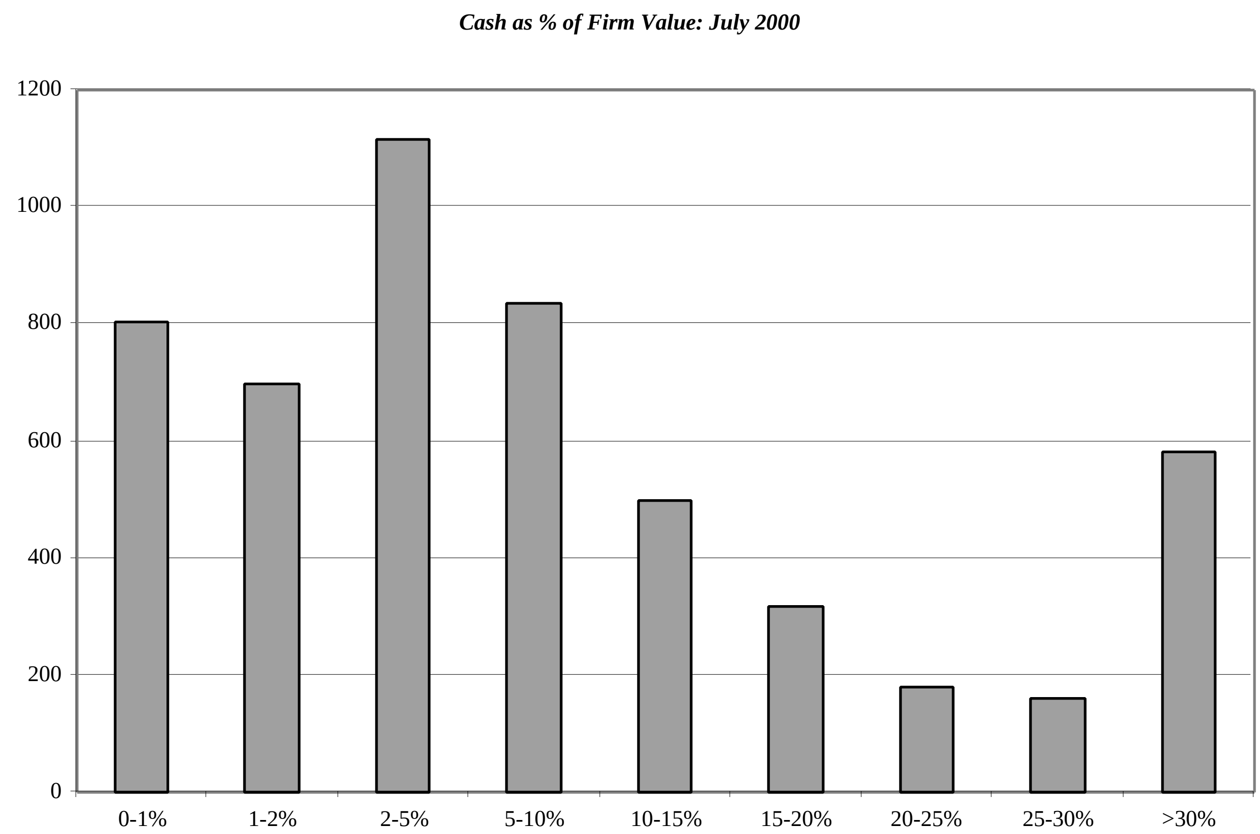
6. Tying up Loose Ends

Dealing with Cash and Marketable Securities

- The simplest and most direct way of dealing with cash and marketable securities is to keep it out of the valuation - the cash flows should be before interest income from cash and securities, and the discount rate should not be contaminated by the inclusion of cash. (Use betas of the operating assets alone to estimate the cost of equity).
- Once the firm has been valued, add back the value of cash and marketable securities.
  - If you have a particularly incompetent management, with a history of overpaying on acquisitions, markets may discount the value of this cash.

How much cash is too much cash?



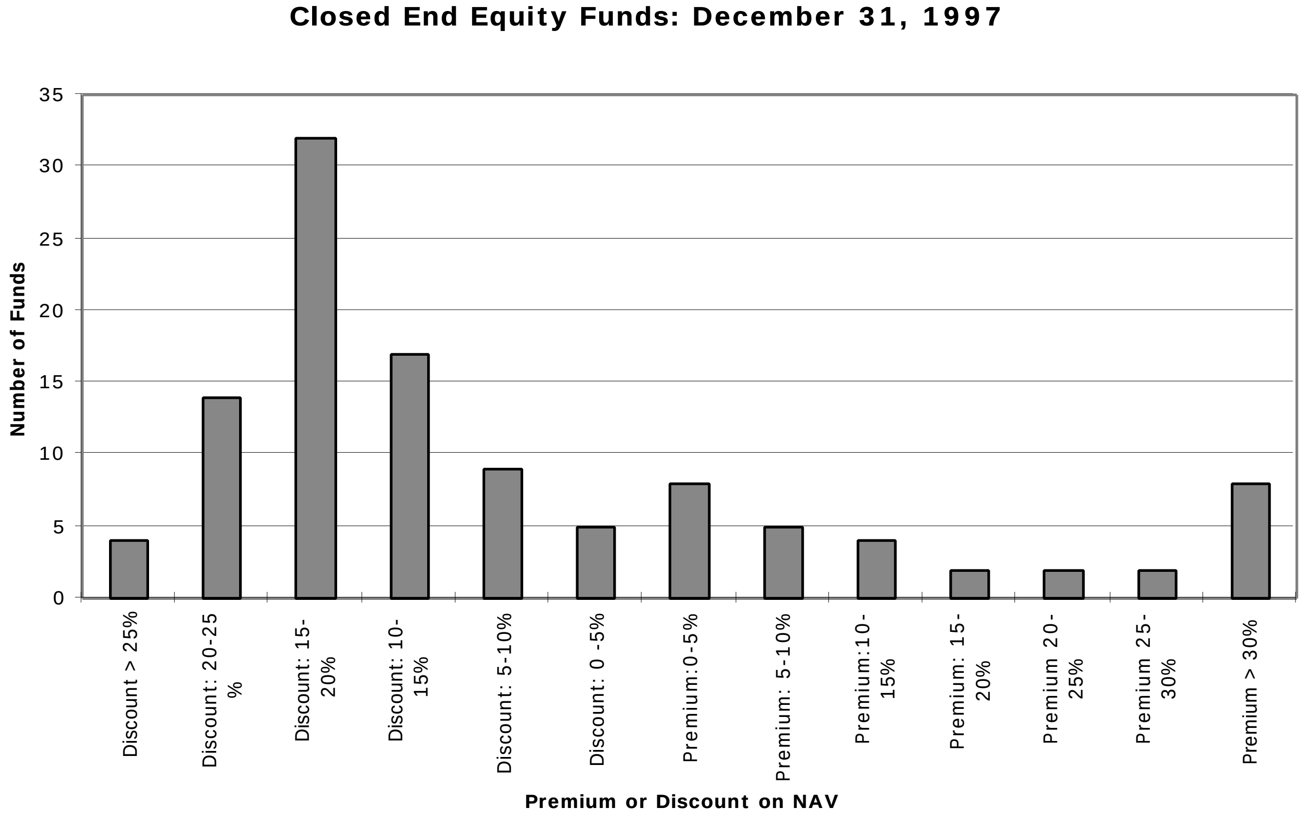
The Value of Cash

- Implicitly, we are assuming here that the market will value cash at face value. Assume now that you are buying a firm whose only asset is marketable securities worth $ 100 million. Can you ever consider a scenario where you would not be willing to pay $ 100 million for this firm?
  - ❑ Yes
  - ❑ No
- What is or are the scenario(s)?

The Case of Closed End Funds

- Closed end funds are mutual funds, with a fixed number of shares. Unlike regular mutual funds, where the shares have to trade at net asset value (which is the value of the securities in the fund), closed end funds shares can and often do trade at prices which are different from the net asset value.
- The average closed end fund has always traded at a discount on net asset value (of between 10 and 20%) in the United States.

Closed End Funds: Price and NAV



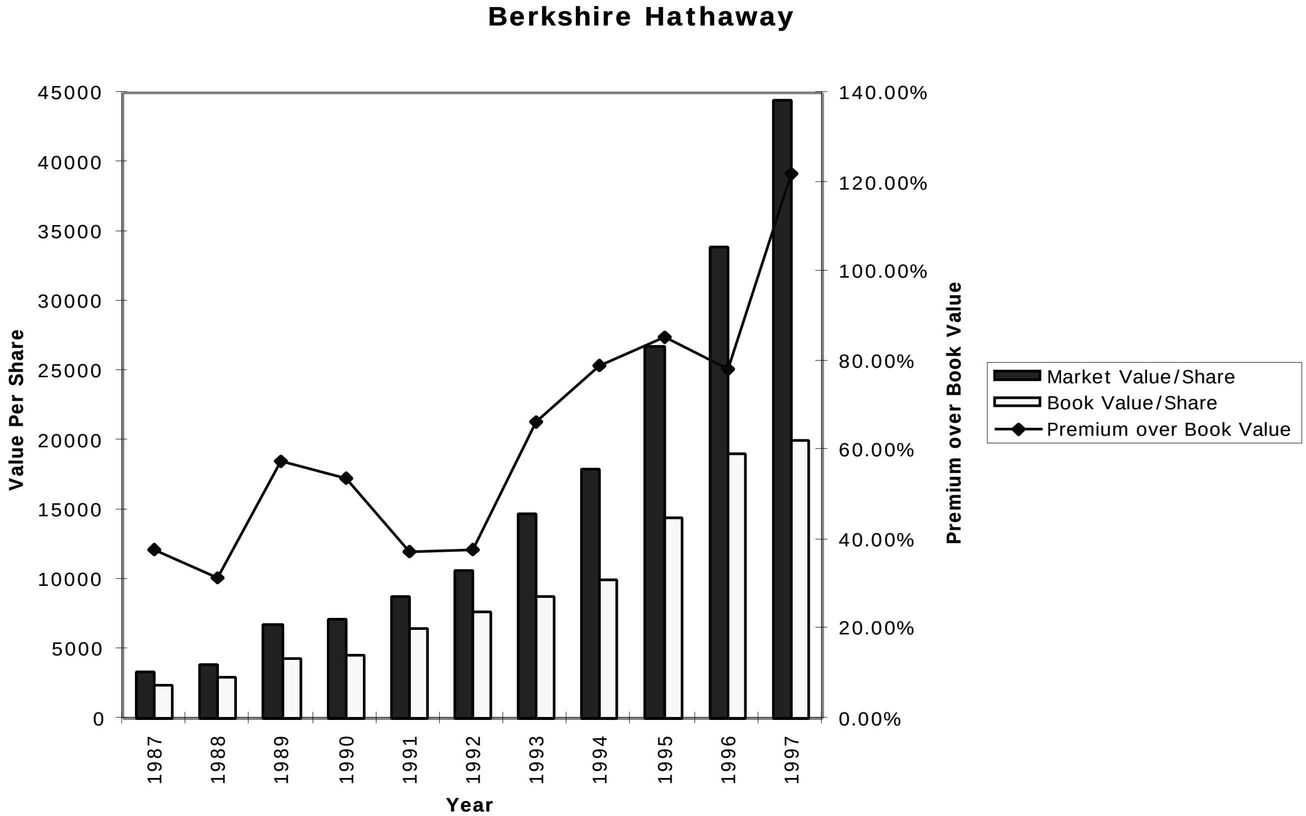
A Simple Explanation for the Closed End Discount

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

A Premium for Marketable Securities

- Some closed end funds trade at a premium on net asset value. For instance, the Thai closed end funds were trading at a premium of roughly 40% on net asset value and the Indonesian fund at a premium of 80%+ on NAV on December 31, 1997. Why might an investor be willing to pay a premium over the value of the marketable securities in the fund?

Berkshire Hathaway



Dealing with Holdings in Other firms

- Holdings in other firms can be categorized into
  - Minority passive holdings, in which case only the dividend from the holdings is shown in the balance sheet
  - Minority active holdings, in which case the share of equity income is shown in the income statements
  - Majority active holdings, in which case the financial statements are consolidated.

How to value holdings in other firms

Fin Statement	*Valuing*	*What to do…*
Not consolidated	Equity	Value equity in subsidiary and take share of holding.
Not consolidated	Firm	Value subsidiary as a firm and add portion of firm value. Add portion of debt in subsidiary to the debt in estimating equity value.
Consolidated	Firm	Strip operating income of subsidiary and value subsidiary separately. Add portion of this value to value of parent firm.

How some deal with subsidiaries...

- When financial statements are consolidated, some analysts value the firm with the consolidated operating income and then subtract minority interests from the firm value to arrive at the value of the equity in the firm. What is wrong with this approach?