CHAPTER 2- SOLUTIONS

INTRODUCTION TO VALUATION

Problem 1

A. False. The reverse is generally true.

B. True. The value of an asset is an increasing function of its cash flows.

C. True. The value of an asset is an increasing function of its life.

D. False. Generally, the greater the uncertainty, the lower is the value of an asset.

E. False. The present value effect will translate the value of an asset from infinite to finite terms.

Problem 2

A. It might be difficult to estimate how much of the success of the private firm is due to the owner's special skills and contacts.

B. Since the firm has no history of earnings and cash flow growth and, in fact, no potential for either in the near future, estimating near term cash flows may be impossible.

C. The firm's current earnings and cash flows may be depressed due to the recession. Other measures, such as debt-equity ratios and return on assets may also be affected.

D. Since discounted cash flow valuation requires positive cash flows some time in the near term, valuing troubled firms, which are likely to have negative cash flows in the foreseeable future, is likely to be difficult.

E. Restructuring alters the asset and liability mix of the firm, making it difficult to use historical data on earnings growth and cash flows on the firm.

F. Unutilized assets do not produce cash flows and hence do not show up in discounted cash flow valuation, unless they are considered separately.

Problem 3

a. Value of Equity = $ 3,224 (Discount cashflows to equity at the cost of equity – 12%)

b. Value of Firm = $ 5,149 (Discount cashflows to the firm at the cost of capital of 9.94%)

Problem 4

A. Average P/E Ratio = 31.98

B. No. Eliminate the outliers, because they are likely to skew the average. The average P/E ratio without GET and King World is 25.16.

C. You are assuming that

(1) Paramount is similar to the average firm in the industry in terms of growth and risk.

(2) The marker is valuing communications firms correctly, on average.