Good american greetings analysis report example

Business, Company

Executive Summary

Evaluating investments risks' and potential return is crucial for investors' as a way of establishing the expected return for their portfolios. In that respect, the analysis has used the Darden Case on American Greetings and the analysis on the Company as an investment has been done with use of DCF model that uses the present value of the expected future cash-flows. In addition, the analysis has been done using the future cash-flows for the years 2012 to 2015.

The company's WACC has been established to be 0. 11% given the risk-free rate of 0. 05% and the Market rate of 11%. With that consideration, the enterprise values for the two scenarios including a bullish and bearish scenario have been calculated as $659. 41 and $546. 43 respectively, but which are identified as lower than the 2011 value of $714. However, the values still reflect a higher value for the company's stock compared to the 2011 market price of $12. 51. Thus, the company is undervalued by the market at the 2011 and has potential for a rise towards its fair price. In addition, the company has a relatively better credit rating by the credit rating agencies being an indication of its relative low risk. In conclusion, the company's stock has been identified as a buy, and its fair price for the year 2011 has been estimated to be $18. 64.

Company value depends on a number of factors. Those factors include the capital structure that determines its cost of resources as well as the market situation that defines its risk and future cash-flow prospects. On the other hand, investments' valuation is crucial to decision making. In that respect,

investors have a growing need to know the proposed of their target investments and the suitability of their current market valuation. Thus, it is important to identify the company’s value and compare it with its stock’s market price. In that view, this analysis seeks to demonstrate the valuation of a company considering its capital structure and the market situation. To achieve the objective, the analysis uses the Darden case of the American Greetings and analyzes it over a period of four years beginning 2012 to 2015. The analysis estimates the company’s WACC and Enterprise value as well as the corresponding stock price. With the use of the estimated values, a recommendation is made on its suitability as an investment stating whether it is a buy or not.

- Discounted Cash-flows (DCF)

DCF is the most common method of firms’ value evaluation. The model stipulates that the value for a firm is the present value of its future cash-flow streams that are discounted at a rate that reflect their risk. The method is widely used by finance analysts and managers with a goal to maximize shareholder's wealth. The model mainly uses the Weighted Average Cost of Capital to discount the expected stream of future cash-flows. Thus, the present value obtained is the value used to evaluate and estimate the firms’ potential as an investment. In that view, DCF values that are higher than the costs of capital of the firm are an indication of a better investment. (Agar, 2005)

The DCF = [CF1/ (1+R) 1] + [CF22/ (1+R) 2] + .. + [CFn / (1+R) n]

Where

r = WACC.

DCF is the present value of the expected future cash-flowsCF n is the cash flow in the respective yearn is the number of periods in the valuation model. (Agar, 2005)The model entails a number of variations in use of the cash-flows and the discount rate and The free cash-flows can be used and calculated as.

Free Cash flows = Operating profit + Goodwill Amortization + Depreciation - Capital

Expenditures – change in working capital- Cash taxes

However, the model, presents a number of challenges including being merely a technical tool that is subject to the garbage in garbage out the axiom. Thus, small errors or changes in the inputs could distort the value. In addition, it mainly uses a terminal value instead of projecting cash flows to infinity. Thus, a simple annuity is mainly used for a number of years that reduces the difficulty of estimating cash-flows over a longer period. Further, the valuation method follows a process with several stages as explained

First stage: Developing scenarios that are used to predict the future cash flows. In this case, the scenarios are a bullish and bearish markets.

Second stage: Determination of an appropriate discount rate mainly the WACC that will be used for discounting the expected future cash flows

Third stage: Estimating a terminal value that is the NPV of the expected future cash-flows that accrues over the covered period.

Final stage: Estimation of the present value of the discounted future cash flows using the terminal value. (Damodaran, 2010)

- Cash-flows

Business operations are subject to market factors that determine their performance in terms of sales. That is further dependent on factors that determine market demand as well as the business' competitiveness. Thus, business scenarios can be classified as either bullish or bearish with bullish representing conditions with potential for growth while bearishly represents conditions that adversely affect growth. Considering those two scenarios, American greetings' cash-flows for the period 2012 to 2015 are calculated as follows.

The assumptions applied are as explained on the terminal value assumptions section and the following are the results interpretation.

Bullish scenario:

Although there will be growth in revenues and operating profit, the growth is not significant enough to counter the expected increase in capital expenditures and change in working capital. In that respect, the cash-flows during the period would reduce.

Bearish scenario:

The marked would be marked with decrease in revenues and operating profit. That in addition to the change in capital expenditure, as well as working capital, would result to the overall decrease in the cash-flows.

- WACC estimation

Companies have different sources of capital including retained earnings, common stock, debt and preferred stock. Thus, the WACC presents an average cost of the total capital after the tax cost. In that respect, it is estimated by multiplying the relevant weight of a specific capital and its cost and then summing the products. (Agar, 2005)

The cost of equity estimation is done using different models such as a dividend growth model or the capital asset pricing model. On the other hand, debt's cost is dependent on the involved instruments' yield to maturity. However, in cases with no maturity yield, the instruments current yield is used. Regarding the weights, they are dependent on the market values of the relevant capital components or the weights of their book values. (Agar, 2005)

Thus, the WACC accounts for all capital sources including long-term debt, bonds, common and preferred stock. Further, the costs of capital increases as the company's beta increases and the return on equity increases. Thus, an increase in WACC results to a decrease in valuation and increase in risk. (Damodaran, 2010)

WACC = [(E/V)*Re] + [(D/V)*Rd*(1-Tc)]

Where:

Re is the cost of equity

Rd = debt's cost

E is the firm's total equity value.

D is the total of company's debt.

V equals the company's total capital.

Thus, D/V is the proportion of financing that is debt while E/V is the proportion that is in equity form.

Tc is the corporate tax rate

In that view, WACC represents overall required rate of return for the business as a whole and is used to evaluate the feasibility of the business opportunities. (Agar, 2005)

In consideration of the above elements, American Greeting's Weighted Average cost f Capital is computed

Thus, the American greetings' WACC is 11% and is the rate that is used to discount the expected future cash flows that are in turn used to estimate the enterprise value.

- Terminal value assumptions

A company's terminal value captures the value of the business beyond the period that is projected in the DCF analysis and presents the present value of all the subsequent free cash-flows. However, there must be great attention to the assumptions applied in determining the terminal value because it depends on the circumstances considered. (Damodaran, 2010) Thus, in the case of the American Greetings, it is assumed that:

- Marker rate equals the American greetings' ROE = 11%
- Risk-free rate is equivalent to the three months Treasury bill rate = 0. 015%
- Tax rate is taken as the US corporate tax rate of 35%
- Amortization for goodwill for the two scenarios is taken as being zero following the trend that had been set over the past years where it was taken to be zero.

- Depreciation is taken to be zero in the two scenarios as there are no past records on the financial statements for the item.

- Implied enterprise value and corresponding share price

Enterprise value is a measure of the Company’s value and is alternatively used instead of the straightforward market capitalization method. The equity’s value is obtained by discounting the expected cash-flows to equity that represent the residual cash-flows after all the tax and all expenses, as well as interest and principal. (Damodaran, 2010) In view of the model, the following is the estimation of America Greetings enterprise value given the estimated cash flows and the WACC.

The free cash-flows for the years involved are discounted with the WACC and a terminal value obtained for the two scenarios as shown above. In results, it is estimated that the business value in the bullish scenario is $659. 41 and $546. 43 in a bearish scenario.

In view of the Enterprise values and the number of outstanding shares being 38. 3 million, the company’s share price corresponding to the two scenarios are as follows.

Bullish scenario:

Share price = Bullish Enterprise value / Outstanding shares

Share price = ($659. 41 / 38. 3) = $17. 21

Bearish scenario:

Share price = Bearish Enterprise value / Outstanding shares

Share price = ($546. 43 / 38. 3) = $14. 26

Thus, the corresponding share prices for the two business scenarios are $17.

21 and $14. 26 for bullish and bearish markets respectively.

- Share value and recommendations

Compared to the industry peers, American Greetings has a better credit rating with a bond rating of BB+. The rating is an indication that the business has a relatively better outlook compared to the others hence being less likely default on its debts compared to the competitors. Further, given the enterprise values in the two scenarios, they are lower than the current enterprise value of $714. In that respect, the business could face reduced value in the future even considering the bullish conditions. That would be because of the expected increase in outflows in terms of capital expenditure.

In respect to the share price, the 2011 price of $12. 51 id relatively low given the relatively high Enterprise value at that time. Thus, projected prices of $17. 21 for a bullish market and 14. 26 in a bearish market shows that the price in 2011 was below its fair price that should be ($714/38. 3) = $18. 64. In that respect, the share is undervalued by the market by the 2011 price and even with the two scenarios, it would still be undervalued. Thus, the stock can be concluded as a buy given the positive outlook that the industry agencies have on it and the undervaluation by the market.

Works cited

Agar, C. Capital Investment and Financing: A Practical Guide to Financial Evaluation. Elsevier Ltd. ISBN: 978-0-7506-6532-2. 2005.

Damodaran, A. Applied Corporate Finance. 3rd ed. Colorado: Wiley. 2010