FINANCIAL STATEMENT ANALYSIS – 22E00100
Exercise 3

Please use the Exercise 3 Template for performing your calculations. You should read the relevant coursework on Valuation and Cost of Capital before taking this assignment.

Required return versus cost of capital
What is your required return? Does your investment decision depend on how the operations are financed?

Scenario 1. To illustrate, let us assume that you decide to set up ice cream stand for a two-month period. You start your first day of business by buying €70 ice cream, €10 cones, and a stand €20. Hence, your total amount of investment is €100. Let us assume that the required rate of return per period 12% (i.e., the cost of equity capital Re=12%).

You expect to receive to following future stream of cash flow.

Week1	Week2	Week3	Week4	Week5	Week6	Week7	Week8
€20	€20	€20	€20	€20	€20	€20	€20

Questions:
1. How much is the company worth?
2. Would you make the equity investment?

Scenario 2. Let now assume that you take a loan of €50 which has an interest rate of 8% and use only €50 of your own money. You pay interest and principal each week. You pay fixed principal amount starting in period 1. Interest is calculated periodically on the new balance (so Week1 interest expense is simply €50 x 8% = 4€). Assume no taxes and that all your customers pay in cash. Assume also that excess cash is distributed as dividends at the end of each period.

Required:
- Prepare pro forma financial statements (see, Exercise 3 template.xlsx). Use straight-line depreciation method.

Questions:
3. Use the dividend discount model to compute the equity value. What is the value of equity?
4. Would you now make the equity investment?
5. What is the value of debt?
