COST OF CAPITAL
AND
COMPUTATION OF DCF VALUE

PRESENTED BY

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VALUATION – MANAGEMENT'S DREAM OF 'APPLE' VALUE !

Valuation – what does industry players look for?

The process of determining the value of an asset or company

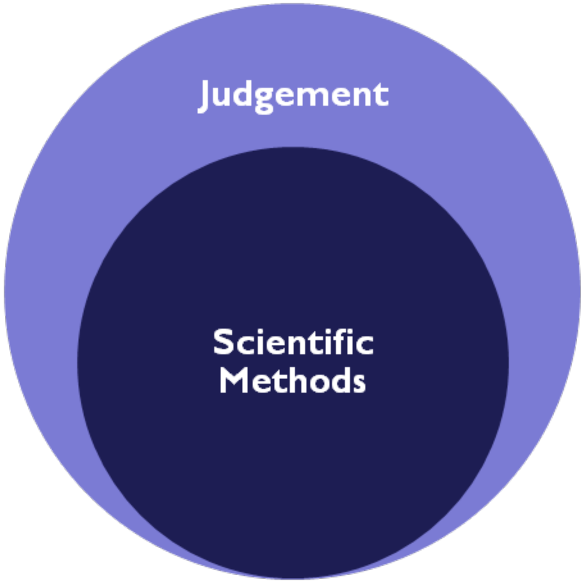
The act or process of assessing value or price; an appraisal.

Intrinsic value: The actual value of a security as opposed to its market price or book value

How industry views it…

Perceived value for an asset or business which is agreeable to both seller and buyer at negotiated terms in the framework of valuation arrived and as on that particular market scenario

Its more of a science of judgement than a pure science!



Methods + judgement + Experience
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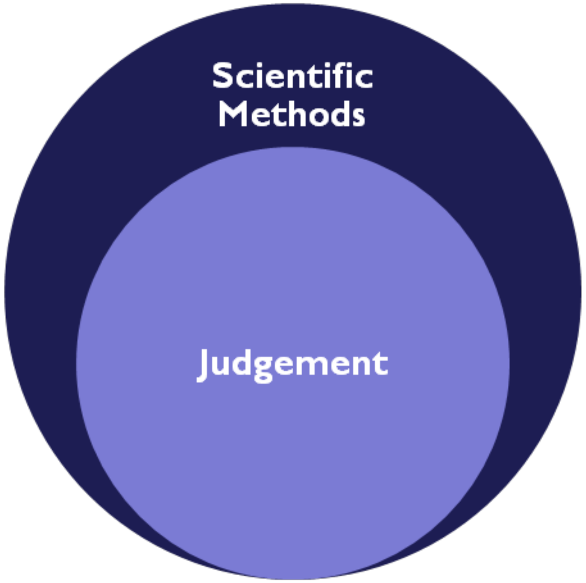
VALUATION
FRAMEWORK

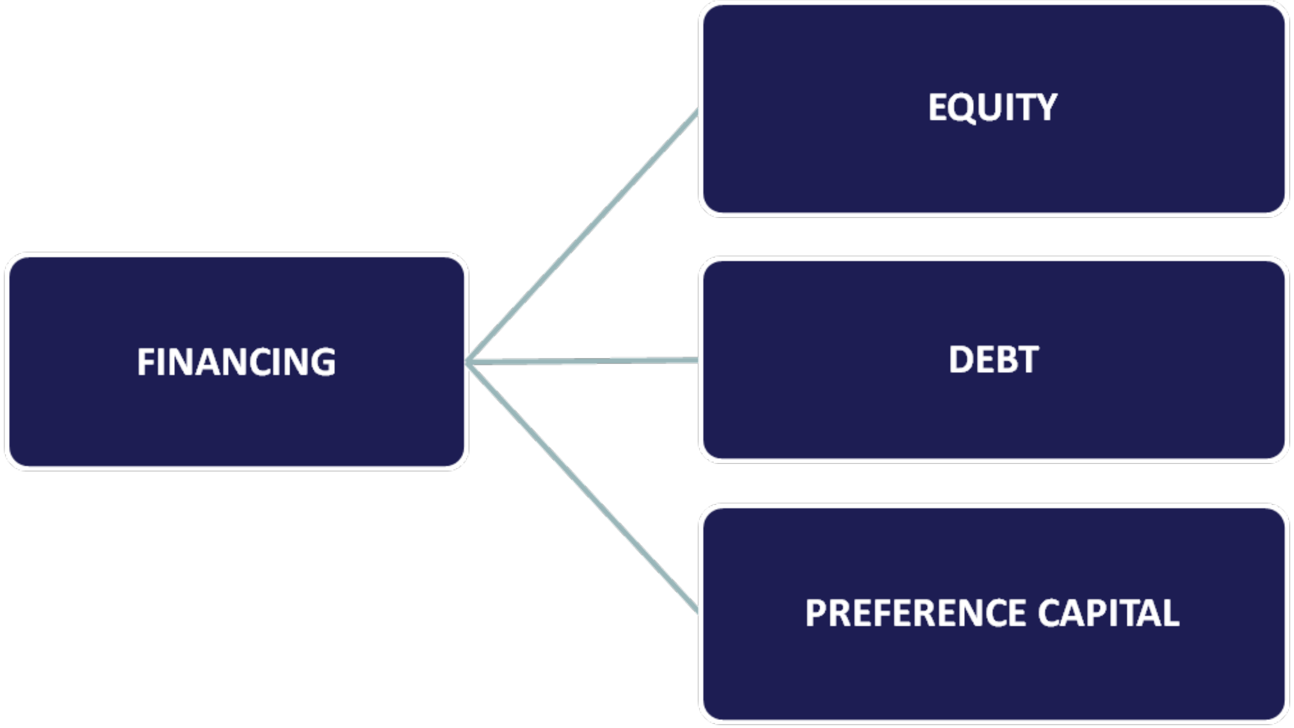
Actually composition practiced in the industry !!



COST OF CAPITAL

COST OF CAPITAL – ONE OF THE MOST CRITICAL INPUT FOR DCF

- It is the cost at which the business and the growth gets financed
- Different for each sector, different for each of the companies within a sector
- <u>A moving part – fluctuates on account of macro and micro economic changes</u>



COMPONENTS OF COST OF CAPITAL

FIXED YIELD INSTRUMENTS

- Coupon/interest rate is applicable on the fixed yield instrument is considered
- The tax shield on account of such coupon and interest is factored in

E.g.

COST OF DEBT (Kd) = Interest rate * (1- Tax Rate)

EQUITY

- Multiple methods available to determine cost of equity
- Represented by Ke
- The key method to find cost of equity is Capital Asset Pricing Model (CAPM)
- Other method available is Arbitrage Pricing Theory (APT)
- CAPM considers the following parameters for its computation
  - Rf – Risk Free Rate of Return
  - Beta – asset specific risk
  - Rm – Market Return

UNDERSTANDING COST OF EQUITY

$$Ke = Rf + Beta * (Rm – Rf)$$

Rf – Risk Free Return

- Why do we start with Rf? What is the rationale behind it?
- What is the correct benchmark why?

Rm – Market Return

- Which market do we benchmark?
- What should be the period of considering the returns?

Beta – Risk Parameter

- What does it signify?
- What does it factor in?
- What are the underlying fundamental assumptions which are not very explicit?

Other Premiums

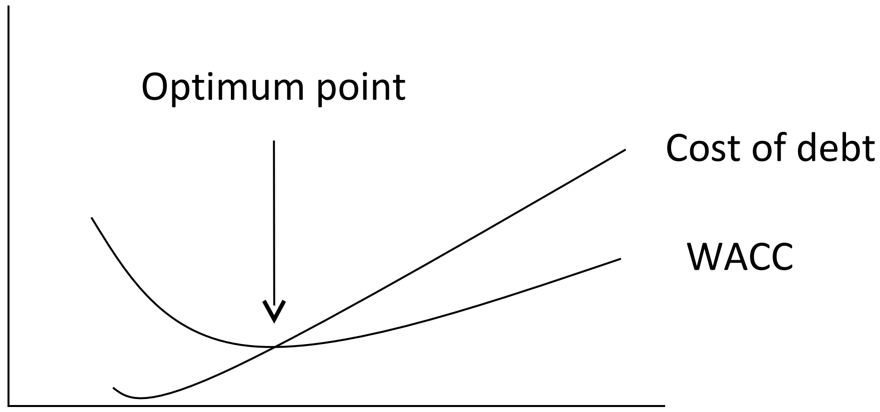
- Do we further add risk premiums?
- How do we decide?
- E.g. Liquidity premium, sector premium, industry cycle premium

CALCULATION OF WACC

- Weighted Average Cost of Capital (WACC) pertains to blended cost of financing the business

- Blending debt with equity leads to optimising cost of financing – but only upto a point !

- Leverage magnifies return on equity – both positively and negatively



CALCULATION OF WACC

WACC is calculated by considering cost of each of the financing options in proportionate to its weight in total financing of a company

WACC = D/(D+E) * Kd + E/(D+E) * Ke

DETERMING EQUITY VALUE BY DCF

DISCOUNTED CASH FLOW VALUATION

- Difference between Pre Money and Post Money Valuation

- Methods of determining free cash flows

FCFF:
- Determines cash flow available to all financers of capital
- Discounted by WACC

FCFE:
- Determines cash flow available to all equity shareholders
- Discounted by Cost of Equity

FCFF – Free Cash Flow to the Firm

To arrive at FCFF…
Adjust Post Tax EBITDA/Operating Profit with

a)Change in Working capital

b)Capital Expenditure

FCFE – Free Cash Flow to Equity

To arrive at FCFE…
Adjust Post Tax EBITDA/Operating Profit with
a)Change in Working capital

b)Capital Expenditure

c)Debt payments

TERMINAL VALUE

Projections can be made only till a point. The value of a Business is the present value of cash flows forever

Many a times, terminal value influences the total value significantly

Valuation of cash flows till infinity

Represents maturity of the company and the industry in which it operates

DETERMINING EQUITY VALUE

CALCULATION OF ENTERPRISE VALUE

- Calculate FCFF and terminal Value
- Discount it with WACC

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Long Term Debt

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Investment **Why this ?**

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PRESENT EQUITY VALUE

THANK YOU

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