

Homework and Suggested Example Problems
Investment Valuation – Damodaran

Lecture 3 – Estimating Earnings and Cash Flows

Lecture 3 continues our discussion of inputs for discounted cash flow (DCF) valuation models. In this lecture, we will focus on measuring past earnings and on moving from reported earnings to estimates of cash flows. In measuring past earnings, we will discuss how to deal with specific items such as one-time charges, R&D expenses, operating lease expenses, and acquisitions. In estimating cash flows, we will discuss how to measure and forecast both capital expenditures and working capital requirements.

After completing this material, we will turn our attention to forecasts of future cash flows. We will also discuss the practical application of DCF models to several real companies.

Discussion Problems:

Complete the problems on the attached pages and be prepared to discuss your solutions in class.

Additional Suggested Problems:

The following suggested problems will serve as additional examples related to our class material and should give you a basic idea of the topics that I want to emphasize from the text. The solutions to these problems are available on the class web site.

Chapter	Topic	Suggested Problems
9	Estimating Earnings	1, 2, 3, 4, 5
10	From Earnings to Cash Flows	2, 3, 4, 5

Discussion Problems - Lecture 3

1. **Operating Lease Adjustments:**

Future operating lease commitments for Nike, as listed in Nike's most recent 10K, are shown below. Use this information to answer the questions below.

Year	Operating Lease Commitments (\$ millions)
2012	374.0
2013	310.0
2014	253.0
2015	198.0
2016	174.0
>2016	535.0
Total	1,844.0

- a) In the Lecture 2 homework, we found the cost of debt for Nike to be 4.09%. Using this cost of debt, calculate the value of the operating lease debt and operating lease asset for Nike as of May 31, 2011 (the end of Nike's fiscal year). Use these values and any necessary information from Nike's financial statements to estimate the adjusted book values of debt and assets for Nike.
- b) Using your answers above and any necessary information from Nike's financial statements, calculate the value of after-tax operating income and Net Income in the most recent fiscal year, both before and after adjusting for operating leases. Assume a marginal tax rate of 26.1%. Also, note that the firm paid operating lease expenses in the most recent year of \$446 million.

2. **Capitalization of Advertising**

Advertising expenses for Nike in each of the past five fiscal years are listed below. Use this information to answer the subsequent questions.

Year	Advertising Expense (\$ millions)
2007	1,912.4
2008	2,308.3
2009	2,351.3
2010	2,356.4
2011	2,448.0

- a) Assuming a three-year life for advertising, calculate the Advertising Amortization for Nike in the most recent fiscal year and the unamortized value of Nike's Advertising asset at the end of the fiscal year (May 31, 2011). Use your answers and any necessary information from Nike's financial statements to calculate the adjusted book values of equity and assets.
- b) Using your answer above and any necessary information from Nike's financial statements, calculate the value of after-tax operating income and Net Income for Nike in the most recent fiscal year after adjusting for the both operating lease and the capitalization of Advertising.

