impairment studies or other write-offs when you do that take the right off your return on invested capital. It might also be the case Michael Jordan advertisement is the biggest investment for Nike and those do not show up at capital and capital expenditures for inventory investment or other sorts of investments in cash flow statement it might be the case that other companies such as Coca-Cola consistently have a Federal expenditures to depreciation.

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Harvard case study on sensors.

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Change in Return on Investment and Growth



# Chapter 9: Absurd Idea that the Same Valuation Models and the Same Cost of Capital Can Be Used Over the Life of an Investment

## Deciding on a University Degree versus Deciding on a Job Offer

An irritating aspect of applied and finance and financing teaching is that the models and analysis attempt to put all problems into the same tired framework of net present value and cash flow. I am afraid I have fallen into this trap so far in this book. Just about all of my suggestions implicitly or explicitly applied the same discount rate or rate of return to a company or an investment over its life. The earlier chapters also did not consider the possibility that the distribution of cash flow can be different than a similar upside and downside. My methods of analysis for terminal value, multiples, computing returns and evaluating costs and benefits applied the same model over the life of an investment. When you think about all sorts of valuation decisions, the implicit idea that risk and the evaluation process can be the same over time is crazy.

To illustrate how risk and valuation models change, consider the life of person who wants to become a doctor. The first valuation decision is whether to go to university and take up medicine. In the U.S. there is apparently a low probability of making it to the end: “Only about 17% of US Freshman pre-meds earn admission to med school. About 140,000 start out. Half drop the program before completion. Of those who “stick it out” and take the MCAT (~70,000), half do not do well enough on the MCAT even to apply. Of the ~ 35,000 who apply, a little under half get in.”<sup>14</sup> Presumably, when you make this difficult decision, you must have the self-confidence to be able to make it. You would also have to consider the possibility that your life

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<sup>14</sup> I admit I just found this on the internet

will not be very interesting as a doctor and there will be a big chance that you are wasting a whole lot of time and money. Now fast forward to your life as a doctor and you are deciding whether to accept a new job offer. Your decision-making process concerning whether or not to select the new job will be very different than you decision making with respect to entering university. The new decision will be a lot more boring where you may implicitly or explicitly write down the pros and cons of the different alternatives (maybe you will do something as silly as putting the alternatives with different salaries, risks and quality of life in a spreadsheet). It may be possible that one alternative would have a lower salary but more possibility for upsides.

## Avec Macron, cinq ans de plus pour la "Start-up Nation"

Par Maxence Fabron (@max\_fabron) | Publié le 05/05/22 à 07h00

Partager :



COMMENTER (2)



© Getty / Jean Caluffe - Emmanuel Macron

Avec un soutien sans faille affiché en faveur de l'écosystème numérique de l'Hexagone, Emmanuel Macron, qui entame un second quinquennat à l'Élysée, a su entretenir la flamme auprès des entrepreneurs tricolores. De grands défis l'attendent pourtant...

### Corporations as Collections of Assets in Different Stages of Development

Extreme examples are Amazon and Tesla but very many other companies are trying the same kind of thing. Applying financial modelling ideas built from evaluating stable companies to start-up or fast growth companies is one of the failures of finance. Whether a company has projects in a start-up stage or whether all of its projects are mature, a corporation is made up of a portfolio of projects. To understand a corporation, I posit that it is best to understand first the underlying value of the projects that make up a corporation.

Consider new locations for McDonalds and the valuation of a new place. Wouldn't think of this as a start-up company, but it goes through stages. Do not really know how it will work until have some experience. Venture capital has to use probability. But applies in building solar plants. Sun Edison example.

### Absurd Suggestion to Apply Concepts of Diversifiable Cash Flow, Beta, Constant IRR to Investments with Changing Risk

The contrast between the start-up decision to attempt to gain a medical degree and the decision to select a new job is analogous to very many investment decisions ranging from start-up ventures to exploration projects to infrastructure investments to new product development. In this chapter I will discuss some valuation approaches for different valuation over the lifetime

of an investment. I suggest that many if not most investment projects go through different phases beginning with a start-up or development phase and ending with the keep calm and carry-on phase. It certainly should not be a radical proposition to suggest that the framework for evaluating investments must be very different and cannot fit into the net present value model.

As any corporation is an amalgamation of projects, if the tired old model is not appropriate for a single investment, it is also not very good for assessing different corporations, some with a lot of projects in the development stage and other corporations with assets that are earning stable cash flows. If the risks are different for the corporations, how can we suggest that the beta statistic can really capture the risk.

### **Time Travelling Through the Life of an Investment Project**

When you think about the value of a person or an investment, the first basic point is that the value diminishes as you get old. This is simply because you have less time left. We have already implicitly dealt with this issue in all of the discussions about economic depreciation, asset replacement in terminal value and age of assets in multiples. In Figure XXX I have taken two minutes and made an example with 2% growth in cash flow and different discount rates. Then the value is simply the present value of those cash flows. The first graph discounts the cash flow at a rate of 5% and the second graph discounts the cash flow at a very high rate of 10%. The pattern of the graph is affected by the simple mathematics of discounting (if the discount rate were zero the line would be straight down and if the discount rate was really high, the line would be much flatter). In thinking about a corporation as a collection of assets, you could imagine a whole lot of these graphs on top of one another. If the corporation has older assets, those assets must be replaced sooner and the value of the corporation should be less. This is counter to the return on invested capital that would be increasing because of accounting with straight line depreciation.

Imagine old or new portfolio. Old will have to replace. New will have long life. But old will be confusion because of high IRR. Will add together different ages. This is not intended to represent a company. If a company continually replaces assets and grows, then the value can gradually increase without the extreme swings. But if capital expenditures are reduced, then the value.

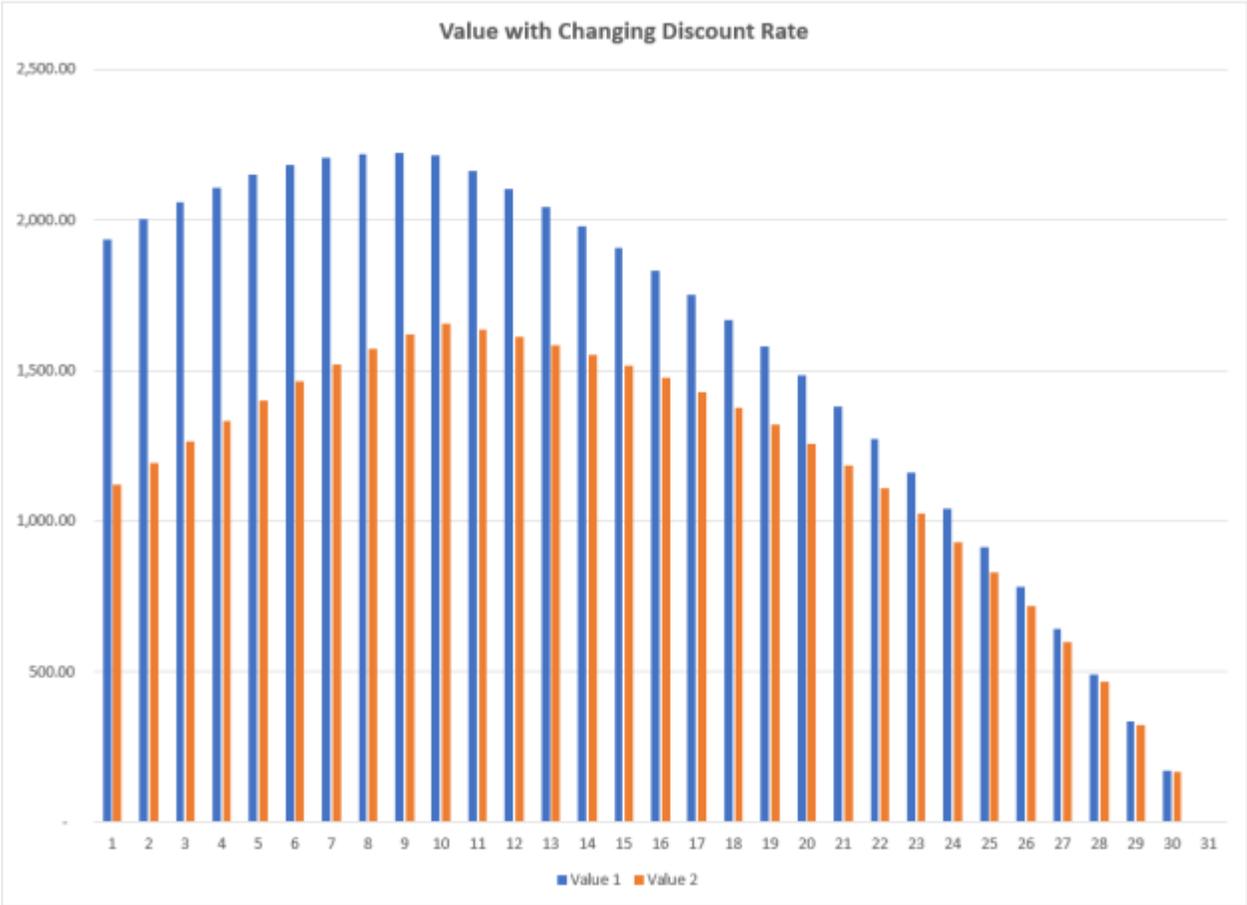


**Figure 55 - Value Progression of Asset and Equity for Single Project**

A second notion about the value of an asset is that the risk of most projects change over their life. This change in risk can be represented by a decline in the discount rate as the project moves through its life until it reaches the keep calm and carry-on phase. The example with one project demonstrates how you can use the projected cash flow to derive discount rates. Examples of industries where projects are often bought and sold include real estate investments, oil projects and renewable energy projects. I would argue with quite a bit of emotion that if you have a reasonable idea about the projected cash flow, it is much better to derive the discount rate from evaluating projected cash flow than to make some sort of CAPM estimate. All you have to do is use a goal seek with the value and the cash flow (after accounting for taxes).

Figure xxx illustrates the effect of changing value on the value of a project over time. In this case the discount rate starts at the level in the previous case and then moves. In the top case it moves down from 5% to 3%. In the second case it moves down from 10% down to 6%.

In this case But because of accounting with straight line depreciation, the observed return on investment goes up. Value is the NPV of future cash flows as illustrate in the simple example below.



**Figure 56 - Asset Value and Equity with Changing Discount Rate (Buyer Required IRR)**

Discuss how IRR can account for changing risk. In this case compute a holding period that consists of negative cash flow when the project is constructed. This demonstrates that an IRR is distorted. Your friend Warren Buffet in implying that private equity people are bad says that his holding period is forever. The fact that he is not a very bad person who dismantles corporations and squeezes out money by treating employees badly. But this idea of risk reduction and this

increase in value happens whether you hold the assets or sell them. In Think of a person or a person's brain. You will depreciate away and become worthless. Allocation of value is depreciation and change in value can be computed different ways. One way is straight line which is absurd. Best is to compute value and then the change in value.

The next sections we'll address that there the changes in the risk over time and some more nuanced issues with projections. The final issue will address cash flow pattern ultimately realized by equity investors again at every section that the corporation that a corporation the portfolio relation of project and to understand the risks faced by a corporation you need to understand the risks of the project. It bears repeating that even if that the ideas of project finance in terms of deriving risks both downside risks and upside risks should one day hopefully be an integral part or reports.

Try to go one step further and compute the NPV over the construction period and the development period.

### **Development and start-up risk and proof of concept**

Value is driven by cash flow for a project as well as capital gains from changes in the returns required by investors. You can see this by using a simple perpetuity formula –  $\text{Value} = \text{Cash Flow} / \text{Discount Rate}$ . When cash flow changes, value obviously changes. But value changes also when the denominator changes. The denominator represents risk. When the discount rate goes down because of risk declines, the value goes up. We can call this value increase a capital gain. Here I will suggest that value should consider capital gains as well as the cash flow forecasts.

I am thinking about a wind farm, but you may be thinking about development of a hydrogen truck; an initial project in Madagascar; a port in Pakistan;

Get paid a development premium or a development fee and be taken out by other investors.

Fund capital expenditures with debt and may or may not be compensated by the lenders for the development fee and maybe achieve really low cost financing.

This is a lot like valuing a start-up company by a venture capital fund. At the initial stage the value is driven by the probability of achieving success. This continues as you make some kind of estimate of the value that can be realized if you do achieve success. Eventually, if you achieve a proof of concept through selling products, you have a better idea of the potential cash flow and the probability of success increases. This is a capital gain. The risks of an investment continue to decline as risks are resolved – the risk of construction problems, the risks of not achieving expected results after the project is finished with construction.

## **Crazy Developers**

### **What is the General Process for Valuing Start-up or Development Investment**

Start with valuation once achieved some sort of milestone. Maybe proof of concept where your project is really being sold. Maybe financial close in project finance investment. Raises many issues. First is how to make valuation after you clear the early hurdles and change method to standard cash flow. A second issue is whether you should make some kind of explicit cost and benefit valuation. Third, is if you make a valuation, whether you are a venture capital investor or whether you are an entrepreneur how can you assess the explicit or implicit probability. Fourth, how do you assess the changing probability and the risks of different stages and options to exit the investment. Fifth, should you back into the risk premium or development premium and use this premium in analysis or should you back into it from the final valuation. Sixth, should the measured return on a successful project consider the opportunity cost of failed projects in measuring returns.

I go a bit crazy with all of this. I argue that you should be able to come up with some kind of cost benefit analysis. I argue that you cannot perform this cost and benefit analysis with some kind of adjustment to the discount rates. I suggest that you should explicitly or implicitly consider probability so you can present the costs to investors and bankers. I suggest that you should put the risk of failure into the analysis.

I try to develop a couple of examples. One example which is real is to imagine a competitive bidding for a Solar project in Dubai. There are multiple bidders and each has about the same chance of success. Each bidder has to get bank financing. Each bidder has to do a lot of engineering. Each bidder has to pay staff and for trips to Dubai. Each bidder has to pay for lawyers to go through the documents. All of this has a significant cost and I assume there are bidders. This is a simple example where the probability is and costs are clear. How do you recover the costs of losing. While the costs are big, they are only two percent of the overall project cost.



Please note that this could be a new company, it could be investment in developing a vaccine or other drug, it could be investment in software. You can try to value this investment with some kind of IRR or NPV, but without accounting for probabilities, this gets you very little.

### **How to make valuation after you clear the early hurdles and change method to standard cash flow.**

Do need some kind of valuation when successful. Many projects this would be some kind of business plan. Unfortunately, may be valuation from EV/EBITDA ratio with high growth or net present value at unknown discount rate. Could use a high growth period with some kind of interpolation. For most start-up or development projects this would be speculative and something like the terminal value discussion. The drivers are a realistic assessment of growth and a reasonable assessment of short-term and long-run returns.

In Dubai example assume that somehow know the required return. If do not recover the return on failed projects would be out of business. Development companies are real. Solar is not too hard. Development companies will be out of business unless they recover the unsuccessful projects.

Key point is that make some kind of valuation and critically evaluate the prospects for earning a return on investment and thinking about competitive pressure in Box 1.

### **Should you make some kind of explicit cost and benefit valuation or just evaluate the difference between the ultimate value and the initial cost**

If you make a cost and benefit analysis, you need to have some kind of cost. This cost is irrelevant if it does not include probability. Should you even bother or should you just use the final value compared to the pure cost. The difference can be called the premium. You could make some kind of vague judgmental assessment of the probability of success.

The alternative is to make an explicit assessment of probability. This can be presented to bankers. It can be shown to venture capital investors. It can even be used by accountants (not very relevant). For example, when making a project finance loan the lender can agree to put development fees into the calculation. Development fee is controversial but can be a big deal in financing. You can understand a banker not wanting to lend to a round-trip fee.

Discuss the general issue of development premiums and alternative models. Multiple of cost.

Diagram of Round-Trip with Developer and Sponsor and SPV. Also the Bank.

You can find the total value. Either the lower cost of capital for the Dubai project or the risk neutral valuation.

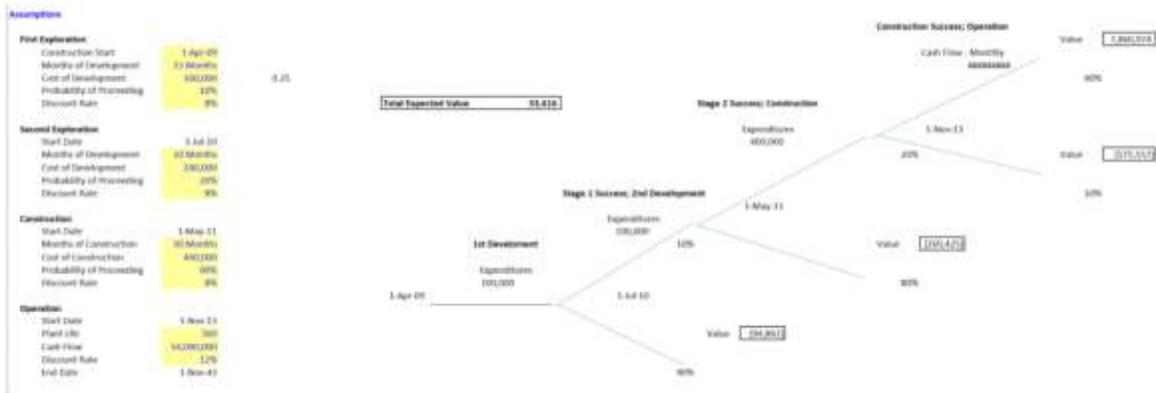
My point is to make some kind of cost and benefit analysis and understand if the business activities. The cost is not the profit. Dubai example where have the final return.

**How can you Assess the Explicit or Implicit Probability.**

It would be fraud to claim that you know the probability. But how could you do this any other way. Could compute the break-even probability. Could compute a series of different probabilities and get a distribution of cost and benefits. If do not make some kind of probability, would not have an objective cost. Show graph of profit.

**How do you assess the changing probability and the risks of different stages and options to exit the investment.**

So many options are the options to get out of something or options to cancel. The distribution of options is not anything like some kind of normal distribution of cash flow. Show the distribution with stages compared to a normal distribution.



**Figure 58 - Real Options to Exit During the Development Period and Expenditures in Different Stages**

Should you back into the development premium and use this premium in analysis or should you back into it from the final valuation.

Should the measured return on a successful project consider the opportunity cost of failed projects in measuring returns.

### **Risk Analysis for Start-up Ventures – Attempting to Put Risk of Failed Start-ups into the Cost of Capital**

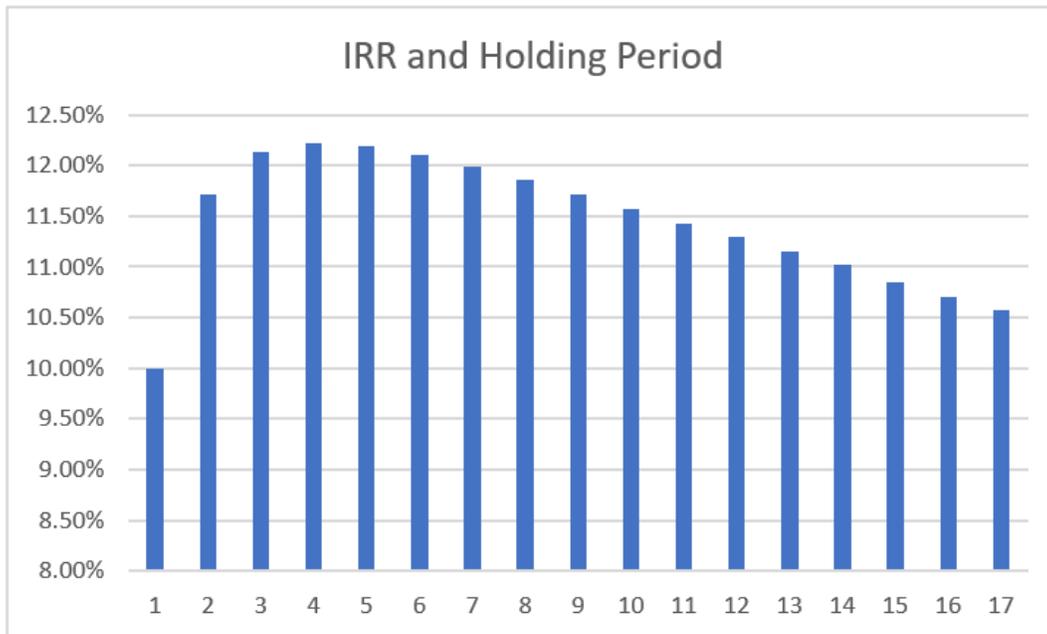
The start-up phase. Should explicitly consider risk and adjust the return for the probability of failure. Contrast traditional finance again and show how crude it is. Need to earn a return that compensates for the probability of failure.

When assessing returns, go back to the graph of returns and risks. Is there a competitive advantage that is sustainable Let's go back the risks of an investment also set a risk related to start-up ventures. These are extremely often at least extremely risky proposition where the chance of failure is high.

Imagine we have two corporations. One Corporation has a number of new projects that do not yet have a proof of concept. Another corporation has boring old assets operating for a long time. Finance professors would say that the market in some kind of Wizard of Oz like knowledge can drill down to the individual assets and somehow dissect a company to find the risks of start-up ventures that are buried in the asset base. Then, even if a company has a whole lot of very risky ventures, the management will be so smart as to make careful probability estimates of success. So, in the end, the risk of failure of the assets does not have to be understood because it can be diversified away. This is illustrated in the diagram below.

### **Risk and Value over Lifetime of Investment, Changing Risk**

The second point about asset valuation is that if the risk of a can diminishes over time in a dramatic fashion. A project starts with some research and then something very different which is development. Note that the words development and research mean something very different and as usual accountants and people who waste time on financial statement analysis do not think about the difference. Development implies expenditures for a specific project. It could be investments in contracting, permits, start-up marketing, product development. Development risk is analogous to the risk that a start-up company succeeds and can demonstrate a proof of concept. Once the project makes it through development, the risks have declined a lot and the company constructs the project. There are lot of risks involved in constructing the project including whether the technical aspects of the project will be met; whether there will be cost over-runs; whether there will be delays and so forth. After the project is constructed, the risks are less, but there are still supply and demand risks that can be important. For example, if you were told that the wind level will be at a certain level by consultants, this may not turn out to be the case. Similarly oil project.



Graph: Value change from decline in cost of capital with titles. Graph: Just use post development as will be explained below

#### General Inputs

|                           |        |         |                          |       |
|---------------------------|--------|---------|--------------------------|-------|
| Development Period        | Months | 15      | IRR - Cash Basis         | 8.11% |
| Construction Period       | Months | 12      |                          |       |
| Development Cost (actual) | EUR    | 20,000  | IRR with Dev Fee as Cost | 7.49% |
| EPC Cost                  | EUR    | 400,000 |                          |       |
| EBITDA p.a.               | EUR    | 30,000  | IRR to Partner           | 7.51% |
| EBITDA Growth             | %      | 2.50%   |                          |       |

#### Development Inputs

|                                 |        |         |                         |       |
|---------------------------------|--------|---------|-------------------------|-------|
| Probability of Success          | %      | 10.00%  | IRR to Developer - Cash | 8.64% |
| Target Development Profit       | %      | 15.00%  | IRR to Developer - Econ | 7.47% |
| Loss Scenarios                  | Number | 9       |                         |       |
| Costs of Loss from Failures     | EUR    | 180,000 |                         |       |
| Total Cost Including Success    | EUR    | 200,000 |                         |       |
| Target Profit = Development Fee | EUR    | 30,000  |                         |       |
| Developer/Sponsor Investment    | %      | 55.00%  |                         |       |
| Partner Investment              | %      | 45.00%  |                         |       |

Second accounting problem is that do not account for economic costs of start-up projects and businesses. As with economic depreciation and economic ROI, this can be evaluated. As discussed at the beginning of this chapter, companies are a collection of different investments. Some investments are mature and have been operating for a long time. These investments can have fairly certain cash flow like a McDonalds drive through that has been around for 15 years, a beer company like Carlsberg selling in a country for a long time, a wind project that has been operating for five years, an oil field with proven reserves that has fixed forward prices, or a youtuber with millions of viewers who has proven her concept. But other investments can be speculative, like trying a new McDonalds in Barbados (there one of the companies without any McDonalds), exploration for a new oil field, a wind project that has not yet tested local wind speeds, or a youtuber with a seemingly good idea, but few subscribers. Project finance ideas can be used to demonstrate that valuation of development projects with do not have a specific proof of concept or have not yet been able to secure contracts. The projects with development risk cannot be valued with traditional net present value of cash flow.

### **Separation of Value with Probability**

In fact, there are many valuations that depend on probability. Loans, new ventures ... Loans – probability of default x loss given default. Loans do not use beta and equity market risk premium. Instead, you compute the probability of default by the loss given default. New ventures is the probability of making it to the IPO times the expected IPO proceeds. Here I assert that valuation of many if not most assets and ventures goes through different phases; one with probability and a second with standard IRR/NPV. For mature investments, the standard IRR and NPV can be applied from the last chapter, but during the development phase probability should be applied.

- Use both methods for valuing a single asset
- Cannot apply CAPM
- Probability generally does not have diversification in CAPM
- The cost of failures during the development stage should be included as a costs
- Stages in development periods and real option to exit
- Understand risk change

Expected value supposed to be used in boring companies. Supposedly have some kind of variance and the variance in your cash flow forecast corresponds to stock price volatility. Maybe the variance is such that the distribution around the expected value is normal. Very much of the theory of finance comes from boring companies that have been around a long time and have many years of history for their financial statements and stock prices. For example, the McKinsey Book uses examples like UPS, Heineken and \_\_\_\_\_. But so much of valuation is about start-up companies or companies that are growing very fast.

An alternative valuation method is for start-up companies. The second is use of probability where the value is determined by an outcome multiplied by probability. This is like venture capital. There must be a big payoff to overcome the high probability of failure. Using some kind of IRR or cost of capital in this case is crazy.

The case of Sun Edison. It went bankrupt. This company was a manufacturer and a developer of solar project. It tried to acquire a wind company as well which directly led to the bankruptcy the company. I had sold its operating assets to a its own related subsidiary. It kept development assets that those assets that were riskier of course had a would come along with a higher cost of capital and those riskier asset would have been financed very differently than the safe assets. I should say the riskier assets are financed very differently than the development assets. Again, we can look to the financing to understand and the implicit cost of capital. I'm not saying that you can find precise answers. This is just like when I discussed the implied cost of capital from the debt amount and the debt structuring. That doesn't give you any exact number required return, but it gives you a way to think about things. I argue a much better way to relate risks to required returns to compensate for those risks is to directly think about probability. Compare to the asset pricing model that now is the middle of just about every case study.

### **Changing Risk over the Life of a Project – Corporate Finance Pretends that Somehow Diversified Away**

What is the continuing theme – really understand risks from project finance. Contrast with corporate finance. Beta is constant or simplistically adjusted. Terminal value does not have different discount rate. Again, not providing answers, but if any notion that can accurately get down to the value of assets and the potential for making future money, it is crazy.

In the end argued way to measure risk so now back to our example of a development venture. We can move to a project that has development risk before proof or concept or signed contracts and then to construction risk before a project becomes operational and then to different stages in the operational period. For a typical project construction risks after we have our proof of concept have very different characteristics from development risks. During the development period there is a big probability of failure and methods for recouping the high risk of failure must be dealt with. After the development (or after we have a solid proof of concept) we want to make sure the technology is going to work; we want to deal with the potential for delay risk and we better make sure technical aspects of the project will work.

After construction operations for the project begin and we want to see how it really will perform. Now you start to have real data instead of feasibility studies and consultant reports. The data on actual production, actual revenues and actual operating cost start to mean a lot more than estimates which were made when the project was initially developed. The risk of

variability in future cash flows is reduced. After we gained some history the risks go down dramatically changing risk. Of course not every project has the same characteristics of declining risk from the development period to the mature operating period. We start with high risk lower some projects may have minimal development and construction risk. Some projects may experience even higher risk over time because they are subject to changes in fashion or obsolescence. Take me to technology change so idea is how do we apply a method of valuation for the real world for risks for items that don't have the same risk over time.

### **Upside Potential in Projects and Valuation – Standard Finance Does Not Recognize Distribution of Cash Flow**

I'm repeating that a corporation is a portfolio of projects. The same sort of upside potential will apply to a corporation to understand the upside associated with the change in the risk over time. The value comes from the change in the risk over time. Equity with individual projects has a very different structure typical equity return assumption that's the foundation of the capital asset pricing model. I don't know how the CAPM is taught in business school. I need to admit and that learning the capital asset pricing model I remembered that there was something called independent and identically distributed and follow a normal distribution. The assumptions the capital asset pricing model the computation of beta other academic discussions there was always a assumption about return daily rates of return weekly monthly rates of return being identically distributed and normal and having a normal distribution this normal distribution is nothing like what happened for returns on a project. Again, a theoretical project an actual project and the equity returns have an upside potential that does not match the downside risk.

Upside potential from to resources that I will discuss. The first upside return, from the risk declining and the evidence of the risk declining is to sell an asset at a profit. The second issue is the ability to change the financing structure. Because of the issues discussed the cost of capital declining in the cost of capital. Just like the evidence what is the sales sell the assets we know this upside outside from selling an asset and receiving a capital gain. We emphasize in the next two sections it doesn't matter if the asset is really sold. The answer matter that we refinance we can refinance or so means is that if we have a corporate. Corporation with a portfolio of a whole lot of different asset the value of that Corporation should go up as the risk declines. The graph shows the value changes in a base case.

I'm not saying that this corporate value adjusts to changes in the risk of individual projects because the last thing I'm saying is that markets are tremendously efficient, and they can understand the risk profile of every single asset in a portfolio. But if we want to dig deeper into really what drives the value of an asset drive to value of a corporation, we need to understand how the risk profile of different assets in the portfolio changes. The value of the asset comes about this ability to sell the asset depends on the resolution let's start with some relatively

simple financial modeling have to get really sophisticated. In the simple case let's assume we have three scenarios a low case a base case and an upside case.

We could construct the volatility and perhaps in the downside case barely gets repaid. The debt holders in theory going to create a model and become comfortable that even in a low case they can be repaid. The low case may even be after some restructuring. In a base case, things work out well and rate of return on equity that was targeted should be achieved. A high case now if we three different cases we don't have to sell the asset. In the downside case we can't get much for our asset and we probably won't sell it. In a base case as the risk has come down and the plant has operated as we expected the plant can be sold at a capital gain. We will be able to realize an implicit capital gain when actually when we sell whether we sell the asset or not because the risk has come down. In the third case -- the high case willing we will receive a very high value from selling the asset.

So now if we begin with our three cases a base case with a downside case and a high case. We maybe even attached probabilities to those cases can be very crude and we'll just say for now there's a 25% chance of realizing 50% of the base case and a 25% probability of the upside case. If we don't recognizing that we don't incorporate the capital gain because the example is developed so that the turn the overall rate of return is approximately the same as in the base. Then e have a downside case and a downside case and leave yeah there are three different cash flows with probability on those cash flows. I get about the same rate of return now if we incorporate the upside. But if we incorporate the upside from ability to sell the asset, the rate of return increase because of the capital gain associated with the reduction in the risk of the project for evaluation and analysis. The issue is making an assessment of this project which is the right rate of return to you are expected case that recognizes the upside.

### **Project Finance as a Convertible Bond**

I argue in case the recognize the upside the end of the day the cash flows look something like a convertible Bond. With a convertible bond we might have a very low basic interest rate, but we get an upside if the entity paying the bond interest does very well. This is the similar to the equity cash flow for the value distribution.

#### Upside from Re-financing

To consider the upside from refinancing way back first section of this when we discussed the debt structuring when it's being constructed and that that structuring was driven by construction Risk by faded construction risk bye operating risks where we didn't have any history and by technology after project achieve an operating history the Risco. And the financing structure should follow them we follow the logic the initial section that would just that this increasing in that capacity has led to a lower cost of capital the same sort of lower cost of capital achieve by being able to sell the asset where the fire is accepting a lower because the

fire the buyer has a lower risk accepting a lower risk now in the graph below made some assumptions about refinancing and use the three cases before when we look at the three different cases we add refinancing into the cases in the downside case just as before we wouldn't refinance the asset but and the hot case we would refinance DSS do Equity return free from the three cases is buffer without refinancing I think we get the upside let's have a new section is Dakshin again and on this introduction we need to do we want to say dad typical project Finance his talk with some diagrams talk with understanding some financial ratios like the DSCR, LLCR, PLCR and working through some technical aspects of project Finance I've read these books make it there very good but this chapter is going to look at project Finance in a very different way it's going to use project Finance to draw implications took a Valium corporations and it's going to.

And it's going to make you hopefully think about project Finance in a different way at the end chapter I hope you will see that project Finance can provide some foundational ways to think about finance. You can see that project finance for equity investors can be thought of as a convertible bonds or have the cash flow patterns with the upside case potential of a of a convertible bond. I also you see that the way in which you can stop the development with something like a strike price that with Investments and how probability assessment and capitalizing cause

### **Real Options in Project Finance and Corporate Finance**

During the dot com bubble real options were a big top and people were looking for real options in anything and claiming that value could magically be increased from real options. Somehow you could find a stock and believe that the market had not valued real options correctly. You could buy a stock with negative cash flow and say that the company has the option to stop its cash outflow.

### **Example of Risk and Probability – The Risk and Valuation of Projected Synergies in a Merger**

When teach M&A, use the basic formula that after-tax value of synergies must be more than premium. I note that claims to measure synergies is utter nonsense. Highlights the application of different risk to different cash flow.

Consider a Beer Company. When I went to Denmark the students suggested I use called now Carlsberg had kind of a nice boring return on investment and think about people buying beer during a recession. Maybe even more beer effective these continuing let's say and let's give you an example that's a Carlsberg has some nice boring old Investments and now engaged in an acquisition another company alternatively they could be engaged they want to develop some new business strategy moving to another kind of beverage.

If Carlsberg pays a premium in a merger for another company and expect some kind of synergy (a word that I hate) you cannot say the risks remained the same. The risks of a creating

synergies has anything like the general risks of a beer company. If you believe in beta and the beta of the stock doesn't change suggesting that there is not a change in the risk structure. However, the synergies they have a very different probability distribution. The synergies achieving the synergies achieving is like a new business venture where there is a limited probability of success. In evaluating the synergy, you can go back to the way the risk is capitalized into a development fee. The premium is the development cost and you could compute the return on this premium from making synergies.

Nobody would do this analysis of a premium. But again I am making suggestions about different ways to think about finance. You could add the probability of failure in computing the return on invested capital for the merger.

We can now return to our Amazon and GE cases. If Amazon is entering into a new growth business as the business. When the business becomes mature and as the business is demonstrated to be a reasonable strategy the risk changes. We could use grocery store business. Even if the cash flow stays the same, the value of the company or has increased just like selling assets in the project finance analysis.

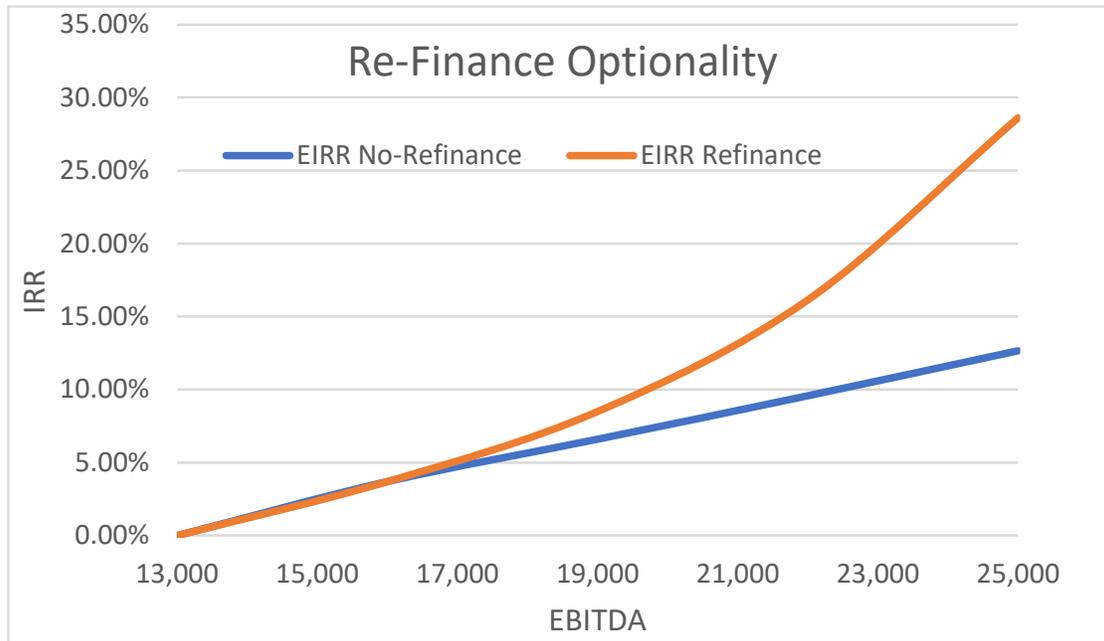
For people studying valuation and studying finance these ideas have relevance.

Continue discussion of project finance. Note that different because do not have a terminal value. Instead make a long-term forecast as much as 60 years. This may be crazy, but remember that when making a corporate forecast you are making an even longer forecast. Often in project finance you have some contracts or economic principles that allow you to make a reasonable forecast.

### **Capital Gains and Project Finance as Convertible Bond**

Capital gain is change in value that is not driven by cash flow. Your house value goes up because interest rates go down. In project finance, if the risk declines while the prospective cashflow does not change, value increases. Absurd to suggest that anybody knows what will happen to future discount rate.

Illustration of capital gain in positive case and negative case



Re-finance the project once you can demonstrate to bankers that the risk has been reduced. Sell your project to an insurance company. Compute the IRR with and without cost of development. Compute the cost of development with probability analysis and stages

Imagine if you could see Amazon projects in data centres, in transport, in retail, in other activities. Imagine if there are no distortions. Imagine if banks would tell you about the risk of each project by virtue of the amount of money they lend.

When I discuss project finance, I use the analogy of analogy of a relationship. This time, the relationship is a very quick engagement without much testing of the market. After a quick \_\_\_ period, a marriage contract along with a pre-nuptial agreement is signed. This time, unfortunately, one party is not happy with the contract and arguments make the whole project difficult for all parties.

Transparency in Project Finance and Financial Statement Analysis

One of the advantages of project finance for a bank is that you can see the cash flow.

### Debt Structure Around the Economics and Risk of a Project

Transparency of value in project finance that cannot find in corporate finance. But can use project finance ideas to see what you would really like.

Set the debt capacity to earn an equity return and evaluate the project with equity cash flow rather than overall cash flow (no Miller and Modigliani).

Practical, IRR with changing risk, IRR and ROIC with economic depreciation  
Changing Risk, DSCR versus Debt to EBITDA  
Debt Sizing



| EBITDA          | EIRR<br>No Sale | EIRR<br>Sale  | PIRR         | Probabilkty |
|-----------------|-----------------|---------------|--------------|-------------|
| 13,000          | -3.48%          | -3.48%        | 2.01%        | 15.00%      |
| 16,000          | 3.10%           | 3.10%         | 3.40%        | 20.00%      |
| 19,000          | 5.72%           | 10.87%        | 4.64%        | 30.00%      |
| 22,000          | 8.03%           | 21.11%        | 5.78%        | 20.00%      |
| 25,000          | 10.28%          | 29.48%        | 6.84%        | 15.00%      |
| <b>Expected</b> | <b>4.96%</b>    | <b>12.00%</b> | <b>4.56%</b> |             |

# Chapter 10:

## An Alternative Way to Think About Risk and Return with Project Finance

### The Essence of Project Finance Versus Standard Definitions

The Horrible Definition of Project Finance in HBS Write-ups and the True Essence of Project Finance

There is no single agreed-on definition for project finance. For example, Finnerty (2007, p. 1) defines project finance as

the raising of funds on a limited-recourse or nonrecourse basis to finance an economically separable capital investment project in which the providers of the funds look primarily to the cash flow from the project as the source of funds to service their loans and provide the return of and a return on their equity invested in the project.

In contrast, Nevitt and Fabozzi (2000, p. 1) define it as

[a] financing of a particular economic unit in which a lender is satisfied to look initially to the cash flow and earnings of that economic unit as the source of funds from which a loan will be repaid and to the assets of the economic unit as collateral for the loan.

The real essence of project finance and the horrible definitions in HBS cases. A Harvard Case Study defined project finance as .... The essence of project finance is that somebody from outside of the company developing an investment accepts a whole lot of the risk of the project. Because of this, the risk of the project is defined by somebody outside of the company. Turns Modigliani and Miller on its head.

## **Does Anybody Really Believe that Beta Really Captures All Risk**

This chapter continues my obsession with the idea that studying the nuances of project finance can tell you a lot about evaluation of all sorts of financial issues. Here, I move from using project finance to measuring the rate of return to the difficult issue of evaluating risk. If you are a true believer in the stuff taught in finance, you should believe that every risk in an investment that is not related to the overall market can be diversified away and all of the risk that you should care about is stuffed into the beta statistic. I am not disputing the mathematical fact that when independent time series have a reduced variance when combined and a portfolio of investments reduces risk. But I do think it is dangerous to somehow believe a statistic derived from historic data can accurately be used to evaluate different types of risks and nuances that happen with actual projects.

In making an investment decision ranging from buying a stock to choosing a career to recommending an investment for your company, you need to assess risks in a more practical way than applying a beta statistic from historic data. There will be ups and downs in the cash flow or happiness from your investments. There also may be permanent changes in the future benefits that will never reverse. There is certainly not easy alternative to translating risk into value and one of the problems with beta is the presumption that this translation can be made. As an alternative, I will try to work through the issue of risk and value by studying how people whose entire job it is to assess risks of a particular investment – bankers and other lenders – implicitly measure the risks of individual projects. Maybe my real motive is to write about the essence of project finance which is to structure financing around the risks of a project. The idea of this chapter is that you can evaluate risk using project finance ideas. In project finance the debt is carefully structured around the risk of project. What I do not do in this chapter is to work through the mechanics of project and contract structure.

But we can be quite confident in one thing. That is, that no lender would use beta and the CAPM to assess the risk of investing in a new venture like an IT project; a boring project like a solar project with a lot of history; a project subject to commodity price fluctuations like an oil exploration project; a venture that depends on women liking a particular fashion of lingerie. I will try to do something that is very difficult – to derive the returns implicit that derive from different types of risks from use project finance as a base.

If you are asked about the risk associated with a forecast of cash flow for Amazon or GE, I cannot imagine that your assessment of risk would really be based the betas of the company. Perhaps if you're making some kind of big portfolio me about are you comes from how to practically get an assessment of the volatility.

My objective is to prompt thinking of investment risks in a different way. When structuring the debt of a project financed investors, lenders come up with a I hope you think about mean reversion and cyclicity. I hope you think about the ultimate question of return and the dispersion of returns – even if you do not make a fancy financial model.

Do you really evaluate risk with beta. Examples of new investments. Example of stable investments. Examples of investments with upsides.

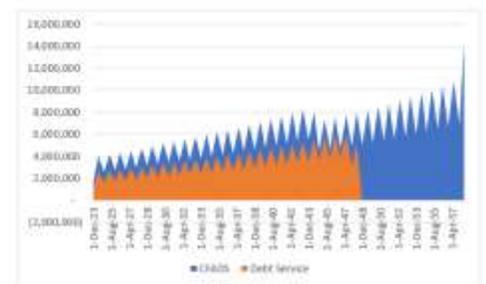
### Project Finance and Debt Capacity

Here is something I have observed about project finance and cost of capital. I ask people about required returns to see if I can find secrets about their required returns (I am not really that impressed with their secrets, but more curious). I ask this question knowing that different there are kinds of projects with very different kind of cash flow patterns and certainly different kind of risk. I don't even ask whether they are talking about project IRR or equity IRR. What I often find is that investors (developers of the projects) are almost exclusively talking about return on equity capital (the equity IRR). Further, and more interestingly, they generally have similar required rate of return on equity capital for different types of projects. The projects may be a toll road could be a conventional electricity plant such as a natural gas plant or other projects like a hospital or a factory.

the required return vastly different projects on equity is it is very is often very similar let me put it that way find that return you can say well I found the cost of equity capital because the cost of equity capital is

| Key Dates                              |                    | Start    |
|--|--------------------|----------|
| Financial Close Date                   |                    | 1-Jan-21 |
| Commercial Operation                   |                    | 1-Dec-21 |
| Operations Period End                  |                    | 1-Dec-58 |
| Key Metrics - Tariff & Financial Score |                    |          |
| PPA Rate (USD/MWh)                     |                    | 33.00    |
| PPA Inflation                          |                    | 200.00%  |
| Capacity (MW <sub>ac</sub> )           |                    | 132      |
|  | MWh/AWp            | Cap Fac  |
| Annual Yield - P50                     | 1,580              | 22.60%   |
| Annual Yield - P90                     | 1,726              | 19.71%   |
|  | USD                | USD/AW   |
| EPC Cost                               | 118,800,000        | 900.00   |
| Total Plant Cost                       | 127,400,000        | 962.41   |
| Uses of Funds                          |                    |          |
| Total EPC Cost Incl. Contingency       | 118,800,000        |          |
| Interest During Construction - Senior  | 3,800,000          |          |
| Up-Front Fee                           | 2,537,583          |          |
| Commitment Fee                         | 842,937            |          |
| Interest During Construction - SHL     | 192,179            |          |
| DSRA                                   | 1,065,999          |          |
| <b>Total</b>                           | <b>127,038,698</b> |          |

| Return Metrics                         |   |
|--|---|
| Equity IRR - All Equity                | 8.70%   |
| Post-Tax Project IRR                   | 7.72%   |
| Pre-Tax Project IRR                    | 7.46%   |
| Debt Metrics                           |   |
| DSCR Output from Scheduling            | 1.23  |
| LLCR                                   | 1.53  |
| PLCR                                   | 1.91  |
| Average Debt Life                      | 18.25   |
| Model OK                               | THRU  |
| Debt Size                              | 84,293,745  |
| Resource Standard Deviation            | 10.00%  |
| Yield                                  | 1.980   |
| Debt Tenor                             | 25  |
| Apply Minimum Debt Amount              | <input checked="" type="checkbox"/> Minimize THRU |
| Structuring Case                       | PSD Debt Size Case                                |
| Debt Fixed from Other Structuring Case | THRU  |
| Circular Resolved                      | THRU  |
| Degradation Scenario                   | Base Degradate                                    |
| Construction Period                    | 11  |





## Risk and Return Analysis from Project Finance

Some of the things that may be a little new in this chapter come from incorporating project finance ideas into corporate finance and valuation. As with other chapters, I do not suggest some kind of formula which can solve the problems. Ideas like the fallacy of assuming a constant cost of capital over the life of a project, understanding why straight-line depreciation distorts, impairment write-offs and development risks distort rate of return statistics and using debt capacity to measure risk. These ideas will be the basis for a lot of analysis in subsequent chapters.

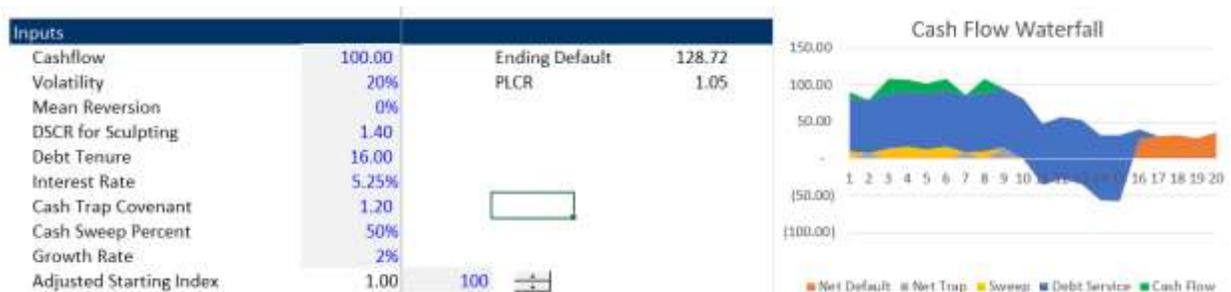
Different types of risks and mean reverting risks versus permanent risks. Victoria Secret example.

1. Start with development risk and understand that development and research are very different – can allocate development risk to a project and it is done in project finance.
2. Development risk demonstrates the difficulties in valuing companies that have a lot of start-up projects where the probability of failure should be allocated to the cost of a project and can measure the ultimate return by accounting for the development risk. When sell all or a part of the project based on the investment, should account for the development risk.

3. How the development risk is relevant for corporate valuation. Corporate valuation includes as operating expense, but if change the growth rate should change the capital expenditures. Does not work as a percent of revenues. Example of no real growth.
4. How changing risk over the life of projects affects the measured IRR and valuation over the life of a project and results in capital gains
5. How start-up risk and development risk can be incorporated into IRR, ROIC and valuation analysis through asset value write-ups and probability rather adjusting target IRR
6. Why debt capacity and debt structure are part of the fundamental analysis in project analysis and why risk is not measured with anything like beta in real world project analysis
7. How equity IRR is used instead of project IRR and why WACC is irrelevant in project analysis

### The Beauty of Project Finance – Lenders Structure Financing Around the Economics and the Risks of a Project

Need discount rate or minimum required IRR to compute the value. The practice is to have required equity discount rate. With discount rate can compute the equity value that depends on the risk of the project. Risk evaluated by debt structure. Use debt to compute the project IRR or the required ROIC. Show table with different DSCR and the same equity IRR.



To introduce problems with measurement of return use project finance analysis. Modigliani and Miller and Project Finance Theory. Fundamental idea that project return should be higher than cost of debt (not ROIC and WACC but analogous). Then use Equity IRR to evaluate different investments. This is theory. No Beta. Really good to compare. This is the real world.

The most essential and beautiful part of project finance is that a lender – somebody who is not in the management of your company and who does not have vested interests in a project or who does not manipulate numbers to make a project look good – drives the investment

decision. This may seem abhorrent to people who worship Merton Miller (like me), but it is not. The lender gets access to massive information about the project; the lender hires engineers and consultants to evaluate technical aspects of the project; the

So let's take a trip across time the life of a project finance transaction and while we are taking this trip we can think about valuation implications for corporate corporations that own different portfolios of assets.

### **The Magic of Letting Somebody Outside of Your Company (who puts a lot of money in your investment) Tell You About Risks**

Earlier I defined the cost of capital using a hypothetical bidding situation and I wrote that the cost of capital is the lowest rate of return that managers will accept to win the bid. so how does this idea in project finance defining risk well in establishing the minimum rate of return -- the definition of the cost of capital work.

In project finance the debt financiers will make an assessment of the risks of the project will carefully structure the debt and the risks of the project and around structure of the cash flow. You as the developer would like when we focus on the rate of return. If the risk is higher the debt terms will be negative is that the amount of debt will be less meaning that the tenor of the debt will be shorter and even the premium on the interest rate spread may be higher.

I am careful with the discussion of credit spread because a typical rule in Project Finance is that you push the debt up and push it up and push it up until you achieve a something like a BBB or Baa rating. Or in other words and investment-grade rating. In fact project finance loans often are or not rated. You can ask Bankers what kind of rating is typical internal rating is typical on Project Finance. They will give you some kind of numbering system or a letter system that is analogous to S&P and Moody's. Generally they will tell you that the project finance debt has typically has a rating in their system which is very much like a triple B or Triple B minus equivalent.

The key from this discussion of the bond rating is that if one project is riskier than another project, the structure of the debt will change. Through structuring the debt, the project finance lender has told you about the risk. If a project is considered to have more risk, the banker will put less debt into the project, the tenure will probably be shorter and there may be restrictions on the and the dividends from a cash flow sweep. We don't need to go through all of this stuff on the details of lending agreements. But we do need to see that, all else equal, the expected equity IRR with a lower amount of debt will be lower than equity IRR if there was more debt. This is why they say leverage in the U.S. and gearing in the U.K. As long as the overall return (for now you could either call it the return on invested capital or the project IRR) is more than the cost of debt, the equity IRR will be more than the project IRR.

Later on I complain about measuring the risk of debt that has limited downside risks and the cost of equity which can have a lot of upside potential – an aspect of cost of capital that is not implicitly or explicitly recognized in the CAPM. For now, we can assume that there is more variability in the risk to equity cash flow if a project has more debt. The idea is that debt is carefully structured from the risks and the structure of the project. Change the idea of return being greater than the cost of capital to Project IRR begin greater than the overall cost of debt. The cost of debt can include fees and changing credit spreads. The most fundamental idea is that project IRR should be higher than the debt IRR to achieve this Equity rate of return.

Figure xxx – Demonstration of Different Risks, Pushing Up and Down Debt and Leveling Volatility of Equity

### Problems of Considering Risk

Looking for definition. Looking for categories. Looking for pricing risks. Looking for ways to simulate risks. Sticking it all into beta does not get you anywhere.

### Adjusting Debt Capacity for Two Projects with Different Risk

General theme is that you can let financiers tell you about risk and return. Let them tell you as a check on your assessment rather than trying to measure risk yourself. Many implications. If you are beginning a project and evaluating a new venture. If you have a really boring project what is the cost of capital. If you have a mixture of new ventures and boring assets how should you make an evaluation.

Let's take an example let's say we have a relatively risky project with new technology, and we have another project that has very conventional technology and safer cash flow. The debt structure includes the amount, the length of debt repayment and the manner in which debt is repaid. If the risk of the debt default is similar for the two projects, the amount of the debt could be more, the length of the debt could be longer and the pattern of debt repayment could be more aggressive for the project with less operating risk.

If you look up how Standard and Poor's makes credit assessments and comes up with their credit ratings (AAA, AA, A, BBB etc.) you cannot find all that much and there seems to be a whole lot of mystery. But you will see how the ratings depend on both operating risk and financial risk. I could add credit rating agencies to my complaint list, but I my list is already long enough. With different structures, you could look at this from equity perspective and imagine that for the first project, increased operating risk is offset by lower financing risk (from less debt, shorter debt, and a structure of repayments that is more front-end structured). The project with safer operating cash flow would have the opposite structure with more debt, a longer tenure and a back-ended payment structure. The diagram below illustrates the leveling out effect of debt to the risk of equity.

Continuing with our hypothetical case, you could imagine that a safer project has a lower rate of return if no debt were used to finance the project. But when more debt is added to the project, the equity return is increased. This is just leverage. See below. For the risky project – with the lower debt, the equity return does not increase much above the expected overall project return. We could go further and make an assumption that when you combine the operating risk and the financing risk, the equity risk is about the same. With this assumption, the banker has made the risk assessment for you and after they do their risk analysis job, the required return for the equity risk is about the same, meaning that the cost of equity for the projects should be about the same. I realize that there are a lot of assumptions in this hypothetical example, but the point that the lender has in some sense equalized the risk for different projects remains. Turns Miller Modigliani on its head.

If you could find the general minimum requirement in terms of equity returns, you would have the cost of equity capital. This general equity return requirement would not depend on any beta calculations or other problems. You have an alternative way to assess risk. For project finance this is very real. There are many entities that buy and sell projects and there are general return criteria that are used. How much premium should add to debt. This depends on the premium to debt if any for taking equity risk. Suggest that because of upsides, that this premium may not be very much.

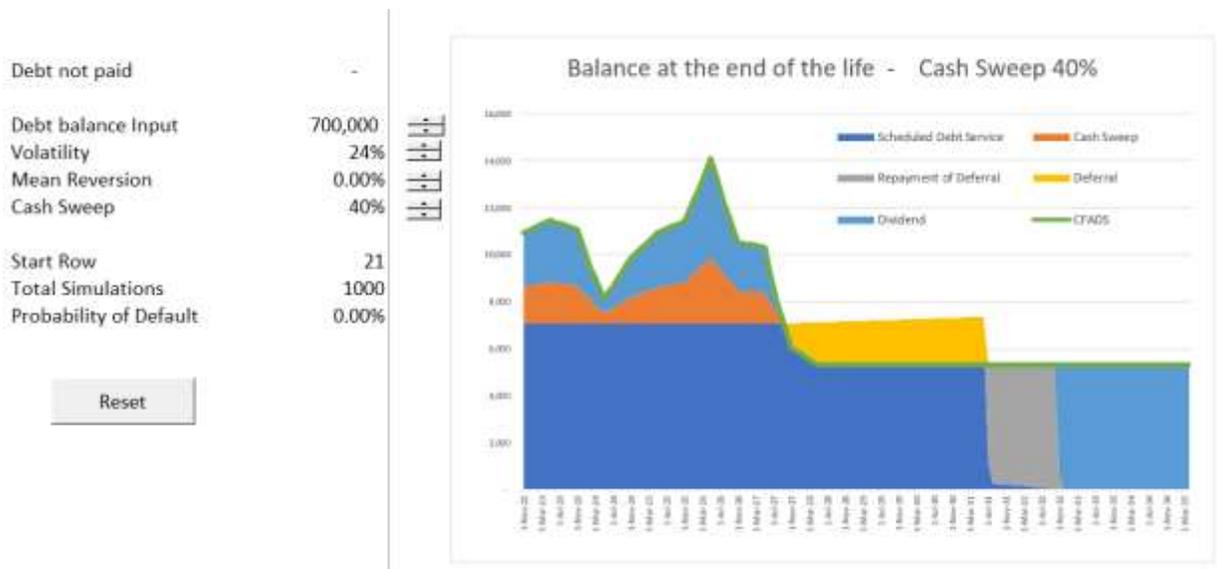
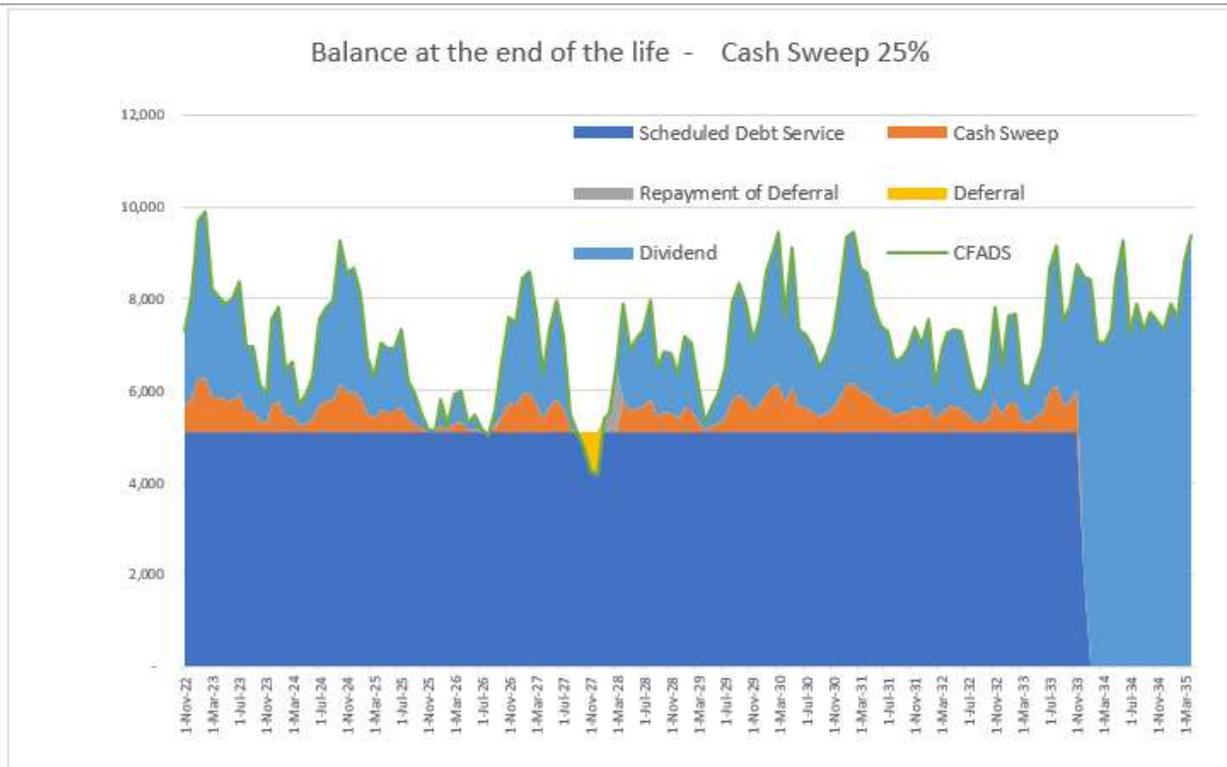
### **Monte Carlo to Illustrate Risk, Not to Measure Risk**

Equity has upside and downside. Use simple Monte Carlo simulation to illustrate risks. Do not suggest that about volatility in a very simplistic faces let's assumption that Equity cash flow Equity cash flow has more risk with more debt. In other words, if two projects have the exact same dial are which means they have the same return on invested capital economic depreciation then if these projects have the same risk to different projects Jack with the higher level of debt higher variability in equity cash flow and the graph below uses a very simple example to give us breaks babe given that the equity cash flow is and if you want to that's okay that you can say if that slowly economy and therefore the overall Market then at the end tell her that she should have today if you want to go there and you could even put together the Forum either of the asset Equity the capital equity the capital times debate of the Dead if there is more that there's more risk associated with it.

If we have two projects exactly the same if we have two projects that have exactly the same return on invested capital the project with higher level of debt has a higher required Equity irr because of the higher Beta. And so long no turn if the two projects has this at the same required return on Equity or equity IRR then the if the bankers adjust the debt structure to meet the same triple B credit requirements they even out equity risk the lower amount of debts or the shorter debt tenor or other debt terms associated with the riskier project Lower the equity IRR on a project being equal at the same Equity I are

For different rates of return or required rates of return on invested capital all of this means that the debt providers the debt structuring a way to come up with the required rate of return or overall return on invested capital and overall return on invested capital is the overall cost of capital for the project. That is essentially a weighted average cost of capital because of tax issues and we can't say weighted

average cost of capital because structure over the life of a project might not be we will not be in the same across time.



**Why Project Finance is a Good Starting Point for Risk Analysis and Valuation**

Objective of discussing some nuanced issues in project finance analysis. Work through different issues. See that can get real understanding of risk and contrast to corporate finance that has crude methods and not real understanding.

So that's the way it's a different way of backing in cost of capital. Now to think and come up with real world answers to acquired rate of return is. In the next section/chapter we're going to talk about the more nuances of project financing Finance. We will work through some risk issues with project Finance in Finance literature add and come up with some very general chance of risk of business risk it might be called these things a categorize the wrist evaluate and when you we need how credit rating agencies example come up with the credit rating on a on a bonds or how bankers evaluate the credit rating of a loan you might see a score for the business risk of a company which covers things like competitive risk covers things like maybe they even tried to measure the volatility and cash flows from the trough of a business cycle to the peak of a business cycle maybe it has a category called illogical risk all of these things which almost meaning when I try to think about risk. I will try to have some sort of way to quantify risk I'll mention two ideas hopefully they'll not take me way off track one idea is issue of mean reverting and cyclical kinds of risks for example risks that the oil price go up and for even a more extreme case risks that will have a cold winter or a warm winters.

### **Mean Reverting and Non-Mean Reverting Cash Flow – Does Beta Really Distinguish Between Risks**

Project finance delves into individual risks and studies them. Never any discussion about diversifying risks. Contrast with beta, CAPM, DCF where through everything into crude concoction and magically come up with a measure of risk. I am not advocating that project finance is somehow better. But hopefully making you think. The second type of risk of things going out of fashion risks of the first case with mean reverting patterns. One should be paid very differently for risks that are mean reverting from risks that suddenly and dramatically change. Think of your life. A mean reverting risk may be if you have education and skills, but you have some bad periods. A non-mean reverting risk may be that your skill becomes worthless. Maybe a finance professor can say that non-mean reverting risks can be diversified away and that beta can capture these risks. The finance professors may also say that the lower risks with mean reversion can also be incorporated in beta and when the overall market moves up or down, the company with mean reverting risks will have a lower beta.

In the first things are cyclical where the sun comes up and down where are Commodities move up and down where they called mean reverting. In those sorts of circumstances that risks are mean reverted we might have to have a lot of patience we have some we know that there's going to be volatility associated with a mean reverting cash flow. But that is really different from volatility of a non-mean reverting cash flow. A mean reverting cash flow are things like fashion and how do you know when something will go out of fashion. Victoria Secret would be a good example of a non-mean reverting Cashflow. When we go back to examples of Amazon and mean reverting item covid pandemic there certainly experienced some positive effects pandemic doesn't last forever. General Electric makes more money on conventional power plants like power plants. When there's a move out of fashion conventional technologies this is a non-mean reverting Cash Flow. Risks are very different. And when lenders Stay will evaluate the risks of they should evaluate these risks very different. You would have to be a real believer to suggest that beta can incorporate all of these different risks.

Now think about betas and the CAPM. Do you really believe the beta and arbitrage pricing model will correctly account for risks that are mean reverting and non-mean reverting cash flows. I don't. Much better to Evaluate the risks and give us an assessment structuring their debt around quantifying those risks setting the structure of the debt. Around those risks and using data risk analysis back in to the cost of copper. That's enough for free now. Discuss how to measure risks with mean reverting cash flow and estimate mean reversion parameters.

Graph with mean reversion and non-mean reversion

# Chapter 11

## Cost of Capital Part 1 – General Concepts and Why it is so Difficult to Measure

### Mean Reversion of Beta and Article from the 1970's

I have testified many times on the cost of capital in cases where a government agency sets prices for companies. You write long report that nobody reads. You go through some theory about the cost of capital. You come up with a number. If you represent the utility company, you suggest a high number and argue that regulated companies are really risky, that the overall risk for stocks are much higher than for government debt instruments (the EMRP) and you present data from Value Line of MarketWatch that shows the beta for these companies is high. You don't make your own beta calculation and you don't explain why the beta calculated by Yahoo finance is so different from the beta presented by Value line and Marketwatch (see Figure xxx).

The reason that the beta statistics are so different is because of a formula used by Value line where beta computed from the stock price variance – the raw beta – is adjusted by an arbitrary 33.33% to push the beta towards the mean. This means that companies with raw betas of below 1.0 are adjusted upwards and companies with betas of below 1.0 have betas that are adjusted downwards.

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### BETAS AND THEIR REGRESSION TENDENCIES

MARSHALL E. BLUME\*

#### I. INTRODUCTION

A PREVIOUS STUDY [3] showed that estimated beta coefficients, at least in the context of a portfolio of a large number of securities, were relatively stationary over time. Nonetheless, there was a consistent tendency for a portfolio with either an extremely low or high estimated beta in one period to have a less extreme beta as estimated in the next period. In other words, estimated betas exhibited in that article a tendency to regress towards the grand mean of all betas, namely one. This study will examine in further detail this regression tendency.<sup>1</sup>

The next section presents evidence showing the existence of this regression tendency and reviews the conventional reasons given in explanation [1], [4], [5]. The following section develops a formal model of this regression tendency and finds that the conventional analysis of this tendency is, if not incorrect, certainly misleading. Accompanying this theoretical analysis are some new empirical results which show that a major reason for the observed regression is real non-stationarities in the underlying values of beta and that the so-called "order bias" is not of dominant importance.

Adjusted Beta = Raw Beta (0.67) + 1.00 (0.33)

If you look a Coned in Figure XXX, you can see that the yahoo beta is .19 using Yahoo Finance and it is .50 using MarketWatch. Using the “fancy” formula above,  $.19 \times .67 + .33$  (I did not multiply by 1.0) gives you .46 or about the value of MarketWatch. For Coned you can go back to the 1960’s and in minutes compute the beta for different time periods. When you do this you will not see any mean reversion (If you read on to the next chapter you can see this). The truly remarkable point about this so called mean reversion adjustment is that it comes from a paper written in 1975 by somebody named Marshall Blume. With due respect to the Dr. Blume, when you read the paper you see there is not much there. We can give Dr. Blume the benefit of the doubt because acquiring data was difficult in 1975. But these days you can in minutes compute the beta over different periods. If you want to see how much crap there is in cost of capital estimation, you can stop here. I am shaking when thinking about this.

| Company                           | Yahoo Beta | Market Watch Beta |
|-----------------------------------|------------|-------------------|
| NEXTERA ENERGY                    | 0.26       | 0.71              |
| DOMINION ENERGY                   | 0.40       | 0.68              |
| DUKE ENERGY CORPORATION           | 0.29       | 0.66              |
| SOUTHERN COMPANY                  | 0.46       | 0.71              |
| AMERICAN ELECTRIC POWER COMPANY   | 0.32       | 0.53              |
| EXELON CORPORATION                | 0.47       | 0.91              |
| SEMPRA ENERGY                     | 0.65       | 0.82              |
| XCEL ENERGY                       | 0.35       | 0.64              |
| CONSOLIDATED EDISON               | 0.19       | 0.50              |
| PUBLIC SERVICE ENTERPRISE GROUP   | 0.58       | 0.69              |
| WEC ENERGY GROUP                  | 0.21       | 0.55              |
| AMEREN CORPORATION                | 0.32       | 0.69              |
| AVANGRID                          | 0.31       | 0.62              |
| OTTER TAIL POWER                  | 0.42       | 1.06              |
| ALLIANT ENERGY CORPORATION        | 0.37       | 0.60              |
| NISOURCE                          | 0.31       | 0.74              |
| CONSUMERS ENERGY COMPANY          | 0.21       | 0.57              |
| OGE ENERGY                        | 0.67       | 0.74              |
| MGE ENERGY                        | 0.61       | 0.88              |
| IDACORP                           | 0.50       | 0.69              |
| HAWAIIAN ELECTRIC INDUSTRIES      | 0.25       | 0.60              |
| PORTLAND GENERAL ELECTRIC COMPANY | 0.43       | 0.80              |
| BLACK HILLS CORPORATION           | 0.43       | 0.92              |
| PNM RESOURCES                     | 0.50       | 0.87              |
| Average                           | 0.40       | 0.72              |
| Median                            | 0.39       | 0.69              |

### What if we Knew the Cost of Capital

Define the cost of capital as the minimum return acceptable for taking the risk. Or, the minimum target IRR. Cannot read this anywhere like interest rates. Strong incentives to make

this number high and not unbiased in many circumstances. Regulatory, justify monopoly profits ... But we do not know the number. If we did, we could compute the PV of ROIC and solve the IRR problem. We could compute terminal value in a sensible way.

### **Basic Problem with Cost of Equity Capital – You Cannot See It**

The question of what kind of growth rate you need to compensate for risk is at the centre of all finance. It drives project finance, the WACC in corporate finance.

The most basic problem with estimation of the cost of capital is that nobody can observe the number. There are no contracts between investors and a company that write down the percentage cost of equity number such as 6.5% for the cost of equity capital; you cannot track cost of capital changes in the same way that you can see changes in stock prices, interest rates, gold prices, exchange rates and other things. These days you can easily find data for things like earnings per share, operating income, cash flow, price to earnings ratios and so forth for companies on the internet; but you cannot find a number for the cost of equity anywhere. Furthermore, measuring the cost of equity is different from measuring the cost of debt. Components of the cost of debt are written in loan contracts where parts of the interest rate such as the base interest rate and the credit spread are explicitly written down in loan agreements. These credit spreads are collected in databases.

As the cost of equity cannot be directly observed, different methods have been created to implicitly derive and estimate the cost of equity. But all of the methods require estimation of variables that are subjective. These subjective variables include the market risk premium; the beta; the expected growth rate; the expected return, and the expected market risk premium. This difficulty in measuring the cost of capital should be a backdrop for all of the seemingly sophisticated economic equations that are used for variables like beta, country risk premia, expected growth rates and other items.

Coming up with a cost of capital number can be frustrating from both a theoretical and a practical data standpoint, particularly when working with the CAPM. Indeed, working through the details of cost of capital illustrates a panoply of flaws in financial theory. Some of the difficult technical questions include: if long-term bonds include inflation risk can this be called the risk free rate; is there a risk premium for stocks versus risk free bonds (the EMRP) that is stable; for non-US companies, should betas be computed on the basis of an international index or the local index; should betas be measured on the basis of daily, weekly or monthly returns; how should betas be un-levered and re-levered; how should the country risk be computed when local companies borrow at a lower rate than the government; can a good alternative to the CAPM be developed from implied cost of capital inside cash flow forecasts. I emphasise in this chapter that pretending that the cost of capital can be precisely estimated is misleading.

## **Cost of Capital is the Minimum Return You Need Before You Walk Away**

Given the difficulty in measuring the cost of capital, I begin with a definition of the cost of capital, which is not as simple as one may think. The cost of capital is not simply the rate of return that is desired by an investor. Rather, it is the minimum return that is acceptable for to compensate for taking risk. The key word here is minimum. It is not the expected return; it is not the return that other people get on investments. For example, when an investor complains that the rate of return is too low to invest in a hydro plant, the investor is correctly interpreting the meaning of the cost of equity. But if the investor would continue build the hydro plant even if the return was lower, this return for which the investor would not walk away is not equal to the cost of capital as defined by the minimum acceptable return.

The only way to really find the cost of capital is to ask industry participants what return they need in order to invest in real projects (i.e., before they will walk away from an investment or before they will not purchase a stock assuming they have some kind of good forecast of cash flow). Even if participants have estimates that appear to not conform with data on betas, market premiums or other factors that may seem irrational in the context of financial theory, it is the point at which investors will not make investments that we are looking for when we measure cost of capital. I do emphasise that caution should be taken in these industry participants as the most fundamental objective of any business is to earn a return above the cost of capital and they have a strong incentive to overstate their hurdle rate.

You can think of the cost of capital in a bidding context. In a highly competitive bid for a project that does not have some kind of provisions that give one company an advantage over another company (e.g., a solar plant bid in Dubai). You want to win a bid and offer a low price. Your manager wants a pretty high return. If you are to have any chance of winning the bid, you negotiate with you manager to push down the acceptable return to win the bid until you arrive at the minimum acceptable return. This minimum return must compensate for the risk you take if you win the bid. You can imagine how difficult it is to come up with a true number.

One can think of any cost of capital – the debt cost of capital; the equity cost of capital; the weighted average cost of capital; the cost of capital on mezzanine debt -- as the build-up of a real interest rate, inflation and a risk premium. A general formula for the cost of capital in Pakistan includes a real interest rate, the expected rate of inflation, a general risk premium for investing in equity, a company or industry specific risk premium and finally, a country risk premium. This simple equation is consistent with the CAPM can be represented by the formula below:

Cost of Capital = Real Interest Rate + Expected USD Inflation + General Risk Premium +/-  
Company Risk Adjustment + Country Risk Premium

Big Points

1. History of earnings power and market values and capital gains
2. Equity returns from stock markets and debt returns
3. CAPM Problems
4. EMRP and Economic Growth
5. Beta and Time Period
6. What is Risk Free Rate
7. When the Debt Cost is Greater than Equity Cost

### Crazy Cost of Equity Capital in Harvard Case Studies

Table xxx shows estimates of the cost of capital in an HBS case. This was published in \_\_\_\_.

| WACC                               |             |
|------------------------------------|-------------|
| Risk Free Rate, rfr                | 3%          |
| Risk Premium, rpm                  | 6.50%       |
| Rate on Debt, rd                   | 4.80%       |
| Rd(1-T)                            | 3.12%       |
| Beta (Based on comparable company) | 1.25        |
| Rate on Equity                     | 11.10%      |
| Weight of debt, wd                 | 84.7%       |
| Weight of equity, we               | 15.3%       |
| Tax Rate                           | 35.0%       |
| <b>WACC</b>                        | <b>4.3%</b> |

The CAPM market risk premium is obtained from historical data, with allowance made for the judgment of the analyst. For purposes of this calculation, we will assume that it is 7%. LBO Note

### Attempts to Find the Cost of Equity Capital from Projects

Another general source of cost of capital/return on equity estimates is data presented by Bloomberg when developing reports on the levelised cost of electricity for different technologies. Table xxx presents comparative data for 2019 when the Bloomberg used feed-in tariff with data from a Bloomberg report presented for the first half of 2021. Data in the table is supposed to reflect project costs and investment in USD, but there is some confusion with respect to currency adjustments. For example, when discussing returns in China, the Bloomberg report states that “we estimate that some projects can go ahead with a 6.5% nominal equity return.” It is not clear whether this is a local return in Yuan or a return that is in USD. In Table xx there is also some question as to whether the numbers represent the cost of equity which is the minimum acceptable return or alternatively whether the data is the hoped-for return. I believe low values for return on equity in the table (for example, Solar Low 2021) are the best representations of the cost of capital defined as the minimum return that is acceptable for the given level of risk. The return on equity data for Germany and Japan are notable and

demonstrate that the international cost of capital for wind projects in 2021 can fall below 5% (as stated above, the return on equity represents a maximum cost of capital estimate and the true cost of capital can be lower).

Bloomberg Return of Equity/Cost of Equity

| Countries   | Wind Onshore<br>2018 | Solar Low<br>2019 | Solar High<br>2019 | Solar Low<br>2021 | Solar High<br>2021 | Wind Low<br>2021 | Wind High<br>2021 |
|-------------|----------------------|-------------------|--------------------|-------------------|--------------------|------------------|-------------------|
| India       | 12.00%               | 11.50%            | 13.30%             | 11.00%            | 12.80%             | 10.80%           | 13.00%            |
| Australia   | 9.00%                | 7.50%             | 11.00%             | 6.50%             | 11.50%             | 6.50%            | 11.50%            |
| China       | 10.00%               | 8.00%             | 10.00%             | 6.50%             | 8.00%              | 8.00%            | 8.00%             |
| Philippines | 10.00%               |                   |                    |                   |                    |                  |                   |
| Vietnam     | 12.00%               |                   |                    |                   |                    |                  |                   |
| Thailand    | 10.00%               |                   |                    |                   |                    |                  |                   |
| South Korea | 9.00%                |                   |                    |                   |                    |                  |                   |
| Indonesia   | 12.00%               |                   |                    |                   |                    |                  |                   |
| Japan       | 8.00%                | 6.00%             | 7.00%              | 5.00%             | 6.00%              | 4.50%            | 5.50%             |
| Malaysia    | 10.00%               |                   |                    |                   |                    |                  |                   |
| Germany     | 5.00%                | 5.00%             | 5.00%              | 5.00%             | 5.00%              | 4.00%            | 5.00%             |
| UK          | 8.00%                | 7.00%             | 8.00%              | 6.50%             | 7.00%              | 7.00%            | 8.00%             |
| US          | 9.00%                | 7.00%             | 7.00%              | 8.00%             | 8.00%              | 8.80%            | 8.80%             |

### Can We Just Ask People What is Their Minimum Required Return

One can argue that this is a psychological/philosophical number that reflects investors minimum requirements can only really be determined by asking investors about their minimum expected returns. In the next chapter, I suggest that estimates of the general EMRP of more than 5-6% cannot be theoretically reasonable in the context of an economy that grows at 2-3% on a real basis because returns are growth rates. But if market participants have irrational requirements for the EMRP numbers, one could accept a higher number than the 2-3%. I emphasise that the EMRP estimated from the value of a stock index less the risk-free interest rate is completely distorted by capital gains caused by the change in the cost of capital itself. For example, if the value of stocks increases by 10% because of a decline in the cost of capital, this change in the value does not reflect earned returns of companies and should not be included in the risk premium.

### Equity Risk Premiums of Above 4% are Not Plausible in a Developed Economy

The term equity market risk premium (EMRP) is supposed to represent the amount by which the market is expected to outperform the risk-free asset. It is the centre piece of the CAPM; it is a real number (without inflation); surveys of what people use do not matter; it can only be estimated through measuring implied returns. In practice,  $R_m$  is approximated by the return on a broad stock market index like the S&P 500, and  $R_f$  is measured as the promised return on a

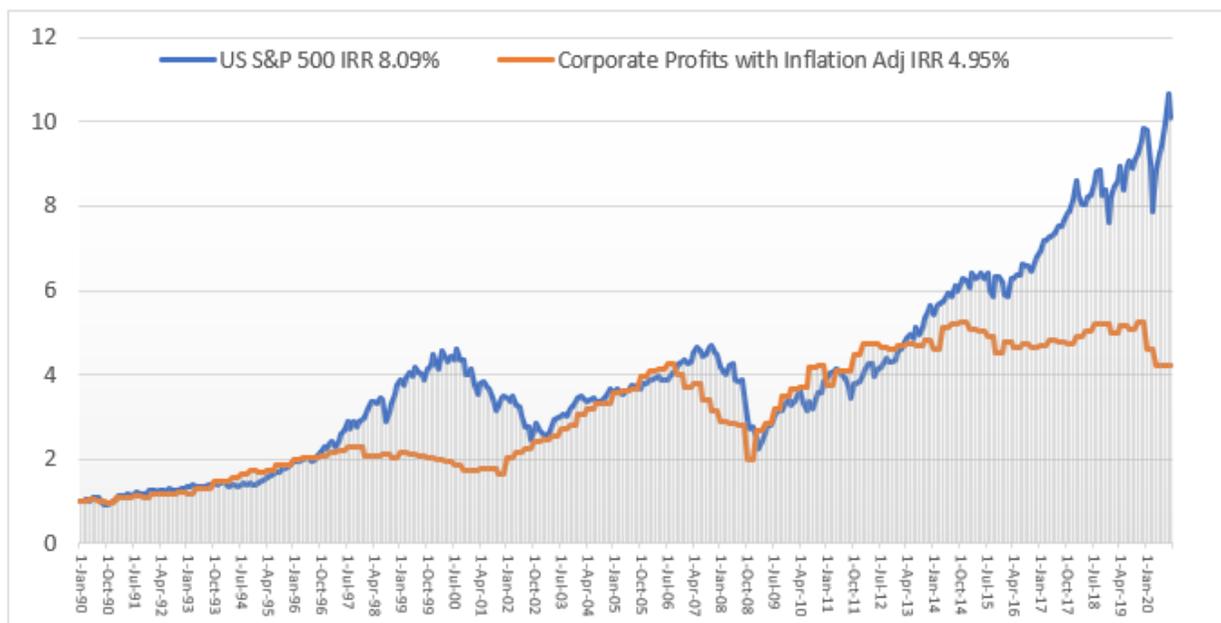
long-term U.S. government bond. According to a Harvard case study publication, “(t)he market risk premium has historically been about 7.5%, on average, although academic estimates of the ex ante premium range from 0.5% to 12%.” 2 Valuation

If somebody wants to criticize the CAPM, they could point to the uncertainty and variation in measurements of the EMRP. The following quote illustrates the problem: “While users of risk and return models may have developed a consensus that historical premium is, in fact, the best estimate of the risk premium looking forward, there are surprisingly large differences in the actual premiums we observe being used in practice. For instance, the risk premium estimated in the U.S. markets by different investment banks, consultants and corporations range from 4% at the lower end to 12% at the upper end.” With this kind of range in the equity market premium, the CAPM becomes useless. The range in the EMRP is the primary argument for deriving the implicit cost of capital from cash flow forecasts.

Estimates of the market risk premium can vary by a wide margin and some analysts have used estimates have been more than 7% in the past. If you go back to the fundamental definition of the cost of capital, the risk premium is minimum return that investors will accept relative to the risk-free rate.

An example of the main things that I question, that the equity market risk premium is anywhere near 6%, is illustrated on Figure xxxx. In teaching my classes I sometimes ask students how fast your money would have grown if you invested in the overall equity market (I will show you that it is best to define the IRR as a growth rate). My students seem to have been taught somewhere along the line that 8% is about what you could have earned if you invested in the stock market.

Perhaps this comes from the S&P 500 time series in yahoo. Finance website which for me has been revolutionary. With this website you can scrape data and then compute returns for most stocks in the world. Better yet, you can combine it with data from the Federal Reserve Economic Database (FRED) and then evaluate real and nominal returns, compare stocks to economic series, adjust for exchange rates, and evaluate stock performance relative to commodity price movements. Perhaps the 8% comes from an equity market risk premium of about 6% with a risk-free rate of about 6%. When you look at this more carefully,



## Market Returns and Cost of Capital

At the bottom of all things in finance, the value of an investment or anything else is driven by two things. The first is the level of cash flow and the second is the risk associated with the cash flow. The second item, the risk associated with the cash flow, is represented by the cost of capital. Keeping this basic idea about cash flow and risk in mind allows some interpretation and understanding of financial markets. First, if stock prices increase, it does not necessarily mean that companies are earning a higher return. Instead, if stock prices have gone up but the cash flow has not, you can surmise that the cost of capital has declined. To illustrate this, consider valuation of a perpetual cash flow stream (with a perpetual cash flow stream, the value is the constant cash flow divided by the cost of capital). Assume that the investment made for the stream is 1,000 and the return is 100. If the cost of capital is 10%, then the value is the same as the investment and the cost of capital is the same as the return. This is illustrated below:

$$\text{Value} = 100/10\% \text{ and } \text{Return} = 100/1000 = 10\% \text{ and,} \\ \text{Value/Investment} = 1.0 \text{ and } \text{Value/Earnings} = 10$$

Now assume that the cost of capital declines to 9% while the return remains at 10%. In this case the value increases to 1,111 while the return earned from the company remains at 10%. The investor has experienced a capital gain, but the capital gain is not from the investment earning a higher return. If NEPRA would interpret the return to be 11.1%, and set the return on this basis, it would not be setting the return to the cost of capital which would be 9%. This confirms that NEPRA cannot apply returns from increasing market indices when computing cost of capital.

This example illustrates the trap of assuming applying a stock price index increase either directly or indirectly applies to return measurement. This simple idea also implies that the change in a stock index cannot be used as the basis for computing the EMRP in the CAPM. Figure 10 graphs the U.S. S&P 500 Index and Corporate Profits published by the US government. It data is nominal and the inflation adjustment relates to adjustments made to depreciation for inflation. The graph demonstrates the idea that increases in stock prices over the past few years are the result of declines in the cost of capital rather than increases in earned returns and profits of the underlying companies.

### **Cost of Capital and Philosophy of Capitalism**

The most influential economists ranging from Adam Smith to Ricardo to Marx have been philosophers and I will argue that thinking a little more deeply about risk and return without computing a regression analysis of stock prices will produce more sensible results.

In applying the equity market risk premium or EMRP in the CAPM estimates, I first note how difficult it is to get your head around what this mysterious number is. If you could somehow pretend there was some kind of marginal investor who is the person or institution who is buying or selling shares, the equity market risk premium would be the minimum extra expected return that theoretical investor would need to take his money out of risk-free investments and invest in a portfolio of shares. Just writing these words can make your head spin. Historically the volatility of US stocks has been about 20%, while long-term bonds have a volatility of 7.6% and short-term bonds have a volatility of 3%. In my opinion, the equity market risk premium is somewhere between a psychological concept and a philosophical idea. But note a couple of things. First, the EMRP is about future returns and not about past experience, it is about expectations. I have written that the EMRP is affected by changes in the cost of capital itself and that returns earned from making an investment should not be distorted by changes in the cost of capital itself. Second, as the EMRP reflects the returns or rates of growth to a group people in the economy, if the returns and the EMRP is greater than the real growth in the economy, then investors as a group will always get richer at the expense of everybody else. I leave it to the reader to contemplate whether this is sustainable in the long-run. Third, any discussion about using geometric versus average returns should have been resolved ages ago. Returns are measured on a compound basis. Fourth, the portfolio of stocks that evaluate the return on stocks relative to risk free bonds should not be limited to a particular geographic location. For example, there is no reason to expect an investor in Pakistan who can invest in stocks all around the world to have a different minimum required criteria for taking equity risk versus bond risk than any other investor in the world. Both investors can invest in the same portfolio.

When thinking about the risk premium without getting trapped by technical discussions of items such as the geometric mean versus the arithmetic mean you can think of some very basic economic analysis of the supply and demand for capital supplied by people who want to invest in the market rather than in risk free securities that are earning almost nothing. You can think of pension funds or insurance companies for example. As the supply of capital increases and the alternatives of investing in bonds produce low returns, the mysterious risk premium which is the minimum acceptable return will decrease. This indeed is just about the only way to explain increases in market indices.

A few things that should be considered in evaluating the EMRP include:

If the EMRP is higher than the real (not the nominal) growth rate in the economy, investors as a group will continue to get richer while the rest of the economy will become poorer. This means that assuming an EMRP much higher than the real growth in the economy is a very questionable idea.

As money grows in an exponential manner with increasing returns, the amount of money that you generate from the risk premium produces a dramatic number relative to the risk-free rate.

If there were no changes in the cost of capital and investor supply and demand for risk did not change -- two completely unrealistic assumptions -- then the historic difference between the market portfolio and the risk-free rate could represent an equilibrium payment for risk. If the return was lower on stocks, then investors would move out of stocks and the return would increase. The problem is that the cost of capital changes as well as the supply and demand for risk capital.

Changes in the cost of capital produce capital gains or losses that are measured in the market index but do not have anything to do with the earning power of a company. For decades, declines in the cost of capital have led to increases in market indices.

In comparing the EMRP with credit spreads on risky bonds, it is not appropriate to assert that bonds have lower risk than equity. Bonds with a rating such as B or BB have downside risk but no upside potential other than the credit spread. Stocks have expected returns with both upside potential and downside risk with an expected return equal to the EMRP. The EMRP compensates for upside and downside volatility while the credit spread deals with only with downside risk.

### **Biases and Vested Interests in Measuring the Cost of Capital**

I have testified on what is the appropriate cost of capital for utility companies since the 1980's and I recognize the controversy, biases, difficulties and uncertainties in the process. Cost of capital is used to set the rate of return and the prices of utility service and as such is one of the most important functions of not the most important function of a regulatory commission. Unfortunately, the cost of capital determination in regulatory agencies as well as business school programs and practiced in the finance profession is subject to important bias and confusion resulting from vested interests. Examples of biases, vested interests with important implications for understanding why cost of capital include:

1. In estimating the cost of capital for utility companies, regulatory agencies are under great pressure from financial interests not to deviate from norms in the industry. In the U.S., utility companies are clearly earning far more than the cost of capital as evidenced by price to book ratios well in excess of 1.0. Lowering rates or return to the cost of capital would cause heavy political pressure on the regulatory agencies from vast financial interests.
2. Country risk premiums applied to increasing returns for Pakistan and other countries allow foreign investors to extract higher profits from a country and allow local investors to increase prices. There is heavy financial pressure from vested interests to promote methods of analysis that result in high country risk premiums as justification for the increased tariffs and financial returns.
3. The notion that the premium earned on stocks relative to the nominal cost of government debt (the market risk premium) is greater than the real growth rate in an economy

implies that investors as a group will continue to have their wealth expand relative to labour and other economic groups. The whole finance industry with natural interests to have stock values to increase at a faster rate than the overall economy has an incentive to argue for a high equity market risk premium (EMRP). The unrealistic and high market premiums have crept into all sorts of financial theory.

4. The risk of inflation rates changing from what is expected in the future is a very big when investing in long-term bonds that have a fixed nominal interest rate. Despite this fact that can easily make investing in long-term bonds riskier than investing in equities, the financial profession maintains that the equity is always riskier than debt which again justifies higher earned returns and higher tariffs.

# Chapter 11

## Cost of Capital Part 2 – CAPM Inputs are Impossible to Measure

### **The Real Problem with CAPM is Measurement of Inputs and Not Some Vague Proofs of Whether Beta Measures Risk**

The CAPM is commonly used for estimating the cost of capital, but inputs for the model are subjective and the model has theoretical problems. The CAPM is difficult to implement and problematic not because of some academic study that questions whether beta is the only relevant measure of risk. The real problems with the CAPM comes about because of difficulties in measuring the risk-free rate, the beta and most of all the equity market premium.

The Capital Asset Pricing Model (CAPM). CAPM was first developed by William Sharpe and John Lintner for which William Sharpe was given the Nobel Prize in 1990. There are now big questions surrounding the CAPM both in terms of whether the model is even theoretically valid in measuring the cost of capital and in terms of the appropriate inputs to the model. But the CAPM is the most used model in computing the cost of capital. For example, a recent academic article stated: “The Capital Asset Pricing Model (CAPM) is the predominant model of risk and return taught by academics in universities and business schools in undergraduate, MBA, and executive education programs.

The CAPM is also widely used in practice, in particular, to estimate the cost of (equity) capital for a firm. However, it is well known that the CAPM does not fit the data.” While some academics suggest that the cost of capital can be estimated with more esoteric methods using the Arbitrage Pricing Model, the real alternative to the CAPM is deriving the cost of capital from valuations and estimates of cash flow. Given uncertainties associated with CAPM inputs it is frustrating to read academic studies that attempt to test the CAPM when the real problem is that the inputs are so difficult to measure.

A simple representation of the CAPM model is the following formula below. This formula is intuitive as you begin with a risk-free rate and add a risk premium as you would add a risk premium for a bond.

Cost of Equity = Risk Free Rate + Beta x Equity Market Risk Premium + Country Risk

As stated above, the only place where inflation comes into the picture is the risk-free rate. However, in using an implicit long-term inflation rate from a long-term bond, the inflation risk is introduced, and it is not appropriate to assume the long-term bond rate is risk free. The other data including the equity market risk premium and the country risk does not include inflation.

### **A 10-year Bond is not Risk Free**

Estimation of the cost of capital for investments that directly or indirectly receive returns in USD begins with an estimate of the risk-free rate represented by USD long-term treasury bond yields. The treasury bond yield is the only element in the traditional CAPM analysis that includes expected inflation. In theory, the period of inflation implicit in the cost of capital should correspond to the duration of the cash flow.

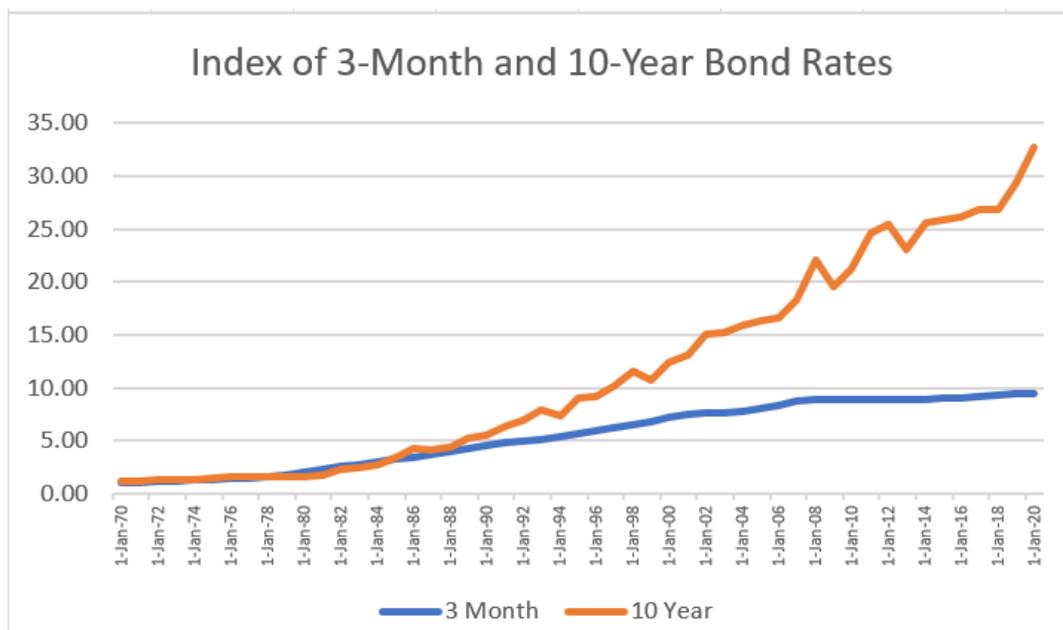
The 10-year bond yield overstates the risk-free rate because long-term bond yields include USD inflation risk. This is because when an investor buys a 10-year bond, the return is in fact not at all risk free in real terms even if the investor holds the bond to maturity. If the inflation rate turns out to be higher than the rate implied when the bond is purchased, the investor loses real purchasing power.

The real interest rate plus the expected inflation is represented by the nominal yield on treasury bonds. If the bonds are realised in USD, the purchasing power realised return is after USD inflation. There is some debate as to whether a short-term interest rate or a 5-year interest rate or a 10-year interest rate should be used in the cost of capital formula. Say investors in bonds are expecting different inflation rates over a 1-year, 5-year and 10-year period. The tenure of the bonds should reflect the USD inflation rates over the forecast period. To illustrate the relation between the PPA period, the inflation rate and the length of debt, assume a hypothetical two-year PPA agreement. If there are two zero coupon bonds, one with a maturity of one year and a second with a maturity of two years, the inflation rate will be hedged.

Treasury bonds using USD yields are generally used as a benchmark for a nominal risk-free rate that includes USD inflation and the real interest rate. Figure xxx shows recent trends in yields of USD treasury bonds with 5-year and 10-year maturities. The graph demonstrates rates were very low at the beginning of the pandemic and have increased. But the rates are below the Treasury Bond rates from 2019.



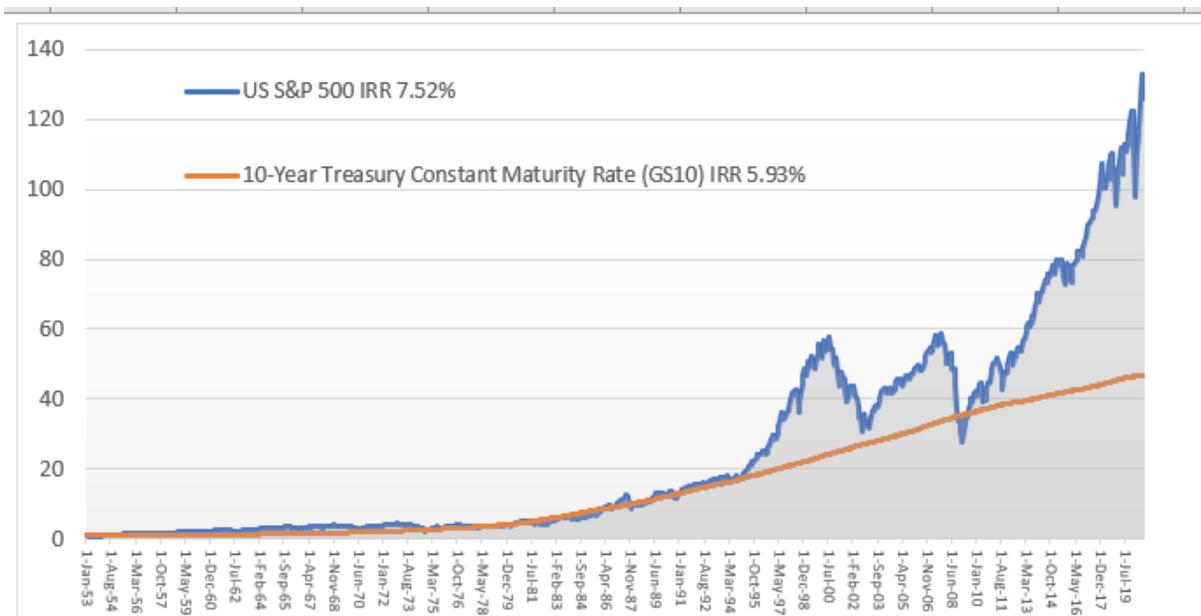
The variation in returns for long-term bonds as compared to short-term bonds is illustrated in Figure xxx. The source of this data is the Ibbotson data that was published by Damodaran.



**Equity Market Risk Premium, Capital Gains and Income Distribution**

The intuitive part of the CAPM is that the method begins with a risk-free rate and then adds a premium for risk. The risk premium (without country risk) consists of two parts, both of which are controversial. The first is an overall estimate of the return required for stocks in general called the equity market risk premium (EMRP). The second is the company specific factor measured with beta. The overall risk for investing in stocks relative to long-term risk-free bonds – the EMRP -- is a mysterious number that supposedly reflects risk and volatility of stocks in general relative to safe and stable bonds. The mysterious risk premium that drives much of the CAPM analysis is often the most controversial and difficult part of the CAPM is measuring the EMRP except for the country risk premium.

Figure xxx shows the measured equity market risk premium for the U.S. using earned returns on stocks versus the treasury bond rates since data is available for 10-year Treasury Bonds in 1953 which is easily available from the internet. The premium depends on the start date of the index and the end date, and the selected date produces a differential of 7.52% minus 5.93% or only 1.59%. This data is from the geometric average (the growth rate) and derived from S&P 500 data published by Yahoo Finance. The returns on the S&P 500 are somewhat lower than the Ibbotson returns used by Damodaran. The alternative stock indices will be documented in an appendix to be developed with NEPRA staff. In recent years, the graph shows a dramatic increase in the earned returns on equities relative to the 10-year bond yield which could lead to an incorrect assertion that the EMRP has increased. I elaborate on this below that the increase in the measured premium has more to do with the decline in the cost of capital as shown in Figure xxx than the return earned by stocks and greatly distorts any measure of EMRP from differential returns between stocks and bonds.

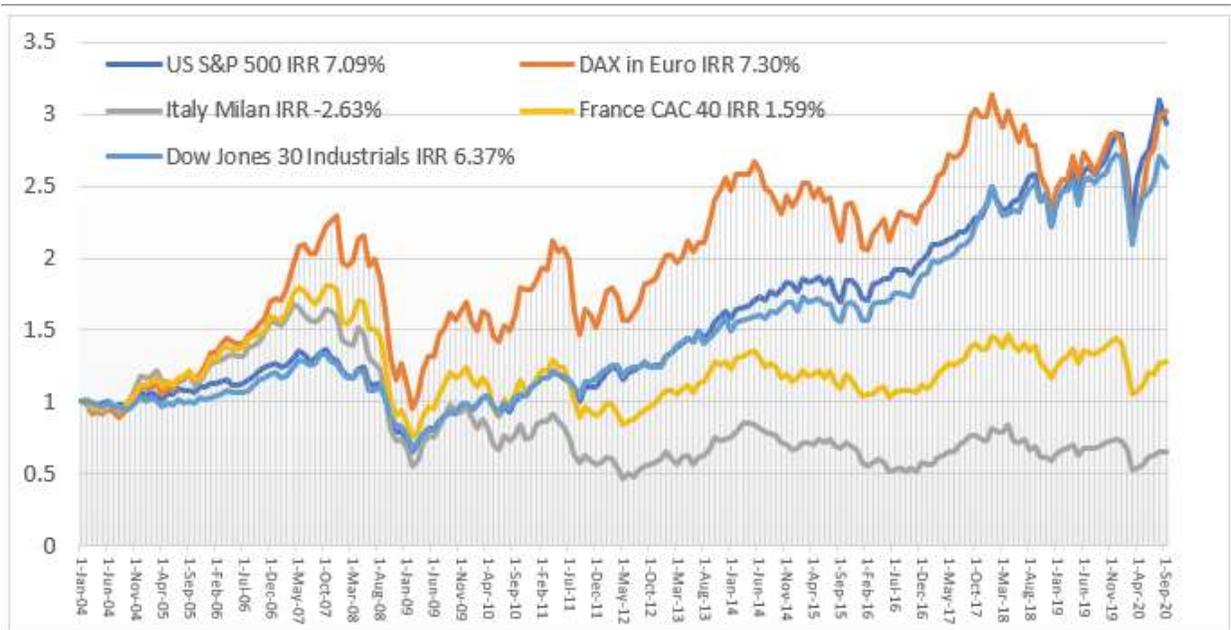


## **Beta Introduction**

Maybe the most famous input into the CAPM is the beta. Rather than thinking about beta as some vague statistical concept, you can think of it as relative risk for an industry or a company relative to the entire market. For the kind of companies that are the subject of this paper – electric companies that are regulated in one way or another -- the relative risk should be low compared to other companies that are more subject to macro-economic risk, over-supply risk from competition, and other risks that are difficult to control such as changes in fashion or subject to obsolescence. When the overall financial market moves up or down in a day for things like changes in the expected cost of capital or general expectations of economic growth, you would generally expect the companies more subject to over-supply and competition to react more than companies that have little price or volume risk such as regulated electric companies. This all means that one would expect the beta to be less for regulated electricity investments than other investments.

## **Beta Problem 1 – Which Index**

The second component of the risk premium added to the risk-free rate in the CAPM is the company or industry specific risk that is measured with beta. The beta is a statistic that is centred around 1.0 for companies that have the same risk as the overall market. In general companies with fixed or regulated prices and stable demand such as IPP's and regulated distribution companies should have betas substantially below 1.0. This is generally observed for international utility companies. It may seem that computing the beta from the volatility of a stock relative to the overall market is objective and not subject to controversy and can be computed with a standard formula (the formula can be computed in a minute in excel by using the slope function for the percent change on a stock relative the percent change in the overall stock index. But betas can vary from using different samples of companies; different time periods (five years or longer or shorter periods); different market time increments (daily, weekly or monthly data); and different market indices.



|                      | IRR    | Vol    | Beta |
|----------------------|--------|--------|------|
| US S&P 500           | 7.09%  | 13.72% | 1.00 |
| DAX in Euro          | 7.30%  | 20.25% | 1.15 |
| Italy Milan          | -2.63% | 23.31% | 1.17 |
| France CAC 40        | 1.59%  | 18.87% | 1.06 |
| Dow Jones 30 Industr | 6.37%  | 13.90% | 0.93 |

## Beta Problem 2 – Time Increments and Statistical Properties

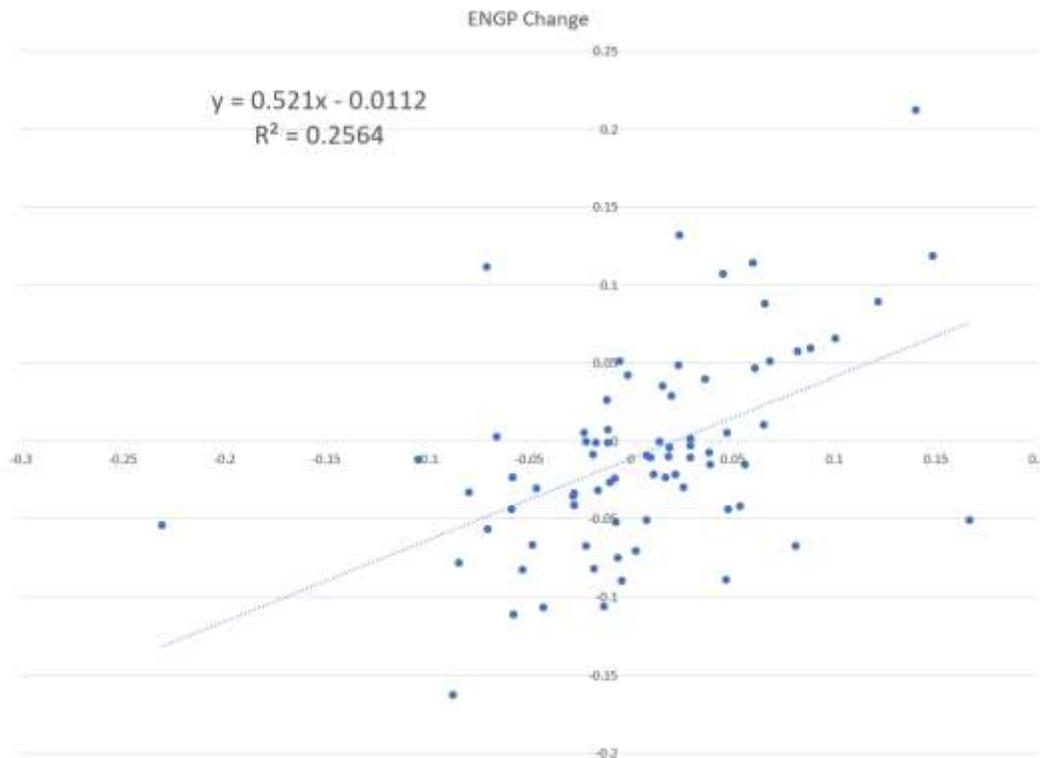
Beta is measured using statistical analysis of the return on a stock versus the return on the overall market.

$$R_s = \text{Alpha} + \text{Beta} \times R_m$$

This is really easy to do these days.

The second issue involves the time-period for computing beta. The conventional method is to compute the beta over five years (sixty months). From an intuitive perspective, the idea of using a time period that is not too long may miss fundamental changes in the structure of the company. The industry may be more competitive with surplus capacity or the company's strategy may have changed resulting in differences in risk. The idea of using a time-period that is not long enough is the general idea in statistics that you should use as much data as possible.

But the time-period of five years is arbitrary. The fundamentals of the business risk have not changed, and it could be argued to use longer term data. If somebody suggests there is some kind of magic in using five years or there is proof that this is the best length, the suggestion is fraudulent.



The S&P 500 is often used as an index for computing Beta in the for US and other international stocks rather than an international index. In addition to the question of which index to use, I suggest that beta calculations be made on a monthly basis using the S&P index rather than the KSE Index.

You may think that once the stock price data is available, the beta which is the slope of the change in the stock versus the change in the index is a straightforward number to compute. But as with other subjects, there are uncertainties with the calculation and the implied company risk can vary a lot. This is demonstrated when computing betas for the nine IPP's in Pakistan which highlight frustrating issues with the beta statistic. Table xxx demonstrates large differences in betas that arise from different historic time periods, different time increments (monthly or daily) and different market indices (KSE or S&P500). The most appropriate beta is the median beta of the Pakistani IPP's computed using the S&P 500 index has a value of .518.

|      |          |          |          |          |          |          |
|------|----------|----------|----------|----------|----------|----------|
| From | 1-Nov-16 | 1-Nov-12 | 1-Nov-16 | 1-Nov-12 | 1-Nov-16 | 1-Nov-16 |
| To   | 1-Nov-21 | 1-Nov-16 | 1-Nov-21 | 1-Nov-16 | 1-Nov-21 | 1-Nov-21 |

| Ticker  | Monthly Prices  |       | Daily Prices    |       | Monthly             | Daily |
|---------|-----------------|-------|-----------------|-------|---------------------|-------|
|         | Relative to KSE |       | Relative to KSE |       | Relative to S&P 500 |       |
| HPWR    | 1.050           | 0.758 | 1.088           | 0.784 | 0.930               | 0.474 |
| SAIP    | 0.621           | FALSE | 0.643           | FALSE | 0.518               | 0.293 |
| ENGP    | 0.520           | FALSE | 0.624           | FALSE | 0.475               | 0.313 |
| NCPL    | 0.753           | 0.637 | 0.853           | 0.662 | 0.511               | 0.328 |
| NISH    | 0.437           | 0.823 | 0.666           | 0.717 | 0.179               | 0.219 |
| KOHN    | 0.506           | 0.260 | 0.418           | 0.509 | 1.394               | 0.234 |
| LPLP    | 0.598           | FALSE | 0.781           | FALSE | 0.450               | 0.266 |
| PKPL    | 0.959           | 1.093 | 0.807           | 0.892 | 0.568               | 0.456 |
| KOTA    | 1.004           | 0.511 | 0.968           | 0.642 | 0.891               | 0.320 |
| Median  | 0.621           | 0.697 | 0.781           | 0.689 | 0.518               | 0.313 |
| Average | 0.717           | 0.680 | 0.761           | 0.701 | 0.657               | 0.322 |

As I already wrote in Section 2, the beta can be computed using alternative methods and yield different results. You can calculate the beta very quickly if you have the stock price of a company and the index used for simulating a portfolio. All you have to do is to first compute the percent change in the index and the stock price and then use the slope function in excel. While beta is easy to compute, there are a number of detailed issues in computing betas that are applicable for the companies that are regulated by NEPRA. One of the problems is to decide whether to use daily prices, weekly prices or monthly prices in making the slope calculation. A second problem is whether to use a general index that represents an international portfolio or a limited portfolio of Pakistani stocks that are represented by the Karachi 100. Third, the general idea of beta is that the risk of an industry is relatively stable. This implies that it should matter whether the beta is computed over one year, five years, ten years or another period. Fourth, given the potential variance in measurement of beta for one company, it is better to try and find a representative sample than using a single company. Fifth, the beta may have to be evaluated together with the country risk premium as there may be double counting of risk. Sixth, is the problem of whether you should compute un-levered betas and then compute re-levered betas for the Pakistani IPP's or other companies.

The first issue related to the timing of the data – monthly or weekly or daily data -- is not often covered by academics. But the equation below shows that the difference causes about 1% different estimates for the cost of capital. I have done work that demonstrates that the use of monthly data rather than daily or weekly data because of statistical properties of the data and fundamental assumptions that the stock prices should be independently distributed. The problem of using monthly or weekly data was illustrated in Table 5 where betas for Pakistani

IPP's were presented. The data is illustrated in graphic form in Figure 17 where you can see that for most of the IPP's the monthly data produces a lower beta, but there are a few exceptions. To answer why you arrive at different beta's when daily versus monthly data is I have made some theoretical research. With a Monte Carlo simulation I measure betas using daily and monthly data when there is no mean reversion in the data.

|                                     | IRR    | Vol    | Beta |
|-------------------------------------|--------|--------|------|
| US S&P 500                          | 20.22% | 15.99% | 1.00 |
| NEXTERA ENERGY INC                  | 33.69% | 15.84% | 0.20 |
| DUKE ENERGY CORPORATION             | 12.11% | 19.69% | 0.22 |
| DOMINION ENERGY INC                 | 5.59%  | 15.83% | 0.37 |
| SOUTHERN COMPANY (THE)              | 14.62% | 18.75% | 0.46 |
| AMERICAN ELECTRIC POWER COMPANY INC | 14.10% | 18.94% | 0.28 |

### Beta Problem 3 – Incredibly Arbitrary Mean Reversion Adjustments

The problem with different beta measurement arises because there is mean reversion in short-term stock price data.

In terms of risk analysis that applies to the electric utility industry in general, I present a sample of U.S. utility companies. Table 18 demonstrates beta calculation from downloading the stock prices and then computing the percent change in the stock price relative to the percent change in the S&P 500 index. This is computed using monthly average prices for both the individual stocks and for the S&P 500. The time period for computing the betas is 2017 to 2021 which is the standard 60 month period for computing beta. For this small sample, the betas range between .2 and .46. The stock price patterns for some utility companies are shown in Figure 18.

A clear example of the uncertainty associated with beta is the difference between the reported beta for the same companies by the MarketWatch website and the Finance.yahoo website. The difference in the reported beta is discussed in Section 3. I demonstrate that when the yahoo beta is about 0.2, the MarketWatch beta is about 0.6 for Finance.yahoo. I also confirm the lower beta statistics with independent calculations directly from stock prices. In Section 3, I delve into the data in more detail and discuss why stable utility companies used to represent the cost of capital for generation projects in Pakistan should be expected to have relatively low betas.

Table xxx shows the betas that can be downloaded from the Yahoo finance and the MarketWatch website. The table shows that the Yahoo betas are very similar to the betas computed in Table 7 from stock prices. Table xxx compares betas computed using the two sources. I use the example of one company to demonstrate some of the issues.

The distribution company that is not subject to merchant generation risks and is a stable company, Consolidated Edison is an example of a pure play utility company. Table 8 demonstrates that the two betas are dramatically different from the different sources. Further the differences between the sources are greatest when the beta is farthest from 1.0. This is likely due to an assumption of beta mean reversion in the MarketWatch beta column where the raw beta is adjusted to be closer to one using a formula such as  $\text{beta} = \text{raw beta} \times .67 + .33$ . As there is no evidence that the risk of companies gradually converge to 1.0, this mean reversion adjustment is not valid. The reasonable beta for U.S. utilities is the value of .4 at the bottom of the table for the Yahoo column. This table demonstrates that typical betas for electric utility companies are below the betas computed for the Pakistani IPPs.

| Company                           | Yahoo Beta | Market Watch Beta |
|-----------------------------------|------------|-------------------|
| NEXTERA ENERGY                    | 0.26       | 0.71              |
| DOMINION ENERGY                   | 0.40       | 0.68              |
| DUKE ENERGY CORPORATION           | 0.29       | 0.66              |
| SOUTHERN COMPANY                  | 0.46       | 0.71              |
| AMERICAN ELECTRIC POWER COMPANY   | 0.32       | 0.53              |
| EXELON CORPORATION                | 0.47       | 0.91              |
| SEMPRA ENERGY                     | 0.65       | 0.82              |
| XCEL ENERGY                       | 0.35       | 0.64              |
| CONSOLIDATED EDISON               | 0.19       | 0.50              |
| PUBLIC SERVICE ENTERPRISE GROUP   | 0.58       | 0.69              |
| WEC ENERGY GROUP                  | 0.21       | 0.55              |
| AMEREN CORPORATION                | 0.32       | 0.69              |
| AVANGRID                          | 0.31       | 0.62              |
| OTTER TAIL POWER                  | 0.42       | 1.06              |
| ALLIANT ENERGY CORPORATION        | 0.37       | 0.60              |
| NISOURCE                          | 0.31       | 0.74              |
| CONSUMERS ENERGY COMPANY          | 0.21       | 0.57              |
| OGE ENERGY                        | 0.67       | 0.74              |
| MGE ENERGY                        | 0.61       | 0.88              |
| IDACORP                           | 0.50       | 0.69              |
| HAWAIIAN ELECTRIC INDUSTRIES      | 0.25       | 0.60              |
| PORTLAND GENERAL ELECTRIC COMPANY | 0.43       | 0.80              |
| BLACK HILLS CORPORATION           | 0.43       | 0.92              |
| PNM RESOURCES                     | 0.50       | 0.87              |
| Average                           | 0.40       | 0.72              |
| Median                            | 0.39       | 0.69              |

# Chapter 12:

## The Only Real Alternative to CAPM is Deriving the Cost of Capital from Expected Cash Flow

### Everybody knows the CAPM is Bad

But alternatives like multi-factor models are absurd.

Alternatives are more reasonable because you have access to so much data and you can derive. If you have the forecasted cash flow and the value, you can derive the cost of capital. This will boil down to whether you think that you can project Beta and EMPR or whether you can make a reasonable assessment as to expected growth and the

Anybody who works in finance should know that measuring the minimum acceptable return that is acceptable for an investment cannot be avoided. The problem with measuring cost of capital is that you cannot observe the number. We know that the value of anything depends on the future benefits – cash flow – and the risk applied to the cash flow – the discount rate. Most of the time you can see the value (the value of a share of stock, the value of an M&A transaction etc.), but you not see either the discount rate or the future cash flow. The CAPM and other useless variants attempt to compute the CAPM using a direct method. Other methods use an indirect method whereby the cost of capital is derived from some estimate of cash flow. The difference between the methods boils down to whether you think you can better estimate things like the equity market risk premium, whether you think it is better to use unadjusted weekly betas or adjusted monthly beta; whether you think adjustments for country risk and company size are appropriate; whether you think a 10-year bond with a lot of inflation risk is really risk free. On the other hand if you use the indirect approach you must compute things like expected earnings and returns and changes in the rate of growth over time.

As there are many theoretical and statistical issues with each of these variables, the only real alternative to the CAPM is deriving the cost of capital from stock values and the expected cash flows. In section 5, alternative cost of capital models are discussed which use expected cash flows and the current value of stocks to back into the cost of capital. One way to use cash flow to evaluate the cost of capital is to review the performance of companies in Pakistan. In Section 5, I explain that when the price to book ratio is above 1.0 meaning the market value of the

stock is above the investment, then this is an indication that the company is earning more than the cost of capital.

Instead of using the CAPM, I have attempted to evaluate differences in cost of capital by evaluating how lenders consider different risks for different projects. For example, the debt service coverage ratio is often lower for a solar project than a wind project because of difference in risk. This difference in lending standards can be used to back in to the difference in cost of capital. Other sources that are not based on the CAPM include using data such as the Bloomberg report that implicitly uses cost of capital from industry participants. As such, I have interviewed investors to evaluate the differences in cost of capital for different projects. In the end, as with other cost of capital issues, judgement is necessary.

The most basic problem is that nobody can observe the cost of equity. You can find things like earnings per share, operating income, cash flow, price to earnings ratios and so forth, but you cannot find the cost of equity anywhere.

The reason that the CAPM has become so universal is that it is simple to calculate and it seems that the inputs are easy to find and apply. It also has some intuitive benefits. The model recognizes that the cost of capital changes when overt all interest rates change; it has a premium and a risk-free rate like credit spreads which are more objective measures of risk. But in terms of giving a realistic cost estimate, it fails.

For decades it has been clear that the CAPM model does not work. More importantly, the model inputs – the risk-free rate; the beta measurement; the equity market risk premium; adjustments for country risk; and other adjustments (e.g. company size or liquidity) make the model prone to manipulation and just about irrelevant in terms of practical use. These days it is easy to find references that the CAPM is bad. According to surveys that are probably not too good – managers make subjective assessments of the cost of capital – the vast majority of managers use the CAPM.

Why cost of capital is so important. Look at the Dow Jones companies with some exceptions. EBITDA and cash flow has been stable. But stock values have increased dramatically.

Alternative methods make use of the general value driver formula that  $\text{Value} = \text{Income} \times (1 - \text{growth}/\text{Return}) / (\text{Cost of Capital} - \text{Growth})$ . The problem is that these methods require some kind of estimate of long-term and short-term growth and return.

Another method recognizes one truism in valuation and finance. That is:

When the value of cash flow is equal to the amount of money invested,

Then, the cost of capital is the same as the rate of return.

You can express the valuation formula in many different ways. You can use equity cash flows and derive it as follows:

Similar references that just about everybody uses CAPM.) One of the revolting things about the

You can start with a simple and stable industry. This can evaluate what EMRP is appropriate.

Comments from a smart person: Well, last year I took Damodaran's class. I started to butt heads with him, because so much of the class was spent on CAPM, and I just don't believe in CAPM. I don't believe in beta, and I don't really believe that we should judge WACC based on market equity instead of book equity. (NFLX, BA, HD, just to name a few, REALLY show the failure of WACC) Anyway, after that class I came across your site and I've been digesting all your material. Which I want to stop and say THANK YOU!!! Your material is the best I've seen anywhere in all my days of doing this, online, 100-200 finance books read, etc.

For example, I think we can agree that humans need food. If you create an investment portfolio of every food company you can find in the world, the growth rate in food quantity sold should be a function of the growth rate of the population -- otherwise the world population would become very fat or thin. There may be some risks associated with changes in productivity and changes in the ability of the industry to earn monopoly profit, but suggestion that our portfolio of food companies requires large risk premia to investors to accept risk of people eating a lot more or less should not be an issue (Food companies have betas of around .6, which is subject to mean reversion and gets to .7, which is multiplied by the equity market risk premium of 6% giving you a premium of 4.2%. This is added to a 10-Year treasury bond yield of about 2.5% which includes inflation risk and gives you a required return or growth rate of 6.7%). This little example of food companies is intended to suggest that questions about what makes people happy and what makes people nervous are at the bottom of taking risks in individual investments. This contrasts to statistics like volatility, beta, equity market risk premium, WACC, value at risk or other attempts financial professors have made to put a monetary value on risk.

My ability to think deeply about the meaning of risk versus return or happiness compared to anxiety is most certainly limited. On the other hand, I have worked on all sorts of financial models in my career. These models may not have much efficacy in predicting the value of stocks, but the models can be used to prove or disprove financial theories. I think they provide better proofs than integral formulas excessive equations that don't tell you much at all. For example, one of the few finance thinkers who I really respect was Merton Miller. He proved his theory with a very simple arbitrage model rather than with a lot of complicated calculus (he compared the case where a company raises debt to the case where investors raise their own debt). So, to work through many financial issues, I have created relatively simple economic and financial models as well as Monte Carlo simulations. I hope you will find these models that contain proofs of why a particular aspect of financial theory is incorrect easier to confirm than absurd and unnecessary equations with integrals that prove nothing other than the authors ability to make up equations.

For example, the McKinsey Valuation book (that some people refer to as the Valuation Bible [footnote]) contains more than 800 pages that praise the virtues of earning monopoly profits demonstrated by the ability of earning a return above the cost of capital and asserts that very high returns are good for everybody in society including workers. The models I create try to demonstrate whether ideas such as this are correct. If you invest in every company in the world, and if profits from companies have the same long-run percentage of the GDP, your portfolio should grow in real terms at the same rate as the real GDP. More importantly, it should have about the same long-term risk that is associated with overall economic growth. Further there should be less risk of changing risk of inflation with your big portfolio than the risk of inflation in long-term bonds. This is the contribution of Harry Markowitz.

### **Finding Particular Examples to Derive Boundaries on Cost of Capital**

As with the analysis of stocks in general, the analysis of cost of capital changes can be made for stocks in the electric utility industry to evaluate recent trends. I have collected financial data for electric utilities around the world, some of which are pure distribution companies, some of which have merchant price risk, some of which are distribution companies and some of which are companies that invest in renewable energy projects.

There is one statistic that gives a simple indication of whether a company is earning its cost of capital which is the price to book ratio. You can think of this ratio as the current value of a company divided by the amount of money that investors put in the company (depreciation is represented as replacement capital expenditures in this framework). In section 5, I demonstrate that a market to book ratio of above 1.0 indicates a company's earned ROE is earning more than the cost of capital and a market to book ratio of below 1.0 suggests a company a company's ROE is less than the cost of capital. Figure 11 demonstrates one example of an international utility company that is earning more than the cost of capital as evidenced by the market to book ratio of more than 4. Figure 11 is for the electricity company with the

largest market capital, NEXTERA Energy. If the company were regulated one could argue that rates should be lowered until the company's price to book reaches a level of 1.0. Indeed, the high market to book ratios for utility companies mean that companies are very reluctant to have proceedings where the rates can be changed. The top graph shows that the return on equity is about 8%. With this return on equity, the market to book ratio is more than four times. These two statistics suggest that the company is earning far more than its cost of capital at the return of 8% and further confirms the decline in international cost of capital.



The general notion of deriving the cost of capital from stock market valuation and cash flow estimates is founded on the idea that the value of any investment can be expressed as a cash flow forecast discounted by the cost of capital. This is illustrated in a very simple manner in the equation below (I write a few equations in this section, but I attempt to make them as simple as I possibly can). In writing the equation you could assume the cash flow occurs for an indefinite period and write infinity.

$$\text{Value} = \text{Cash Flow}_1 / (1 + \text{Discount Rate}) + \text{Cash Flow}_2 / (1 + \text{Discount Rate}) \\ + \dots \text{Cash Flow Infinity} / (1 + \text{Discount Rate})$$

This equation can be simplified to the following if the cash flow is the same each period. In finance this is called an annuity.

$$\text{Value} = \text{Cash Flow}_1 / \text{Discount Rate}$$

The idea behind this equation is the basis of deriving the implied discount rate from the value and the cash flow. By re-arranging the equation, you can derive the discount rate from the value divided by the cash flow. Note that behind deriving the cost of capital in this manner is that you must make some kind of cash flow forecast. The central question in using implied cash flow instead of the CAPM is whether you can make a more reasonable forecast of growth rate in cash flow or whether the CAPM inputs – EMRP, Beta and Country Risk Premium – are more reasonable to forecast.

When the cash flow model to derive cost of capital was originally applied in regulatory proceedings, it used a constant growth rate formula. In 1956 a finance professor named Myron J. Gordon (who wrote testimony in support of increasing the cost of capital for utility companies) used the basic fact from integral calculus that if there is constant growth in cash flow, the value formula becomes:

$$\text{Value} = \text{Cash Flow}_1 / (\text{Discount Rate} - \text{Constant Growth})$$

If the cash flow used in this formula is dividend payments on a stock and the formula is rearranged, then the discount rate or the implied cost of capital can be expressed as the forward dividend yield and the growth rate. This is illustrated in simple formulas below:

$$\text{Stock Value} = \text{Dividend per Share} / (\text{Cost of Capital} - \text{Constant Growth})$$

$$\text{Cost of Equity Capital} = \text{Dividend per Share} / \text{Stock Value} + \text{Constant Growth}$$

This formula as caused a lot of debate in regulatory proceedings as the estimate of constant growth drives the estimate of the cost of capital. A higher growth rate yields a higher cost of capital estimate. When making growth rate forecasts, consultants typically debate whether the growth rate in dividends should be forecast from estimates made by industry analysts or whether a constant growth formula (discussed below) should be used. This debate involves whether published estimates of growth rate are optimistic and whether the dividends relative to the earnings remain constant. In one of the databases provided to NEPRA associated with this project I provide estimates of growth for US utility companies. Figure 24 illustrates how the growth rates that can be found from public sources on the internet are structured for one utility company.

Figure 18 - Estimated Growth versus Past Growth



Instead of using the estimated growth forecasts, one can use a fundamental formula that expresses the growth rate as a function of the dividend pay-out ratio. This formula is: growth

rate = ROE x (1-payout ratio). The formula for growth rate can then be substituted into the cost of capital formula as demonstrated below.

$$\text{Cost of Equity Capital} = \text{Dividend per Share} / \text{Stock Value} + \text{ROE} \times (1 - \text{payout ratio})$$

If the growth rate is constant, then the dividend per share can be expressed using the dividend pay-out ratio and ROE by re-arranging the formula  $g = \text{ROE} \times (1 - \text{payout ratio})$  to  $\text{payout ratio} = 1 - g / \text{ROE}$ . In this case the cost of capital becomes:

$$\text{Cost of Equity Capital} = \text{EPS} / \text{Stock Value} \times (1 - g / \text{ROE}) + g$$

#### Value Driver Formula

The formula above is the same as a formula used in the valuation book published by McKinsey that I referred to earlier in this report. One of the primary points in the book is that value comes from the formula:  $\text{Value per Share} = \text{EPS} \times (1 - g / \text{ROE}) / (k - g)$ . This formula can be re-arranged many ways to drive the cost of capital including the above formula for the cost of capital. One way to re-arrange the formula is to express earnings per share as the book value per share multiplied by the ROE. Then, the value can be expressed using the formula  $\text{Value/Share} = \text{Book Value} \times \text{ROE} \times (1 - g / \text{ROE}) / (k - g)$ . This formula can be moved around to produce and estimate of the cost of capital that is a function of the price to book ratio:

$$\text{Value/Book Ratio} = (\text{ROE} - g) / (\text{Cost of Capital} - g)$$

You do not have to be mathematician to look at the above formula and imagine that if the ROE is equal to the cost of capital, then the top of the formula is the same as the bottom of the formula. If the top and bottom are the same, then the result of the equation is 1.0. This all means that if ROE is equal to the cost of capital, then the value to book ratio (the price to book ratio) is equal to 1.0.

When an analyst makes a valuation of a stock, it is normal to make a detailed forecast over the short-term (maybe five years) and then compute a terminal value using a long-term growth rate that is typically lower than the short-term growth rate. The terminal value could also apply an assumed ROE that converges to the cost of capital. If you mimic this sort of calculation, you can make a more sophisticated cash flow forecast and derive the cost of capital from this more

realistic cash flow forecast that does not have constant growth. The changing growth rate and ROE is the basis for the FERC two stage model mentioned in the introduction to this section. For companies in Pakistan, it is difficult to apply the cash forecasts and the two stage DCF based on earnings or book value because of accounting related to issues associated with the PPA prices. An appendix will document details on applying cash flow forecasts with alternative short-term growth rates, long-term growth rates and convergence to the cost capital.

#### Estimation of the Cost of Capital from Market to Book Regression

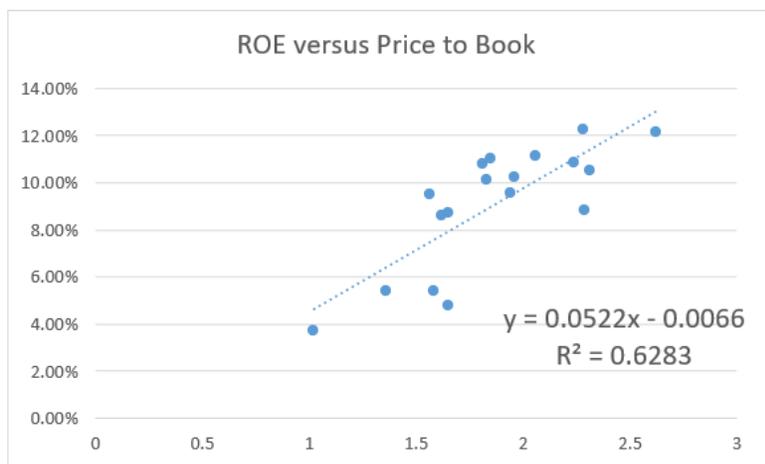
The idea that when the price to book ratio is unity, the ROE equals the cost of equity capital can be used in different ways for derive the cost of capital. The price to book ratio can also be used with the formula: price to book ratio =  $(ROE-g)/(cost\ of\ capital-g)$ . This ratio can be re-arranged to derive cost of capital =  $(ROE-g)/PB + g$ . As with other variants of the method that estimates the cost of capital from assumed cash flow growth, g and ROE must be estimated. The relationship between cost of capital, ROE, and the price to book ratio can be used with a regression analysis. The regression analysis relates the price to book ratio to the earned return on equity. This may sound fancy, but you can just take a group of companies and make a plot of the ROE on the y-axis and the price to book ratio on the x-axis. I present this for U.S. utility companies in Figure 25. Once you make the graph, you can make and easily find the equation that relates the ROE to the price to book ratio. The regression equation is shown on Figure 25. The final trick is to find the ROE from the regression equation. The regression equation is expressed as:

$$ROE = .0522 \times \text{Price to Book} - .0066$$

By pugging the price to book ratio of 1.0, you can derive the ROE that is theoretically equal to the cost of capital. This yields a cost of capital of 4.56% which is below the value of 5.5% derived from the CAPM. I have looked into applying this idea for companies in Pakistan, but it is difficult because of accounting issues associated with the IPP's and the delay in collection of revenues, the analysis does not work.

Figure 25 - Price to Book and ROE

Mkt Watch ▼



|                        |              |
|------------------------|--------------|
| Slope                  | 5.22%        |
| Intercept              | -0.66%       |
| <u>Cost of Capital</u> | <u>4.56%</u> |
| R Squared              | 62.83%       |

### Evidence on the Cost of Capital from Market to Book Ratios

When attempting to apply the implied cost of capital in a careful manner, a simple formula is difficult to apply. If there is one thing we know about cost of capital that is not directly observable, it is that if the price to book ratio is above 1.0, a company is earning more than its cost of capital. Instead, it is sometimes better to take a look at different companies and find evidence for particular situations where the price to book ratio is close to 1.0. If the ROE is stable and the market to book ratio is close to 1.0, the ROE is a reasonable indication of the cost of capital. I have estimated the cost of capital without country risk to be 5.50% for international utility companies. Figure 26 shows a few companies from the international database where the market to book ratio is near 1.0. This confirms the reasonableness of the estimate without the country risk premium.

Figure 26 - Price to Book and ROE

Figure 26 - Price to Book and ROE



I have looked into computing the implied cost of capital from accounting data like the book value and the price to earnings ratio. As stated above, this is very difficult for the Pakistani IPP's because of the relatively high asset values that have not been written-off from revenue collection issues. On the other hand, computation of the implied cost of capital directly from cash flow forecasts driven by the PPA provisions may be a good alternative. I will work with the NEPRA staff on developing alternative cost of capital issues from cash flow forecasts.

# **Chapter 13:**

## **Stealing Money from People who Live in Developing Countries Otherwise Known as the Country Risk Premium**

### **Countries Cannot Develop When Foreign Investors Take Out High Country Premiums**

Why the country risk premium is so important. All of the premiums are in real terms and not in nominal terms. Say a country does not generate internal savings and to make investments in infrastructure it must get capital from outside of the country. If the risk premium is 5% above that for non-developing countries, the country must grow and increase its productivity by 5% just to pay back the cost of capital premium to investors.

### **You Cannot Analyse Country Risk Premium with an App**

The final part of the risk premium involves the country risk premium or CRP. The CRP is a controversial item that suggests the risks of investing in countries like Pakistan are greater than investing in developed countries because the country of Pakistan may not repay debt. In the context of price regulated electricity where payments are made by the government, it may seem reasonable to expect that if the government cannot pay foreign debts, that it will also not be able to make payments associated with the PPA contracts. In addition to the credit spread that corresponds to the default risk, it can be argued that equity experiences added risk because of the priority for debt in paying cash flow. The CRP has been derived from differences in the borrowing rate between Pakistan and the yield on US bonds in other studies (e.g., Damodaran). But note that the entire theory of using the default premiums depends on the assumption that credit rating agencies and foreign investors are valuing the bonds with objective and reasonable assessments of the probability of default. I question this assessment later in this report.

Attempting to use the CAPM to dissect the cost of capital to specific segments of the electricity industry such as hydro plants with output risk versus a coal plant with a fixed capacity charge is not practical. To evaluate cost of capital by segment using the CAPM one would need to find companies that look exactly like the projects in question and try to find differential betas. For example, it would involve finding betas for a set of companies that only invest in wind projects with fixed PPA's of the same type that are allowed by NEPRA. Even companies that are distribute electricity are generally not pure distribution companies as they typically engage in non-utility activities and could not be used for example to measure the cost of capital for KELEC.

Figure 1 demonstrates the risk premium estimated by Damodaran and illustrates the dramatic decline and variability over time. If you are asking whether the dramatic changes in country risk premium represent swings in true risks faced by investors of contract defaults (what country risk is supposed to measure), I think your scepticism would be correct.

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- Credit spreads on Pakistani sovereign bonds issues in U.S. currency versus U.S. treasury bonds with a similar maturity are shown in Figure 5. The graph shows that credit spreads have come down since the beginning of the pandemic. Current spreads for Pakistani government default risk vary between 4.5% and 7.5%. If markets were efficient, these spreads which are theoretically driven by the risk of default on government debt would yield realistic assessments of default probability. The spreads shown in Figure 5 imply very high implied probabilities of default and are driven by questionable assessments of risk made by credit rating agencies.

Figure 5 - Credit Spreads on Pakistani Bonds versus US Bonds

While the general idea of using government bonds of Pakistan seems reasonable at first glance, there is counter evidence that suggests that this method of using sovereign bond spreads significantly overstates the true risk premium for country risk. One piece of evidence is the interest rates actually paid by realised by the nine Pakistani IPPs in Rs. Using public financial

statements, the average interest rates paid in Rs can be computed. When converted to USD, these interest rates paid by Pakistani IPP's are far lower than the sovereign bond rates. Figure 6 shows the average annual interest rate paid Nishat Chun Power in Rs by year and by quarter from financial statements. This is computed through dividing the interest expense in the income statement by the debt on the balance sheet. The annualized interest rates shown in Figure 6 are similar for other IPPs (the quarterly data is annualised because the interest expense is for a quarter rather than for a year and it is therefore multiplied by four). If adjustments are made for Rs/USD inflation, the implied USD interest rate would be much less than the interest rate paid by the Pakistani government.

The lower interest rate for Pakistani IPP's could be explained in a few ways as elaborated below:

1. The interest rate on the Pakistani sovereign bonds issued in USD have had a bond yield that does not reflect the true risk of default for Pakistan because of the manner in which bond rating agencies such as Moody's and S&P evaluate bonds and irrational risk perceptions. This position is that the sovereign bond markets are not efficient in terms of measuring the probability of default.
2. The interest rates for the IPP's are influenced by NEPRA regulation that mandates allowable credit spreads. This regulation is difficult because it assumes that local banks will accept credit spreads that do not cover their risk adjusted cost. If you take this argument to the extreme, one could for example make an argument that if NEPRA mandated negative credit spreads, that local banks would still make loans.
3. The interest rates for local banks consider the relatively low debt to capital ratios of the Pakistani IPP's (documented below). This could mean that if the government of Pakistan defaults on sovereign debt and also on the PPA contracts, there is enough equity buffer to protect against a default on the local debt.

Figure 6 - Average Interest Rate for Nishat Chun Power in Rs

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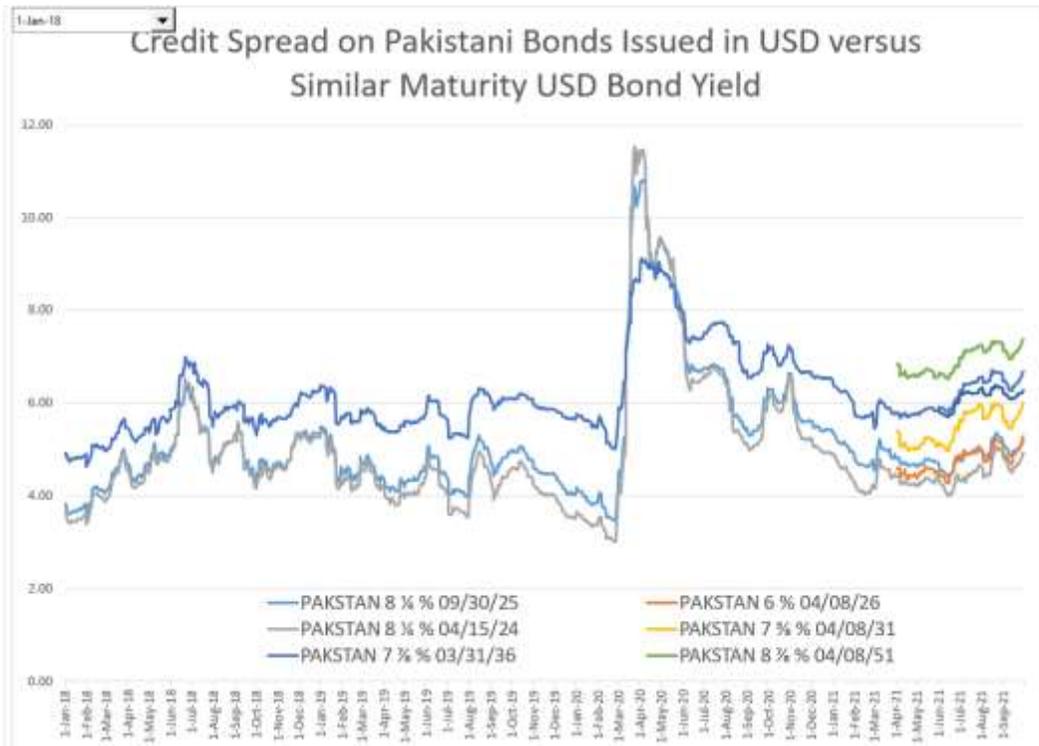
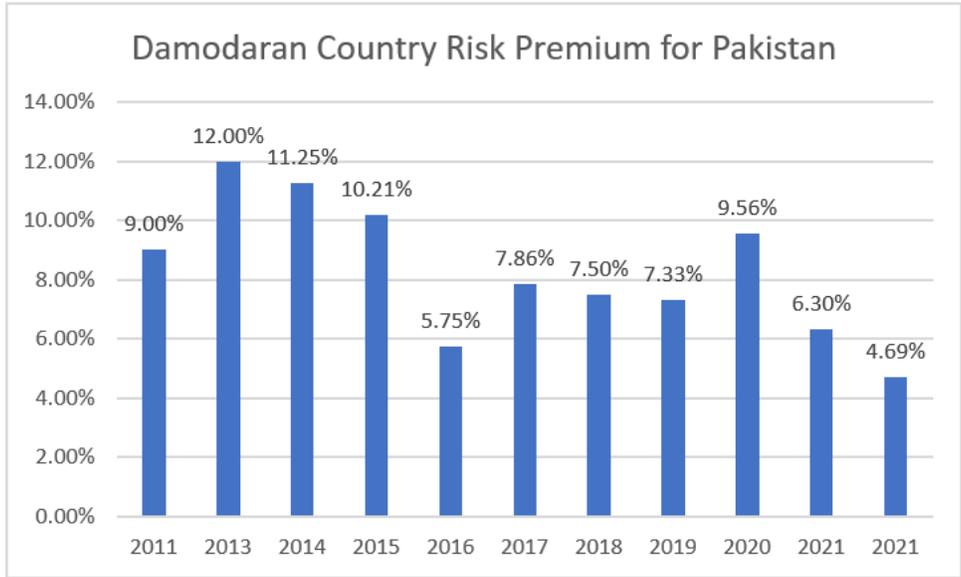
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As the financial statements of Pakistani IPP's are affected by accounting for delayed or lost cost recovery, use of financial data to estimate value is distorted and more work is necessary. One alternative to measuring the implicit cost of capital for Pakistani IPP's is to evaluate the cost of capital for other companies in Pakistan. Figure 7 demonstrates trends in the return on equity and the price to book ratio for one company, Serle Co. Ltd. The fact that the price to book ratio is above 1.0 and that the return is about 16% demonstrates that the company is earning more than the cost of capital.

Figure 7- Illustration of Pakistani Company with Price to Book Ratio Above 1.0



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In estimating the cost of capital for companies in Pakistan and other countries with relatively low credit ratings it is traditional to add a country risk premium to the CAPM estimate. Country risk premium theory comes from the notion added risk arises from government actions that will lead to declines in cash flow that are not part of expected cash flow. When the cost of capital is applied as a discount rate is applied in valuation, there is generally not an explicit recognition of the probability of country default. This means that the cash flow estimate does not include a downside case with a government default as well as an assessment of the probability of this default happening. The country risk premium is and should be a controversial item in valuation and cost of capital because it has dramatic effects on PPA prices, particularly for capital intensive technologies like solar and hydro.

To illustrate the controversy of adding country risk premiums to the cost of capital, take the example of selling toothpaste in Pakistan and in the U.S. The country risk premium would suggest that the cost of capital for a little shop selling toothpaste in Pakistan would have to sell toothpaste for a higher price than a similar company selling toothpaste in the U.S. simply because the shop is operating in Pakistan rather than in the U.S. This is because the capital deployed for inventory, selling equipment, buildings and other equipment associated with selling toothpaste supposedly has much higher risk in Pakistan than in the U.S. While I disagree with the whole concept of country risk premium for many industries such as this example of toothpaste, my opinion is not a conventional point of view when computing cost of capital. In this section I present evidence on the country risk premium that is largely derived from the interest rates on Pakistani bonds where the repayment is in USD.

#### Credit Spread and Premium on Pakistani Sovereign Bonds Issued in USD

When a government issues bonds, denominated in a foreign currency, the interest rate on the bond can be compared to a rate on a riskless investment in that currency to get a market measure of the default spread for that country. In estimating the country risk premium, NEPRA has used a method where the premium on Pakistani government bonds issued in USD is measured relative to bonds with similar maturities. This premium or spread on government bonds is essentially the same as the credit spread on

a corporate bond and it is also the same as the credit default swap for Pakistani bonds. Using the NEPRA approach, this credit spread that has been presented in Figures 5 and 12 on Pakistani bonds versus USD bonds with the equivalent maturity is added as the country risk premium. As the premium is measured for debt investors, the NEPRA approach uses an additional premium for equity which is supposed to be riskier than debt (in general one should be careful in comparing debt and equity returns because debt only has downside and equity has upside). This NEPRA adjustment to equity is computed using a standard deviation ratio. If you believe that the yield on Pakistani bonds with debt service paid in USD reflects the probability of default and the loss given default and also that the default on Pakistani bonds would probably mean that the Pakistani government would default on PPA agreements would occur with a Pakistani default on the USD bonds, then the country risk premium derived from USD default spreads makes sense.

The method used by NEPRA appears reasonable as if there is a serious currency problem in Pakistan and the government debt in USD cannot be paid, it seems reasonable that if the PPA is indexed to the USD, that PPA would also not be paid. Further, the risk for equity holders as reflected in the CAPM should be similar premium on government bonds. If the lenders lose money because the PPA is not paid, then the equity holders will also lose money. Further, if currency crisis results in lenders not being paid, it is possible that the lenders will lose some of their money and the equity holders will lose all of their money. Before working through the mathematics of the probability of default and how it should be incorporated into the cost of capital, I note the average interest rate experienced by the nine IPP's conflicts with the whole concept of the country risk premium.

To understand what the yields on the Pakistani bonds issued in USD mean, the first step is to understand that the fundamental formula for measuring the cost of capital on debt securities that only have downside risk and no upside other than earning the risk premium itself. This formula is a simple one that defines the credit spread or the premium on debt as a function of the probability that the loan defaults and, if the loan does default, what will be the final loss. The first factor is called the probability of default. The second factor is called the loss given default. The theoretical premium on a bond or any loan is given by the simple formula:

Premium on Bond Percent = Probability of Default x Loss, Given Default

The nice thing about this formula is that if you know the premium on a bond, you can back into the implied probability of default (if you make an assumption about the loss, given default). Table 9 shows the premium on Pakistani bonds that are issued in USD with different maturities. It is not surprising that the longer maturities have a higher premium as there is a higher probability of default the longer the bond is outstanding.

|                        | Years to Maturity<br>from November<br>2021 | Basis vs USD<br>Bond in Percent |
|------------------------|--|---------------------------------|
| PAKSTAN 8 ¼ % 09/30/25 | 4.00                                       | 5.19                            |
| PAKSTAN 6 % 04/08/26   | 4.84                                       | 5.29                            |
| PAKSTAN 8 ¼ % 04/15/24 | 2.54                                       | 4.92                            |
| PAKSTAN 7 ¾ % 04/08/31 | 9.84                                       | 6.00                            |
| PAKSTAN 7 ⅞ % 03/31/36 | 7.38                                       | 6.68                            |
| PAKSTAN 8 ⅞ % 04/08/51 | 29.84                                      | 7.38                            |
| PAKWNP 7 ½ % 06/04/31  | 9.52                                       | 6.26                            |

Table 9 - Basis USD Pakistani Bonds and Maturity

#### Computing the Implied Probability of Default on Pakistani Bonds

In this section I compute the implied probability of default given the Pakistani bond premium relative to the USD yield. I have tried to make the analysis of the implied probability as simple as possible by using a short maturity. I have used the closest maturity (the 8 ¼ maturing in 2024) for this exercise. This bond yield to maturity is 5.23% while the equivalent yield on US bonds is only .3%. This means the premium on the yield to maturity is 4.92%. Note that the coupon rate is 8.25% for the bond, meaning the investor would earn a return of higher than the 5.23% if the price of the bond was the par value of the bond. But as the bond has a higher price than the par value the effective interest rate is lower and that is essentially what the yield to maturity represents. In sum, if an investor wants to realise 5.23% while earning the 8.25% coupon, the investor would be willing to pay more than the par value of the bond. A summary of the bond is shown in Table 10.

Table 10 – Three Year Bond Analysis

|                   |       |
|-------------------|-------|
| Maturity          | 3.00  |
| Yield Spread      | 4.92% |
| Yield to Maturity | 5.23% |
| Coupon Payment    | 8.25% |
| USD Yield         | 0.30% |

Table 11 illustrates how you can derive the implied probability of default on the bond. This table assumes that the loss given default is 50%, meaning that if the Pakistani does miss an interest payment,

the bond investor will be assumed to lose 50% of the final maturity payment. Many of the defaults on government bonds (generally in Latin America) did ultimately pay the principal meaning that the loss given default was not 100%. Table 11 shows the amount the bond over a three-year period with the principal payment and the final maturity payment. This bond is valued assuming that the bond will default in year 2 and that no coupon payment will be received. In addition, the final maturity payment is assumed to generate only 50% of the final payment. Table 11 demonstrates that if the default scenario is assumed to have a 24% chance of occurring, then the Pakistani bond will ultimately result in the same value to investors as the USD bond. In Table 11 the final two lines show the difference in cash flow from the expected value of the Pakistani bond as compared to the USD bond. The last line on the table demonstrates that the 24% probability of default does result in the same value to investors as the USD bond.

Table 11 - Implied Probability of Default

|                      |             | Total               | 1        | 2        | 3        |
|----------------------|-------------|---------------------|----------|----------|----------|
| Default              | 2           |                     | FALSE    | TRUE     | TRUE     |
| Bond Amount          |             |                     | 1,000.00 | 1,000.00 | 1,000.00 |
| Coupon Interest      | 8.25%       |                     | 82.50    | 82.50    | 82.50    |
| Total Payment        |             |                     | 82.50    | 82.50    | 1,082.50 |
| PV at Yield          | 5.23%       | 1,081.89            |          |          |          |
|                      | Probability | Loss, Given Default |          |          |          |
| If No Default        | 76%         |                     | 82.50    | 82.50    | 1,082.50 |
| If Default           | 24%         | 0.5                 | 82.50    | 0.00     | 500.00   |
| Expected Return      |             |                     | 82.50    | 63.09    | 945.45   |
| Return from USD Bond |             |                     | 1,081.89 | 1,081.89 | 1,081.89 |
| Coupon Plus Maturity | 0.30%       |                     | 3.27     | 3.27     | 1,085.16 |
| PAK Bond vs US Bond  |             |                     | 79.23    | 59.82    | -139.71  |
| NPV of Cash Flow     | 0.30%       | 0.00                |          |          |          |

The implied probability of default on the bond is affected by the assumed loss given default and the date at which the default occurs. Table 12 shows implied probability of default with different assumptions for these two parameters. The lowest probability of default in the next three years is 12.54% while the highest probability of default is 55.41%.

Table 12 - Alternative Probability of Default with Different Parameters

|                 |   | Loss Given Default |        |        |        |        |
|-----------------|---|--------------------|--------|--------|--------|--------|
|                 |   | 20%                | 25%    | 50%    | 75%    | 100%   |
| Year of Default | 1 | 34.92%             | 31.41% | 20.92% | 15.68% | 12.54% |
|                 | 2 | 42.85%             | 37.69% | 23.53% | 17.10% | 13.43% |
|                 | 3 | 55.41%             | 47.07% | 26.87% | 18.80% | 14.46% |

### Direct Assessment of PPA Cash Flow to Derive Country Risk Premium

Some of the literature on the country risk premium suggests that it is better to make direct assessments about the cash flow loss from country risk rather than making an arbitrary premium adjustment. Unfortunately, these assessments are often made using vague statements rather than an illustration of how the analysis would work. I have created a simple example of how a direct assessment of cash flow can be used derive the implied country risk premium.

Table 13 illustrates that you could set-up a cash flow table and include scenarios where country policies result in lower cash flow. The first case has no default and a probability of 85.54%. The second case has a default in the third year and an assigned probability 14.46%. The weighted average cash flow from the probability is shown below. The implied IRR increases from 5% to 7.55% if the probability and the default are accounted for. The example shows that if you put a probability on the loss of cash flow, you can compute the IRR that is realised and evaluate back into the country risk premium. Table 13 demonstrates in a hypothetical example, that if you make an assumption about the probability that cash flows will be reduced and also the time period of the reduction, that you can back into the country risk premium. The issue with this method is that NEPRA would have to make an assessment that defaults occur because of its own actions.

Table 13 - Direct Calculation of Country Risk

| PPA Analysis                        |        | 1         | 2      | 3      |
|-------------------------------------|--------|-----------|--------|--------|
| PPA Cash Flow to Equity w/o Default | 85.54% | 500.00    | 500.00 | 500.00 |
| Default Case                        | 14.46% | 500.00    | 500.00 | -      |
| Expected Value                      |        | 500.00    | 500.00 | 427.70 |
| Cost of Capital w/o CRP             | 5.00%  |           |        |        |
|                                     |        | -1,299.17 |        |        |
| Implied Cost of Capital from IRR    | 7.55%  | 500.00    | 500.00 | 500.00 |
| Country Risk Premium                | 2.43%  |           |        |        |

### Mystery of Interest Rates Paid by IPP's versus USD Premiums

If an international institution is providing USD funds to Pakistan and assess the default probability of the bonds, there is no reason in theory to expect that local financial entities who lend money in Rs should have a different outlook for default probabilities. If there is a currency crisis and the IPP companies are indexed to the USD or earn PPA prices subject to local inflation, exactly the same risks of the government not being able to pay the PPA prices apply to the local banks. Local financial institutions evaluate loans with assessments of the probability of default and the loss given default in precisely the same way as international investors assess the risk of Pakistani government bonds. If the default on an PPA contract has similar characteristics as the overall government default risk, the risk premium should be at least as high for the loans made to the Pakistani IPP's as for the government debt. But the effective interest rate in the same currency for loans to the Pakistani IPP's is much lower than the USD based Pakistani loans. This is shown in the next section. Possible explanations for this are that the loans are much shorter tenure of the loans or big difference in the assessment of country and political risk as between international investors and local investors.

There is little argument to make that the interest rates charged by local banks are not relevant in the assessment of the country risk. Figure 21 illustrates the average interest rate Saif Power and includes calculations on an annual basis and on a quarterly basis. The calculations use interest expense for the year, or the quarter divided by the average debt balance. For the quarterly periods, the average interest expense is multiplied by 4. Figure 21 shows that the annual interest rate in Rs has been between 5 and 10% over the last year.

Figure 22 -- Interest Rate and Debt to Capital for Saif Power

A final issue with respect to country risk is the question of whether the beta or the EMRP includes some or all risks for serious currency and other problems that could lead to country defaults. For example, assume investors in the Pakistani IPP's are very worried about not getting paid when there is a currency crisis in the country. In this case, every time there is some kind of worry about the country of Pakistan and the KSE declines, then the stock price of the IPP will react strongly. If the beta is computed against the KSE index, the beta will be relatively high. This may be an issue if the beta is measured against the KSE index. If the index includes general country risks and if the IPP stocks react to that risk, this non-diversifiable risk should be reflected in the beta.

#### Damodaran Country Risk Premium

If you search for country risk premium on the internet, you will probably arrive at estimates of the country risk made by Damodaran. Even if the estimates made by Damodaran are questionable and incomplete, the fact that many use these estimates make the Damodaran estimated relevant to understand. I suggest the Damodaran method and explanation have many problems. For example, by not evaluating the implicit probability of default and the loss given default in the estimates and by ignoring

things like the loss given default in the write-up of how the country risk works, there are no checks if the method works relative to financial ratios.

The Damodaran method is illustrated in Table 14 and Table 15 below. Table 14 is the most recent estimate of the Pakistani risk premium from Damodaran. The risk premium comes from the 4.28% credit default spread over US treasuries or alternatively the 5.75% premium that is derived from the general credit spread on bonds with a B- rating. In the case of using the 4.28% premium, a factor of .41% is added to arrive at the country risk premium. When the bond spread is used, the factor added to the credit spread is .55%.

Damodaran explains that he uses the sovereign rating (from Moody's: [www.moodys.com](http://www.moodys.com)) and then estimates the default spread for that rating. This is based upon traded country bonds in general over a default free government bond rate. He also explains that if a CDS spread is available he uses those. This results in the two different methods shown in Table 14. It is unclear what tenure of debt is used for measuring the CDS spread for the country default spread.

Table 14 - Damodaran Country Risk for Pakistan

| Country                                  | Pakistan |
|--|----------|
| Moody's sovereign rating                 | B3       |
| S&P sovereign rating                     | B-       |
| CDS spread                               | 4.51%    |
| Excess CDS spread (over US CDS)          | 4.28%    |
| Country Default Spread (based on rating) | 5.75%    |
| Country Risk Premium (Rating)            | 6.30%    |
| Equity Risk Premium (Rating)             | 11.02%   |
| Country Risk Premium (CDS)               | 4.69%    |
| Equity Risk Premium (CDS)                | 9.41%    |

Table 15 shows how Damodaran's estimates of the risk premium have changed over the past decade. The Pakistani country risk premium has moved from a high of 12% in 2013 to 4.69% as of the most recent report. Part of the reason for this change in the Pakistani country risk premium is the change in the default spread on the Pakistani bonds paid in USD shown in the second column of Table 15. Another reason for the change in the risk premium is the difference between the default spread and the country risk premium shown in the right-hand column. This difference has moved from a high of 3% to a recent value of .41%. The calculations for this added premium are opaque, but the adder can be applied to different calculations of the bond premium.

Table 15 - Factors Causing Changes in Damodaran Risk Premium

|      | Country<br>Risk<br>Premium | Default<br>Spread | Total<br>Risk<br>Premium | Equity<br>Risk<br>Premium | Country<br>Risk vs<br>Spread |
|------|----------------------------|-------------------|--------------------------|---------------------------|------------------------------|
| 2011 | 9.00%                      | 6.00%             | 14.00%                   | 5.00%                     | 3.00%                        |
| 2013 | 12.00%                     |                   | 17.75%                   | 5.75%                     |                              |
| 2014 | 11.25%                     |                   | 17.75%                   | 6.50%                     |                              |
| 2015 | 10.21%                     | 7.29%             | 16.46%                   | 6.25%                     | 2.92%                        |
| 2016 | 5.75%                      |                   | 11.02%                   | 5.27%                     |                              |
| 2017 | 7.86%                      |                   | 12.99%                   | 5.13%                     |                              |
| 2018 | 7.50%                      |                   | 12.99%                   | 5.49%                     |                              |
| 2019 | 7.33%                      | 6.03%             | 13.00%                   | 5.67%                     | 1.30%                        |
| 2020 | 9.56%                      | 7.63%             | 14.79%                   | 5.23%                     | 1.93%                        |
| 2021 | 6.30%                      | 5.75%             | 11.02%                   | 4.72%                     | 0.55%                        |
| 2021 | 4.69%                      | 4.28%             | 9.41%                    | 4.72%                     | 0.41%                        |

Figure 23 - Credit Spread on Pakistani Bonds and Tenure

#### Recommended Country Risk Premium

In recognition of general concerns about investing on Pakistan I recommend using the 6% as the country risk premium to avoid controversy. The 6% is higher than the Damodaran risk premium as I used a longer maturity as shown in Figure 23. The numbers for the basis spread by maturity shown in Figure 23 are for the most recent yields available. As the default risk increases over time, the spreads are higher for the longer maturities. The same kind of argument for using a longer USD treasury bond for the risk free rate can be made for application of the credit spread. I also add 1% to the default spread to recognize the increased cost of equity relative to debt.

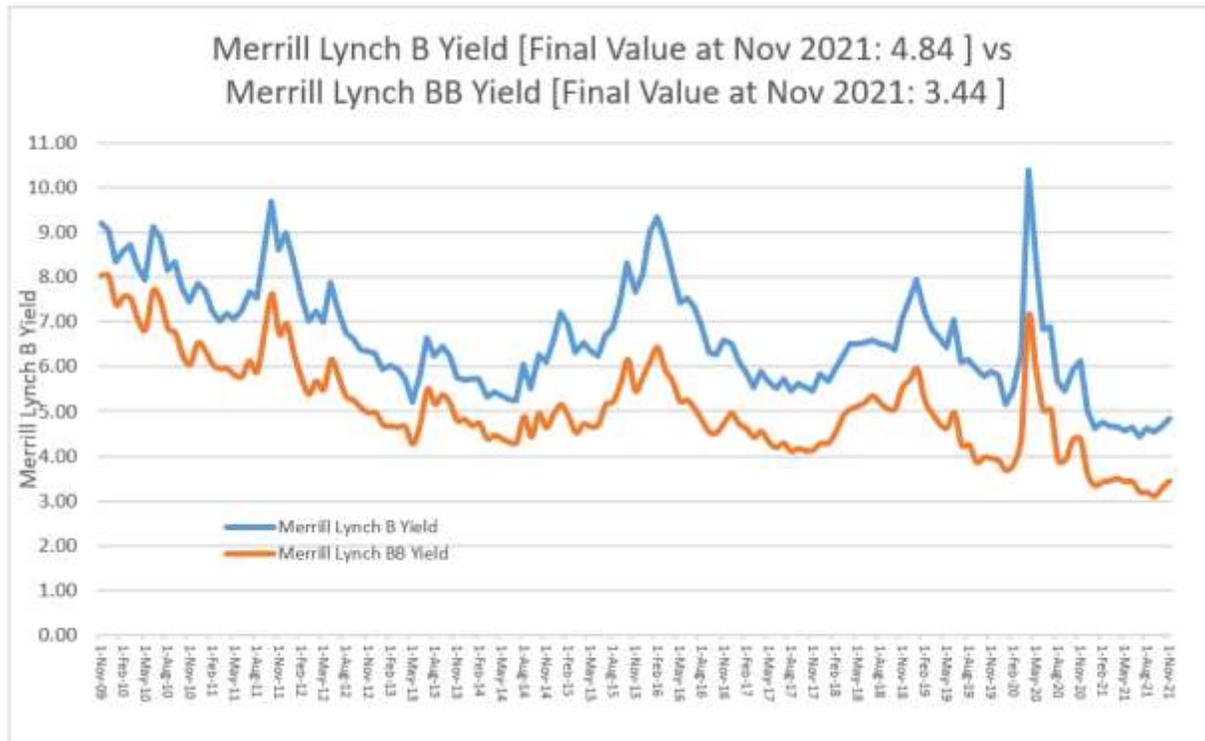
In recommending the 6% country risk premium I come back to the idea that the true cost of capital is the minimum return that investors accept given the level of risk. If this minimum return is not met, important electricity investments will not be constructed in Pakistan. Unfortunately, this country risk can be the perceived risk rather than the risk computed on an objective basis, or it can result from a careful mathematical analysis of risk. In discussion the country risk for Pakistan, I have heard comments something general comments about the high risk of investing Pakistan.

# Chapter 14:

## The Cost of Debt can Easily Be Higher than the Cost of Equity

### Change in the Cost of Capital for Credit Risks

One more way to evaluate general trends in the cost of capital is to evaluate the cost of capital for risky bonds. The general category of risks for bonds is driven by the ratings from S&P, Moody's or Duff and Phelps. The lower the bond rating (a bond rating of B is lower than BB and is lower than BBB) the higher the cost of capital for the bond. Figure 13 illustrates the credit spreads trends for BB and B bonds. The graph in Figure 13 shows that credit spreads have declined over the last decade. This decline in credit spreads implies the cost of capital has decreased for risky investments and is now 4.84% for B bonds which have the same rating as sovereign Pakistani bonds. I note the bonds which theoretically have the same risk of default require a lower credit spread relative to previous years. (The spike in the graph occurred at the beginning of the pandemic). If credit spreads have declined, it is reasonable to assume that the cost of equity has also declined. I note the credit spreads are similar to the credit spreads used by Damodaran in computing the country risk premium for countries that have rated bonds. For Pakistan, the bond rating is B- suggesting that the risk premium would be 4.84% or higher. Note, that the source of the data from Merrill Lynch does not specify the tenor of the debt and that longer bond tenors have a higher risk premium.



I discuss what a reasonable IRR and how the project finance structure. The question of what kind of growth rate you need to compensate for risk is at the centre of all finance. It drives project finance, the WACC in corporate finance.

The final issue related to beta is whether the beta should be un-levered and re-levered. The idea of de-levering and re-levering the beta is that when you collect a sample of beta's you should come up with the risk of an industry that is not distorted by the capital structure of a company. It is an idea that came directly from Merton Miller's work suggesting that valuation should focus on the inherent operating cash flow and not the financing of a company. When you derive a beta from stock prices, it is the equity beta and in theory the equity beta is related to the amount of debt that is outstanding. So, if one company has a high level of debt and another has a lower level of debt then the company with the higher level of debt will have higher variability of cash flow and have a higher beta. One can compute the asset beta or the unlevered beta using the formula (this formula does not consider the tax adjustment made by Bob Hamada:

$$\text{Beta (Assets)} = \text{Beta (Equity)} * \text{Mkt Equity/Mkt Capital} + \text{Beta (Debt)} * \text{Mkt Debt/Mkt Capital}$$

This formula can be used to compute the average asset beta for an industry. With the asset beta, the formula can be re-arranged and given an input debt to capital ratio, the equity beta can be re-derived from the formula:

$$\text{Beta (Equity)} = (\text{Beta (Assets)} - \text{Beta(Debt)} * \text{Mkt Debt/Mkt Capital}) * \text{Mkt Capital/Mkt Equity}$$

When applying this formula, it is common and a big mistake to assume the debt beta is zero. When the debt beta is not zero, the formula produces a very different result than the assumption that the Beta of debt is zero. Due to the credit risk of Pakistan and the country risk discussed in the next section, one can argue that the debt beta for Pakistani IPP's is high. The high cost of debt for companies in Pakistan would suggest a high debt beta and it would result in a lower equity beta. This would complicate the beta process and ultimately not have much of an effect on the cost of capital when the beta is re-levered. Given that the gearing of the Pakistan IPP's is similar, and the international utilities have a similar level of gearing across companies I use the levered beta in this analysis without working through the exercise of un-gearing and then re-gearing.

Importance of Mean Reversion

Detection of Mean Reversion

Estimation of Mean Reversion with Monte Carlo Simulation

Application of Mean Reversion to Beta Estimation

## Chapter 2 – Parked

### Model to Illustrate Alternative Valuation Metrics

In the summary page of a model, you can compute different outputs. I have made a simple model (you don't need anything complex) that illustrates the valuation different measures. I will not work through all of the model details but show you the effects of different methods in table xxx. In this table results for a simple investment with different cash flow is made.

We can also compare IRR's for different investments and make some kind of vague judgment as to how much IRR we want compared to the of similar investments (say we are comparing Amazon to Walmart or GE to Siemens). But in computing the IRR in the above graphs we did not need to directly use a measure of the cost of capital. This can very attractive to investors. A private equity company may have (an absurd) criteria for IRR or hurdle rate of 15%. They can compute the IRR on their investment and make some kind of judgment about the risk if they believe the future cash flow projections.

Can't we get cost of capital out of the valuation equation. IRR can compare investments, just like we compare GE and Amazon. If you compare investments or bid on projects or evaluate LBO's these days, IRR is the criteria. Story of IRR question from Malakoff lawyer. Imagine you are evaluating different alternatives. You could compute the NPV for each as you learn in text books. This requires and estimate of the WACC. You could compute the IRR. There is no WACC. You could compute the MIRR which has WACC. Nowadays IRR is used. Is the B.S. as Oxford professor says. The problem is not.

If Return is constant and cost of capital is easy to compute and growth is constant and return is easy and clear to compute mechanically, then we could stop here. Of course, all of this is not true, and we need to go through the details of each part.

In working through the remaining chapters I will refer to a lot of technical analysis that includes construction of financial models and footnotes. But please do not worry about me mucking up this book with a lot of technical discussion on how to efficiently download data and/or construct financial models that resolve the measurement problems associated with ROIC, cost of capital, terminal valuation, reconciliation of project IRR with rate of return, debt financing signals and so forth. You can watch associated videos if you want to get into the detail and I will put these in the footnotes. To evaluate Amazon and the history I start with a graph of Amazon's share price compared to the return on invested capital and growth in revenues. Note how it is the interaction of the return and the growth that had driven the explosion in the share price. Whether it is possible to continue growing the return and how the growth will stabilize are the real questions in valuation.

I generally defend the use of IRR in evaluating financial performance compared to standard alternatives (like the MIRR and NPV) and I demonstrate how you can reconcile the IRR and the return on invested capital. A big problem with academics is the crazy belief in the CAPM. What is the alternative. You are not going to get very far with arguing for NPV. Does not mean anything to management. The MIRR as a comparison to the IRR gives you no information at all.

## **GE valuation from analyst report.**

The first terminal value case study is an example for GE. In this chapter on applying multiples from how multiples are used in the terminal value calculations. For this, I use a presentation from a company named value line – maybe you could call the precedent of Bloomberg. These Value Line reports were made long before the internet and even before used many computers. I remember paper like sheets that were used we could get coverage of a lot of company. You might say what are you doing using such and old fashion things.

Value Line attempts whole lot of information relevant to the calculation on a single page which is certainly relevant today. These reports concentrate on equity (P/E ratio, EPS, ROE) rather than overall cash flow analysis (EV/EBITDA, EBITDA, ROIC). The reports do not explicitly compute the return on invested capital. However I find some of the ways the reports looked at history, how they use and look at historic multiples, and how they present valuations instructive. Note in the figure below that there are some numbers in big font. These include the stock price, the P/E ratio and the P/E ratio relative to the overall market. The beta has a much smaller font and is computed using a nonsensical mean reversion adjustment from a paper that was published in the 1970's and is for some crazy reason still sometimes used.

The Value Line reports also present a lot of history. This may be somewhat old but looking history on a single newspaper type report may tell you a whole lot more than a fancy excel file with all sorts of speedometer graphs. Recall the discussion of the return on invested capital as a statistical concept. Note that for General Electric we can look at the return on equity line and compare the historic return on equity to the return that is projected for the future. In this report I use it evaluate a few implications related to financial modeling and valuation items.

## **Corporate Finance Models**

Over the years I have taught both project finance modelling and corporate finance in. In corporate modelling courses we would typically gather historic information and we would show for my information from the Internet or from a PDF file. In the old days, the financial modelling would start with actual financial statements. We would do something called spreading the data which may sound fancy, but just meant somebody would type in data show report a hard copy of the financial reports time. With the historic data we would make a model. What I have noticed now is an extremely irritating phrase where people are proud of themselves because they can construct three statement financial model. An example of this type of model is shown figure XXX.

INSERT THREE STATEMENT MODEL

Figure xxx is an excerpt from a financial model for Amazon. I look around this model and it does not have a prominent presentation made return on invested capital. And I think this may be typical. There was also not a clear presentation of the growth rate could be too unrealistic. The size of Amazon relative to the size of the whole economy. Critique standard modeling and worse, that is presented along with case study is included on the website this includes the models themselves bad models.

## **Chapter on Multiples**

I demonstrate that When comparing multiples to account for changes in return . A radical idea. In the hypothetical example below I make the assumption That there are four companies In the industry or four comparable companies each will have the same long-term return and each will have the same growth rate.

I assume arbitrarily that it takes five years for each of the companies to reach the long-term stable XX demonstrate that the price-to-earnings ratios are very different for the different companies even though the growth rate going to be the same. And even though the cost of capital is assumed to be the same. Temple chose that first multiples can be very different four companies, similar risks i.e. in the same industry it also shows value driver formula cannot be applied. Instead I find it necessary to make a little and use inter to derive the implied.

## **Adjusting Multiples**

General discussion that come up with different way to think about multiples.

In this case we are talking about the multiple. If you knew Market expectation for the change in the growth rate the change in the return on Capital ( return on equity ) you could derive . This is the implied cost of capital in chapter hey. You could then cost of capital for each company or some kind of media median or average and then estimate the multiple for the company in question. The process would be something like the process of unclever engine Andre leveraging the betas . New section . 2 please when we to EB Debbie. Things are more complicated and things are Messier this is because the value of a company is driven not only by EBITDA but also by working capital changes bye Capital expenditures Tucson operations and potentially by other factors such as the first taxes and other cash flow adjustments .

Note that I have no quarrel with the classic definition free cash flow ( I do problem with the manner in which tax benefits are included in the capital structure. This will be addressed in chapter XX. EV to ebitda ratio clearly does not account for required to maintain a given level . One with short-term assets such as automobiles and another with long-term such as Rolling Stock.

Assume that the two companies are in the same return. The example below in figure illustrate expenditures that the relative to the for the company your assets . As with other technical modeling examples you can find Associated spreadsheets and explanations on the website. Insert text Ex. In our company example value of the company relative to the is or the company with short-term acid . New section . The business of evaluating required Capital expenditures to meet relative to EV/EBITDA is a subtle but important point and evaluating the problems with our ratio.

Consider an example with no grow and an example of no Road the depreciation is equal to the capital expenditures importantly. Importantly Monroe Road includes no growth in nominal cost not no growth in real cost . The example below the two companies depreciation relative to Capital expenditures with no growth . Once grout is introduced stable ratio Capital expenditures to depreciation interpret.

The idea is where is Grove and you made an expenditure the depreciation that expenditure you made 30 years ago is still in still a part of the depreciation expense that tends to lower the depreciation expense. It doesn't tend to lower the expense depreciation expense it does lower the depreciation expense you would have a two-year depreciation instead of 30 year depreciation then the effect old expenditure still in the depreciation expense is much less .

So when you compute the ratio of the depreciation to the capital expenditure depends on the life of the project for the life of the asset and it also depends on the road trip . This is just mechanical . We should discuss economic life . That should have been a subject Computing economic depreciation. If you have the ratio of capital expenditures to depreciation which is Illustrated hello table XXX. If you have to depreciation to Capital expenditures so confused ratio of depreciation expense Platte Valley . The ratio of depreciation expense to the growth plan balance. In order to compute the ratio of pictures pic appreciation it is necessary compute the retirements . This is a backward-looking process.

As with other technical subjects and modeling issues you can refer the website and yet the backup files as well as an explanation. New section... Don't forget to put a similar technical explanation to r chapter in discussing various points.

With the capital expenditure to depreciation we can have the tool Northern Tools or an essential to evaluate EB to Evie doll ratio in a similar manner as sure. Has the PE Ratio come on . In discussing the EV to ebitda ratio and the PE ratio been assuming that we have a theoretically correct depreciation calculation and that depreciation calculation Is correct by doing a little . A little bit of cheating. The cheating is that I have been assuming that the capital expense Lumpy. Once again real world is not is more complicated. When we have what a witch open replacing if expenditures and we'll have to take expenditures to replace the once again we cannot simply compare the two companies . Once again call Mama helpful more than helpful it is 2 make a financial model and illustrate the .

Bigger XXX call Mama does this .

New section incorporate about different tax rates different working capital ratios different returns into discussion . Include a best case and a worst-case cable EV to ebitda ratio. Show in the eb-2 heavy thought ratio that results influences then the working mother cost of capital . Niger XXX below chose a waterfall cakes . XXX a progression Bass baby doll ( e. CB2 Evie doll) to the lowest TV to Evie doll ratio . New section period. . . In a sense multiples r a in estimating the want to estimate.

There are surveys managers that are performed by business school professor that request how do the companies compute the cost of capital be overwhelming answer to the surveys is that managers use the capital asset pricing model. To be serviced surveys I say rubbish if that investment Bank or a manager is applying multiples they are using the multiples as a short compute the cost of capital whether they know this or no.

One could say that by using companies in a similar industry they are very similar truly assuming at the company have the same growth rate current return expected return asset lifetime Bassett age ratio of working capital to invested capital tax rate expected growth. This chaotic the one thing left that drives value cost of capital and as we discussed in Chapter 3, it is very understandable that managers would like to get around Computing the cost of capital academics can stop and say that they should be using the Arbitrage pricing model.

#### Chapter 4

The starting point in chapter 4 is the that in order to make evaluation we go back to competitive strategy graph. Given this importance of the rate of return, making a forecast of the rate of return this chapter is all about computing and measuring that rate of return with different. The rate of return is a statistic, and that rate of return can be very ambiguous to calculate now let's say we have a good calculation.

Wasting a lot of time looking at investor analyst report and seeing the rate of return made on invested capital would not tell you much. If you think there's some kind of standard formula there's some kind of exact formula to computing the return on invested Capital you would be wrong.

this is the reason the next section there is no standard for me. let's use our General Electric and Amazon case and let's keep going back to these cases try to compute the return on invested capital and see what kind of remarkable Distortion that we end up with most.

in the case this time in the case of General Electric from taking write-offs and from accounting distortions in acquiring companies and revaluing assets and revaluing. The investment when we when we acquire assets

Already

so let's deal with the problem of what to do about how much cash you need how much liquidity do you really need to keep running your business and how much cash is Surplus cash is necessary cash these kind of issues see the people have these silly absolutely silly rule over 2% of investment so let's do something Fancy with some kind of standard deviation and the rest of the companies in the industry we have to make some judgments another understand weird shooting return on investment is that we are trying to look at the core assets of the business a few years ago have a mint amounts of cash on its balance sheet I don't know exactly why it was there but it was there in part 4 tax avoidance issues that cash has changed dramatically now when Apple held its cash and they would have labelled this cash when let's let's look at a balance sheet look at look at the figure below to go XXX glow either the cash on the balance sheet for Apple no getting historic data Blackness long-term historical data can be done by going to the web . I went out Apple have this kind of cash on the balance sheet its earnings on the couch itself was very low but that doesn't reflect that earnings on the cash obviously does not work the overall earnings on the Core Business earnings and making iPhones and getting people to iTunes whatever they do that cash on the balance sheet therefore if you want to evaluate the return on invested capital and this is a good example of where return on invested Capital would be very different than return on Equity you would that Surplus cash you would want to understand just how much cash we needed to run its business now after the tax law changed Apple issue dividends and the cash went down dramatically this fact that the cash went down dramatically would have increased if then if you would have left this on in the invested capital in the denominator of our return on invested capital I would have given you a lower denominator and a big increase in the in the return on invested capital of course that's what we don't want the points and this illustrates the real point of the return on invested capital and that is to compute return from the core earnings that's what we're looking for that's why we harp on return on invested capital and not return on equity and using lit sounds like this other than trying to explain some formula now let's get back so what do we do with Amazon and Vee the graph below the tour the table below shows the Amazon return on invested capital assume that all of its cash on the balance sheet is Surplus cash an alternative Lee when we assume none of the cash on the balance sheet is so close cash and point of this is to illustrate that just this assumption about gives you a very different run and this is without even scratching the surface the other thing we and it's relates to apologies about Surplus cash is we have to decide for example do with deferred taxes the first taxes if you here about deferred taxes or if you think about the first taxes maybe you easy and say oh I don't want to get into this account understandable but defer taxes can be related it's like the valuation the valuation of derivatives the fair valuation of derivatives that you can see on a balance sheet in this case the Deferred taxes would clearly not be related Corbett on the other hand some of the Deferred taxes could very well be related to the and this is accumulated defer taxes some of the accumulated defer taxes could be related to could be related to the difference between speculation and the tax depreciation kind of that classic items could be very I'm in the end it with no let's go back to the Deferred taxes can a deferred taxes what you would do is if your Computing invested capital and your Computing how much capital is used to generate net operating profit which is the core operating profit which does not include I'm from things like cash Investments that we talked about or doesn't pay any interest expense it's got the non financing the pure earnings of the corporation agree with that does not include derivative games from the change in the market value of derivatives or the if these are on the balance sheet in this case the of the company so you can do this and mechanically you can work through the balance sheet and could compute invested capital in two different ways that's it is to identify financing of a corporation that's

related to the Core Business of the assets so let's go return to the Apple example in the Apple example we had all of that Surplus cash the balance remember you don't have to be a count to know that the balance sheet balances you can even be an engineer and I understand that the word balance sheet means to the bouncy. And if we have a whole lot of cash on the asset side of the balance sheet that's being financed play or explicitly by dad and equity make that cash into a lot of things with that cash we could go on a holiday we can pay for nurses we could pay dividends we could use it to buy back stock week tire depth plus cash must be is not related to the Core Business and so you take the debt and the equity and subtract that Surplus cash that's one way to do this and in order to do this mechanically you work through the one next to the Surplus cash and you make a little column that says invested Capital Computing from Finance alternatively you go right next door and make a second little column next to the balance sheet and say Capital computed from direct Investments that are made to finance The Core Business of the asset and when you do that don't include Surplus cash but you do include things like inventories and accounts receivable very importantly the net plant assets the long-term assets of the company things that are related to financing the other business from alterations sprayable and you have to struggle with some deferred taxes and other liabilities and those sorts of items footnote you can see how this works by going to their website and seeing the mechanic okay so the graph below shows the turn on invested Capital overtime for our two companies Amazon and the we show this in two different cases where you use difference different assumptions Surplus cash and other items that's our first ambiguity remember we are trying to do trying to at minimum we are trying to get a handle on return on invested capital this it once we have the turn on some sort of a sort of assumption some sort of prognosis will happen in the future to that return . In the graphs above recognition of the Destroyer in the calculation return on invested because very problematic issue companies assets that are aging will have a higher return on invested Capital because they also they need to subsequently increase the return on invested capital the return on your does not Paramount write-offs but jump in the invested Capital as we saw in the graph for General Electric now hey. Let's start another one return on invested Capital Ford owl 30 companies I am obsessed with return on invested capital and you might see I'm way too obsessed with this statistic and I'm really talking about what kind of investment we have to make what kind of growth in that investment we have to make in order in the long run it's a generate r cash flow and R value it's just if I'm obsessed with this return on invested Capital it's just because I want to consider both the numerator which is the profit and the denominator which is what does it take to get that profit again we can't just get a profit from doing absolutely nothing improving the environment anything we do the so where was I the text now on the issues and with depreciation for that analysis we are going to move to project Finance in project Finance we measure we don't measure return on invested Capital instead we measure project guy around in the next paragraph I'll demonstrate welcome to the true irr of a company of a of a project excuse me of a project if we straighten out Knock straightened out if if we correct the depreciation and if we use economic depreciation then find depreciation testing okay let's switch to chapter number 5 introduced in in the introduction to chapter 5 the discussion is now from the rate of return 2 ballistic Alternatives in measuring Ritz and idea the introduced the chapter is how crazy is it you're investing in a company think about the the beta or the factors that go into the Arbitrage pricing model if you are asked to invest in or GE would you would your decision to invest really be based the faders of the company perhaps if you're making some kind of big portfolio me about are you comes from how to practically get an assessment of the valley be the idea of this chapter is finding specifically using project finance using project Finance ideas more than more

than working through the mechanics of project financing using ideas to see how risk can be realistically assess know the themes of this chapter will begin outline of the chapter and by discussing how the structuring of the debt in Project Finance can be used to go backwards and when you go backwards you can use the debt capacity Define the risk now this is my observation and my own observation ask me different kinds of projects with very different kind of cash flow patterns and certainly different kind of risk have a similar required rate of return on Equity capital when I say rate of return on Equity capital about the equity irr so it could be a toll road could be a electricity plant could be Hospital the required return vastly different projects on equity is it is very is often very similar let me put it that way find that return you can say well I found the cost of equity capital because the cost of equity capital is Define minimum rate of return to accept a given level of risk is the mysterious number where you searching for and this number does not come a map it does not come from a survey of what it's Financial officers tell you that they use the most realistic and think about this minimum cost of capital is to think of a bidding situation contact in the context of project Finance where you have multiple bidders and you are in order to win the bid the offer the lowest price will win the bed and the equipment is van Davis and the estimates of the cost are very similar for different Spinners it's a cash-only to Conventional technology in this case case when it's a similar technology can if it's a similar technology the way to win a bid is to push the rate of return to as low as you possibly can and still earn a return that's acceptable given the level of risk that's exactly how's the cost of copper so how does this 82 project Finance defining risk well in establishing the minimum it's a r r again the definition of the cost of capital financiers the debt finances will make an assessment of the risks of the project will carefully structure the debt and the risks of the project and around structure of the cash flow if you want to like when we focus on the rate of return essentially risk if the risk is higher the debt terms will be negative is that the amount of debt will be less meaning that the tenor of the debt will be shorter and even the premium on the interest rate spread may be higher I say it may be higher cuz the the typical rule in Project Finance is that you push the debt up and push it up and push it up you achieve a something 2A a a fairly investment-grade rating a triple B or a triple B - rated now project finance loans Austin or not rated you need to ask Bankers what kind of rating is typical internal rating is typical on Project Finance I'll give you a something. Very much like a triple B or Triple B minus equivalent the same so here's the point if a project is riskier it has less debt and the required irr is from the last chapter of return on invested Capital they required project irr is higher to achieve this Equity rate of return that is used in bidding and that could be find as the cost of equity capital and there you have it so let's take an example let's say we have a relatively risky project with more new technology perhaps perhaps we we have certainty with respect to okay and we have another project that has very conventional technology and very safe cash flow the amount of debt in both the amount of debt. Drums of the death will be more favorable to the project with safe cash flows bandwidth with conventional technology so project if you want to get the same blink they have the same rate of return on both projects what the lenders do is essentially they are Put-in-Bay are balancing out the risk of the project because as I should have said at the outset that the more debt the the higher the volume till t the equity cash flow we have to be very careful with that statement text to say it because Equity has upside downsides and weed about volatility in a very simplistic faces let's assumption that Equity cash flow Equity cash flow has more risk with more dad in other words if two projects have the exact same dial are which means they have the same return on invested capital economic depreciation Dan if these projects have the same risk to different projects Jack with the higher level of debt higher variability in equity cash flow and the graph below uses a very simple example to give us breaks babe given that the

equity cash flow is and if you want to that's okay that you can say if that slowly economy and therefore the overall Market then at the end tell her that she should have today if you want to go there and you could even put together the Forum either of the asset Equity the capital equity the capital times debate of the Dead if there is more that there's more risk associated with it. Penile go all the way back and say we want the same equity irr course in the example above if we have two projects exactly the same if we have two projects that have exactly the same turn on invested capital the project with higher level of debt has a higher required Equity irr because of the higher Beta And so long no turn if the two frogs has this at the same required return on Equity or equity irr Dan the land if the bankers adjust the debt structure to meet the same triple be requirements Evelyn out equity risk the lower amount of debts or the shorter debt tenor or other debt terms associated with the riskier project Lower the equity IRR on a project being equal at the same Equity I are four different rates of return or choir required rates of return on invested capital all of this means that the debt providers the debt structuring a way to come up with the required Rick Ross overall return on invested capital and overall return on invested capital is the overall cost of capital for the project what's a weighted average cost of capital because of tax issues and we can't say weighted average cost of capital because structure over the life of a project might not be we will not be in the same across. So that's the way it's different way of backing in cost of capital and stration of how to think friendly and come up with real world answers to acquired rate of return is in the next section we're going to move forward we're going to continue the we're going to talk about the the more nuances of project financing Finance work through some risk issues with project Finance in Finance literature add and working through some basics of project Finance of Finance come up with some very general chance of risk of business risk it might be called these things a categorize the wrist evaluate and when you we need how credit rating agencies example come up with the credit rating on a on a bonds or how bankers evaluate the credit rating of a loan you might see a score for the business risk of a company which covers things like competitive rares covers things like maybe they even tried to measure the volatility and cash flows from the trough of a business cycle to the peak of a business cycle maybe it has a category called illogical risk all of these things which almost meaning when I try to think about risk and try to have some sort of way to quantify risk I'll mention two ideas hopefully they'll not take me way off track one idea is issue of meme reverting and cyclical kinds of risks for example risks that the oil price go up and for even a more extreme case risks that will have a cold winter or a warm Winters of course there is in that circumstance there might be some effects of some effects of second type of risk risks of things going out of fashion risks of the first in the first in nose rare things are cyclical where the sun comes up and down where are Commodities move up and down where they called him he's had home. In those sorts of circumstances that risks are mean reverted we might have to have a lot of patience we have some we know that there's going to be volatility volatility associated with a mean reverting cash flow really different mortality of a non Green River than cash flow I mean Reverend cash flow are things like fashion and how do you know when something will go out of fashion Victoria Secret would be a good example of man the non mean reverting Cashflow might when we go back to examples of Amazon and t e a mean reverting item covid pandemic there certainly experienced some positive effects pandemic pandemic doesn't last forever General Electric makes more money on conventional how are plants like power plants When there's a move out of fashion conventional technologies send Vietnam River in Cash Flow risk Are very different And when lenders Stay will evaluate the risks of they should evaluate these risks very different Now think about betas do you really police the beta and arbitrage pricing model will correctly account for risks that are mean reverting and knowing me in Riverton I don't

much rather I evaluate the risks and give us an assessment structuring their debt around quantifying those risks setting the structure of the debt around those risks and using data risk analysis back in to the cost of capital that's enough for free now let's move into well go back the risks of an investment also set a risk related to start-up Ventures these are extremely often at least extremely risky proposition where the chance of failure is due the imagine we have to and one Corporation the number of risky another corporation has boring old assets operating for a long time the case of SunEdison it went bankrupt be a case like that maybe is a case like this company was a and developer of solar projects it tried to acquire a wind company as well which directly led to the bankruptcy the company sold its asset to a its own related subsidiary and it kept development assets that those those assets that were riskier of course had a would come along with a higher cost of capital and those riskier asset would have been Finance very differently then the safe Allison I should say the riskier assets are financed very differently than the faith has it again we can look to the financing to understand and the implicit I'm very careful here I'm not saying that there are precise answers just like when I discussed the when I discussed the implied cost of capital from the debt amount and the debt structuring that doesn't give you any exact number required return but it gives you a way to think about things and I argue a much better way to risks Kabob required returns to compensate for those risks Paris to the asset pricing model that now is the the the middle of just about every case study and then to the end argued way to measure risk so now back to our example app development and then we have a major capital investment project we have construction with construction risk things the Run making sure the technology is going to work construction delays these can be very big room so we look over the lifetime of a project we big begin with development risk two construction risk we open the project I see how it's going to perform when it's dead first operating we we we gained some data actual production actual revenues the actual reading cost of the project. After we gained some history the risks go down dramatically changing rip not every project same characteristic we start with high risk lower some projects may have minimal development and construction risk had some projects may experience even higher risk as because they are subject to fashion changes or Tech take me to technology change so idea is how do we webpay method of valuation 4 the real world 4 risks for items that don't have the same risk over time how do we do all of that and the next sections we'll address that there the changes in the risk over time and some more nuanced issues with pork the final issue will address cash flow pattern ultimately realized by Equity investors again at every section that the corporation that a corporation the portfolio relation of project and to understand the Ava Corporation you need to understand the risks of the project it Bears repeating that even if that the ideas of project finance In terms of deriving risks Both Downside Risks Add upside risks Should one day Hopefully Be an integral part Up the volume of a corporation new section Now let's talk about Upside And again I'm repeating Put the same sort of upside Will apply to a corporation to understand the upside associated with the change in the risk overtime they come from the change in the risk overtime we Equity with tongue has a very different structure typical Equity return assumption that's the foundation 4 like the capital asset pricing model no I don't know in business school I didn't follow this one I'm a little bit different and I need to admit this I need to admit and that learning the capital asset pricing model I remembered that there was something called I i d and normally distributed and the assumptions the capital asset pricing model the computation of beta other academic discussions there was always a assumption about return daily rates of return weekly monthly rates of return being identically distributed and normal and having a normal distribution this normal distribution is nothing like what happened for Returns on a project again a theoretical project an actual project and the Equity returns have

an upside potential imitate downside risk upside potential from to resources that we will discuss that I will discuss 2 section the first upside return from the risk declining and the evidence of the risk declining is 19 to sell a asset at a profit the second issue is the ability to change the financing structure and precisely because of the issues discussed precisely because of the issues discussed financing structure determined to risk and determine the cost of capital flying in the cost of capital just like the evidence what is the sales sell the assets we no this upside outside from selling an asset and receiving a capital gain we need to emphasize the from in the next two sections it doesn't matter we sell the answer matter that we refinance Piazza we can refinance or so means is that if we have a corporate Corporation with a portfolio of a whole lot of different asset the value of that Corporation should go up as the riscos. I'm not saying that this happens because the last thing I'm saying is that markets are tremendously efficient and they can understand the risk profile of every single asset in a portfolio but if we want to dig deeper into really what drives the value of an asset drive to value of a corporation we need to understand how the risk profile of different Assets in the portfolio changes the increase in the value of the asset asset comes about this ability to sell the asset depends on the resolution let's start with a okay again we're not going to demonstrate things with some relatively simple Financial modeling have to get really sophisticated again in the simple case let's assume we have three scenarios a low case a base case and an off-site case why not could constitute the volatility okay and perhaps in the locate the jet barely gets repaid again the debt holders in theory going to locate and comfortable that even in a low case I got can be repaid perhaps after some restructuring then we have a base case things work out well and rate of return on Equity that was targeted should be achieved hi case now if we three different cases we don't have to sell the asset and we can't get much for our asset but we probably won't sell it in a base case as the risk has come down and check has operated as we expected people to sell the assets at a capital gain will be able to Cuba capital gain when actually when we shut whether we sell the answer it or not because the risk has come down in the third case in the high case willing we will receive a very very high so now if we begin with our three cases a bass case with a location of a place and a high case and we maybe even attached probabilities to those cases can be very fragile and we'll just say for now there's a 25% chance of locating 50% of the base station 25% of The Upside case in the in the if we don't recognizing that we don't incorporate the capital gain because the example is developed so that the turn the overall rate of return is approximately the same as bad as the base can she have an outside case and a downside case and leave yeah there are three different cash flows with probability on those cash flows and I get about the same rate of return now if we incorporate the upside if we incorporate the upside from ability to sell the asset rate of return increase because of the capital gain associated with the reduction in the risk of the project for evaluation and Analysis the issue is which making an assessment of this project which is the right rate of return to you are expected case case that recognizes the upside I argue in case the recognize the upside the end of the day have something like a chattering a convertible Bond Oban we might have a very low but we get an upside this is the same as the Equity the cash flow for the value distribution second thing is now we'll go to the next section and we'll call this section is the upside from refinance the consider the upside from refinancing way back first section of this when we discussed the debt structuring when it's being constructed and that that structuring was driven by construction Risk by faded construction risk bye operating risks where we didn't have any history and by technology after project achieve an operating history the Risco. And the financing structure should follow them we follow the logic the initial section that would just that this increasing in that capacity has led to a lower cost of capital the same sort of lower cost of capital achieve by being able to sell the asset where the

fire is accepting a lower because the fire the buyer has a lower risk accepting a lower risk now in the graph below made some assumptions about refinancing and use the three cases before when we look at the three different cases we add refinancing into the cases in the downside case just as before we wouldn't refinance the asset but and the hot case we would refinance DSS do Equity return free from the three cases is is Buffet without refinancing I think we get the upside let's have a new section is Dakshin again and on this introduction we need to do we want to say dad typical project Finance his talk with some diagrams talk with understanding some financial ratios like the dscr l l c i p l c r and working through some technical aspects of project Finance I've read these books make it there very good but this chapter is going to look at project Finance in a very different way it's going to use project Finance to draw implications took a Valium corporations and it's going to . And it's going to make you hopefully think about project Finance in a different way at the end chapter I hope you will see that project Finance Canby while you waited and can be thought of as a convertible bonds or have the cash flow patterns with the upside case potential of a of a convertible Bond . I also you can anyway stop or development risks so she ate it with Finance strike that with Investments and how probability assessment and capitalizing cause SOC 12 failure is Allah aspect Finance used in Valley a. Okay ready no this is the final point about chapter 5 the final points about chapter 5 in are there real vacations for Corporation for the value of Corporation if we if we'd hello okay are there implications that we can derive in terms of corporate valuation even if they're not precise consider a Beer Company the Beer Company could be just as it always has oh I am thinking about Carlsbad and when I went to Denmark like lion the people I was teach some of this stuff suggested I use called now Carlsberg had kind of a nice boring return of that nice boy return on investment and think about people buying beer drawing maybe even more beer effective these continuing let's say and let's give you an example that's a Carlsberg has some nice boring old Investments and now engaged in an acquisition another company alternatively they could be engaged they want to develop some new have some new business strategy moving to another kind of beverage . When Carlsberg when if Carlsberg pays a premium in a merger for another company and expect some kind of Sinner a word that I hate you cannot got the Google has sremained the same . the risks of a cheating the synergies has any Tire Lee different risk run the risk of play the regular old beer . The four Hap's the beta of stock doesn't change suggesting that there is not a change in the risk structure. However the sea the synergies the have a very different probability tribulation. The synergies achieving the synergies achieving is is like a new business probability of success. Something like a development fee capitalized Nobody would do this but a It's not an actual expenditure with 1 ft this could be added to the car invested capital and the valuation in theory reflective . If Amazon is answering we can now return to our Amazon and GE examples . if Amazon is entering into a new growth business as the business mature and as the business is demonstrated to be a reasonable strategy grocery store business Ben even if the cash flow stays the same the value of the company or has increased just like pull up selling Assets in the project financial analysis for people studying evaluation and studying Finance these ideas have relevance . That's my point . Skip to line . Chapter on multiples we're moving more to practical issues. Last chapter may have been nice or somewhat interesting more 4 people directly involved in Project Finance . Issues with multiples are common and all sorts of valuations as in the last chapter where I salt 2 do a few very real implications of the ideas that included Asian of development analysis of The Upside so from risk reduction in this chapter I hope to provide hello okay I have to hello . In this chapter I hope to provide methods of thinking about how you can adjust multiples to receive to remove distortions for example if you have two companies in an industry free companies in an industry . One is the

company you were valuing company. The other two are comparison companies. If one of the companies earning a higher rate of return and the company being valued while the second comparable company is earning a similar rate of return. Then you could see a reticle the company earning the high rate of return and derive an adjusted multiple assuming that company would earn a similar rate of return this may sound a little complicated but unless adjustments are made we will see in this chapter that the whole idea of you suppose can give you hello new section music new section to review multiples I by using a Harvard case study of an acquisition a proposed acquisition the railway industry . The table below chose the the PE ratio and the Eevee to Edith all ratio companies in the industry . One would think that companies in this industry are very stable and very similar but when we look at the and the EV to Ebitda ratios there is a wide range note that the PE ratio varies between X and why. Note B2 Eddie thaw ratio is between y and z. It would be ridiculous to Simply take the average ratio or the median ratio without understanding why these ratios are different has emphasized Facebook differences in value theoretically come from resources the rate of return on investment the growth rate and cost of capital. When we dig a Little Deeper we may explain he may be able to explain why these ratios are different note the lower ratio for the company that has a higher return . Other recent reasons for the difference is in the ratios maybe the upcoming upcoming required Capital expenditures Alma the growth rates , of the businesses are shoes with multiples we have a good idea about the return on investment including Trends in the rate of return we should be able work through differences in the ancient in the in the multiples . We will see that there are Horton's differences between the interpretation of an Eevee Evie doll multiple and a PE multiple . Testing Insert chapter 2 the introduction Note that the x axis Compute or we could Return on investment or we could use return on equity but it's and it does not use ratios such as the operating margin growth in earnings per share Abby Martin or a host of other possible ratio such as revenues revenues to investment the or the number cut revenues per customer cell phone this very important reason the reason is that crucial and be basic idea is that you make an investment in order to turn up we will talk about this in the context of your life your education your raising of children mundane day today if you want to read receive something in the future for a corporation income you have to make some kind of investment an investment could be education educating your employees and investment could be an off-site conference secure better bonding of your employees and investment could be paying an actor to promote people on television the Deep of team of actors in the directive the other ratios such as profits and revenues don't consider essential investment you have to make in order to make a profit in order to earn a profit now you're probably you might be saying what an odd definition you have an investment to include an off-site meeting . Accountant would most certainly label the cost of an off-site meeting as an operating expense we are with the definition of an investment will be further address for now you can consider in anyway and investment any expenditure you make you have to wait a. Of time . This. Of time could be years it could be months and it has nothing to do with the definition of investment made by accountants . Returning to Mom best moments in your life perhaps you are making an investment and gardening that will give you pleasure maybe you could make me investment many different ways maybe you could find a better example. Maybe Could be going to the dentist list You may be reducing Future problems . Return dissection on multiples let's return 2R Amazon and GE example during the time I am Facebook GE at a price-to-book a price-to-earnings multiple blank . Amazon a price-to-earnings multiple of black. You can projected earnings for the two companies let's study Amazon summer let's assume that the growth projections made for the next year and for the next five years earnings per share and in revenues are reasonable we

could even assume for earnings and for revenues a change in the return on investment the analysis below illustrates the implied cost of capital. Rises series of different assumptions. The different assumptions range from keeping the return on investment constant to assuming in earnings arises from an increase in the return on investment. In addition we have to make an assumption about what will happen to the growth rate and return over long term with these we can back into the cost of capital and is there more difficulty in coming up with these assumptions than the assumptions for Equity Market risk premium, beta,  $\beta$ ,  $\beta$ ,  $\beta$  Risk and other assumptions that are applied in the capital asset. 2 discussion of gecko implicit from Project fi corporate are you Asian weather the price Marvel is you or weather my suggestion Ogden driving cost of capital from cash flow expectation Call Ma It is almost universal To compute one single cost of capital number. Demonstrate that this is not the case this is not necessarily the case. Outline of Malta begin with overview actual multiples recall 3 multiples from cyber formula the three multiples include PE ratio no Pat in to know Pat and the price-to-book multiple everything was constant that means a constant cost of capital Wisconsin and growth was constant we could find companies with similar, growth rates, and risk and we should theoretically apply to companies that have similar returns growth prospects, and risk to the company we are valuing. Cost of capital discussion we will go backward and given the multiple The Returned and the growth rate we will back into the cost of capital the problem is that the return the growth rate and even the cost of capital [ar.com](http://ar.com) section heading example of multiples with constant bro and cost of capital. Consider the very unrealistic case where you have a series of companies in the industry in your industry where are the returns and the growth is constant Even In This Very extreme case and very unrealistic case multiples can be distorted. The multiples will be distorted because stay in returns. Comparable and no growth different returns and the same capital it is

Can you hear me trivia okay that's very good let's continue I'm going to talk about chapter four chapter 4 the first point we're going to make I'm going to make and I'm going to repeat this again and again is that that okay continue can I continue continue very good this is a better one in order to make a forecast we need three things no the return Queen growth rate and then in terms of the cost of capital okay can I continue very good as far as the return on investment we don't want to make a assessment of the earnings per share we don't want to make a assessment of some kind of profit margin assessment of some kind of level of profitability in this chapter we're going to talk about that return OU old well we The Returned by we can have some magic formula Furman what kind of return Amazon going to make in the lawn run I'm not I'm also not going to tell you well could have predicted is a downfall of General Electric estimating but by some sort of statistical analysis on the historic Return To Know are you bad in order to get started let's make sure and understand that where the company has been and what kind of return the company is making and whether we think the company can sustain this return whether it's a sticky return or whether the return will converge and come down to a more competitive level all we're trying to do here is really assess what the rate of return is weekend how we can make a forecast of it that's the idea the T in this chapter with is going to be that that's not a very easy thing to do can I continue let me save the spot

## **If you Want the Same Old Blah Blah Blah, then Try to Get a Refund and Don't Read this Book**

If you are looking for a book that gives you instructions on how to apply standard financial techniques for corporate finance modelling, computation of the cost of capital, project finance analysis, use of comparative multiples, then you should stop reading now (if you somehow paid for the book, maybe you can get a refund). I have tried to make the book different with questions of fundamental financial concepts such as getting away from valuation metrics that depend on cost of capital (NPV) and using alternative statistics such as computing the premium earned relative to the risk-free rate. Some of these concepts will not be probably not be used. My desire is to have you think differently and to start your questions at the very bottom. In discussing each topic, I have made a list of different ways to analyse the issues and what is wrong with typical standard analysis.

When I receive articles on finance theory and books on the theory of finance covering subjects such as cost of capital, I may take a five-minute browse through them to see if there may be something creative or new. This is a little mean, but most of the time there is nothing. If you want to be the same old repetition of unproven and undocumented finance theory don't read this book. But if you want to demonstrate some creative thinking on some of the things that are accepted in finance, I hope you take more than a five-minute browse through the book. Other well-known Finance Books include the book written by McKinsey, "Valuation Measuring and Managing the Value Companies" or many similar books written by Damodaran. I use these books and other articles as written with unnecessary complex formulas as the basis of many of my critiques.

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<sup>i</sup> See exercise and video [https://www.youtube.com/watch?v=\\_MOmtW5TlqE](https://www.youtube.com/watch?v=_MOmtW5TlqE)