

The Apple iTV Case: The Ten Essential Components (each worth a point)

<i>Component</i>	<i>What needs to be done...</i>	<i>Comments</i>	<i>Grading template</i>
Cost of equity	Compute the unlevered beta for electronics companies and lever using Apple's debt to equity ratio. Use an equity risk premium that has a component for country risk in it.	Most groups did the right thing, though the bottom up beta did vary depending upon how the debt to equity ratio for comparable firms was computed. (If you used the simple average of the D/E ratio, you got a lower beta... That is fine) You cannot use Apple's beta or a weighted average of Apple's beta and the electronics beta to evaluate this project.	1a. Used beta for company instead of project (-1 point) 1b. Used weighted average of the betas (for Apple) (-1 point) 1c. Did not adjust ERP for global exposure (-0.5 point) 1c. Other: _____
Debt Ratio	Convert operating lease commitments into debt (Will yield between \$ 3.7 and \$3.8 billion, depending upon assumption made about lump sum in year 6) by taking the present value of leases, using the pre-tax cost of debt.	There is no conventional debt and no interest expenses on the income statement. Since you are doing cash flows to the firm (pre-debt), there is no need to forecast lease or interest expenses for this project.	2a. Used wrong discount rate when computing present value of lease (-0.5 point) 2b. Other (-0.5 point)
Manufacturing capacity.	By investing in this project, you find yourself running out of capacity in year 4 instead of just year 10 (give or take a year). The opportunity cost is therefore the present value of spending in year 3 (or year 4) versus year 9 (or year 10).	If you do not show the savings in year 9 (or year 8), you are considering the incremental cost but not the incremental benefit.	3a. Did not show savings from not to invest in year 9 (-0.5 point) 3b. Other (-0.5 point)
Sunk Costs	The money that has already been spent is not only a sunk cost but it should not be part of capital invested, since it was expensed before you did the analysis.	I know that I added back sunk costs to get to initial investment in the Disney case but that is because I treated sunk costs as part of my initial investment. If you did not consider sunk costs as part of your investment, don't net it out of the initial investment.	4. Counted sunk cost in cash flows directly or as a tax benefit (-0.5 point)
Allocated G&A	You should add back the portion of G&A that is allocated. However, remember to multiply it by (1- tax rate) since you are working with after-tax numbers.	Adding back allocated G&A makes sense only if subtracted it out to get to operating income in the first place. If you used only incremental G&A to get to operating income, don't add back the allocated G&A.	5. Did not neutralize non-incremental fixed G&A costs (-0.5 point)
Non-cash	The non-cash working capital	Non-cash working capital = Accounts	6. Change in working capital

Working Capital	investment is the change in working capital each year. It begins right now (year 0) and affects cash flows each year, as it increases with revenues. At the end of the project lifetime (only in the finite life case), don't forget to get it back.	Receivable plus Inventory minus Accounts Payable. It is only the change that should affect your cash flow, not the total working capital.	incorrectly (-0.5 point)
Salvage value in finite life case	This should include the book value of the fixed assets that have not been depreciated by year 10 plus the working capital salvage. You can also add in the salvage value of the expansion facilities, though it is unlikely that Apple will actually sell them.	If you don't salvage working capital and recover book value of assets, you should at least show the tax benefits from having a capital loss.	7a. Did not salvage working cap book assets in finite life case (-0.5 p 7b. Salvaged working capital and assets in perpetual life case (-0.5 po
Terminal value in infinite life case	The terminal value should be estimated using the inflation rate as the growth rate. It should also reflect reasonable assumptions about capital maintenance in perpetuity.	You cannot keep a project going without investing in it. In fact, here is a very simple test. If you look at your cashflow in year 10, it includes a cash inflow from depreciation of over \$ 1,877 million. If you assume that this cashflow will grow in perpetuity, and you have no capital investment, you will run out of capital to depreciation very soon. In other words, that cashflow cannot be sustained. If you set your terminal growth rate > 2%, you will need new stores to meet the additional real demand..	8. Set growth rate > inflation rate, v adding to capacity (-0.5 point)
Capital Maintenance	Consistency and common sense demand that there should be more capital maintenance (even over the next 10 years and not just after), if you are trying to run this as an infinite life business. What is a reasonable cap ex? If depreciation represents depletion in the assets, capital maintenance should make it up.	If you just extend the life of the project without allowing for capital maintenance, projects will always look better with longer lives than shorter ones. The key, though, is to match the capital maintenance assumptions to assumptions about project life. With the finite life scenario, it makes little sense to pump huge amounts into capital maintenance, especially as you wind the project down.	9a. Capital maintenance assumption for finite and infinite life (-1 point). 9b. Inadequate capital maintenanc point). You are depreciating mor you cap ex in perpetuity.

Synergy (iTunes)	The increased earnings at the iTunes stores are also incremental cash flows. They have to be discounted back at the cost of capital for the iTunes business.	You should generally not use the same cost of capital that you did for the iTV cash flows.	10. Used iTV cost of capital to synergy (No points off)
------------------	--	--	---