Session 29: Post Class tests

1. In intrinsic valuation, you estimate the value of a business as a function of its fundamentals. One of those fundamentals is growth. Which of the following is the best description of the value of growth?
   a. Growth has no value
   b. Higher growth is always more valuable than lower growth
   c. Higher growth adds value only if it comes with negative excess returns
   d. Higher growth adds value only if it comes with no excess returns
   e. Higher growth adds value only if it comes with positive excess returns

2. When valuing the equity in a business, which of the following do you try to do?
   a. Discount cash flows after debt payments and reinvestment needs at the cost of equity
   b. Discount cash flows after debt payments and reinvestment needs at the cost of capital
   c. Discount cash flows after reinvestment needs but before debt payments at the cost of equity
   d. Discount cash flows after reinvestment needs and before debt payments at the cost of capital

3. When valuing a business, which of the following do you try to do?
   a. Discount cash flows after debt payments and reinvestment needs at the cost of equity
   b. Discount cash flows after debt payments and reinvestment needs at the cost of capital
   c. Discount cash flows after reinvestment needs but before debt payments at the cost of equity
   d. Discount cash flows after reinvestment needs and before debt payments at the cost of capital

4. If you are valuing a business where you expect financial leverage to change over time, it is generally easier to value the business and net out debt to get to equity value than it is to value equity directly (by discounting equity cash flows at the cost of equity). Why?
   a. Because the cash flows to equity cannot be estimated when the debt ratio is changing
   b. Because the cash flows to the firm are unaffected by changing financial leverage
   c. Because the cost of capital is not affected by changing financial leverage
   d. Because the cost of equity is not affected by changing financial leverage

5. You notice that an analyst has valued a firm (business) using the expected growth rate in earnings per share as the growth rate in operating income. What effect will this have on value?
   a. The analyst will over estimate the value
   b. The analyst will under estimate the value
   c. The analyst will get the value wrong, though it is difficult to figure out in which direction.
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1. **a. Higher growth adds value only if it comes with positive excess returns.** Growth creates a trade off where the higher earnings you obtain in the far future when you have high growth are offset fully or partially by the lower cash flows in the near future. That trade off works in your favor only if you generate a high return on capital, relative to your cost of capital.

2. **a. Discount cash flows after debt payments and reinvestment needs at the cost of equity.** Cash flows after debt payments are cash flows to equity. Discounting those at the cost of equity will give you equity value.

3. **d. Discount cash flows after reinvestment needs and before debt payments at the cost of capital.** The cash flow to the firm has to be pre-debt and the cost of capital is the weighted average cost across all your financing sources.

4. **b. Because the cash flows to the firm are unaffected by changing financial leverage.** You can estimate cash flows to equity when the debt ratio is changing, but it is a lot more work than changing your cost of capital (by changing your debt ratio). The cost of equity will change as your financial leverage changes.

5. **a. The analyst will over estimate value.** The growth in earnings per share will generally be higher than the growth in operating income, because it will be augmented both by financial leverage and reduction in share count (from buybacks).