Thecasesolution.com

Julia Reka: Analyzing Put Options

Cox Communication

Background

Multiple Analysis

Benefits

Negatives

Martin believes multiples are; Primitive, incomplete and static
Assumed that valuation is constructed using the same views, assumptions and accounting policies

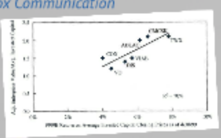
Inputs into Multiples

- Complete
- Utilize relevant market values
- Correct for seasonality
- Include all core and non core assets with value

It is assumed that accounting policies are generic across an industry.

Exhibit 5. ROIC Target Price Analysis for Cox Communication

- Target price of $50.00
- ROIC to increase 30%
- R^2 is OK but not ideal
- Miss-priced industry



Martin's EBITDA Growth Assumptions

- Revenue growth to increase and diversify
- Capital spending to decrease, decreased risk levels
- Increased ROIC from new digital revenue streams

Assumes that all companies considered define EBITDA the same way and calculate it accordingly.

Unaccounted For Changes

- Regulatory changes within the industry
- Difficulty in developing economies of scale
- Dissolving boundaries within the industry
- Potential acquisitions
- Cox super voting shares

Martin assumes that if you can't quantify it, you can't include it

Cox Communication

- Martin's multiple analysis over values Cox Communication
- 33% appreciation of share price is unrealistic
- Qualitative information impacts value
- Biases and assumptions incorrect

Issues with Multiple Analysis

- Only reflects the past figures
- Doesn't account for different accounting practices
- Changing industry structure makes finding comparable firms difficult.

Discounted Cash Flow Analysis

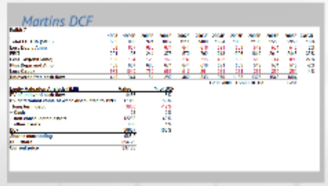
Advantages

Disadvantages

Martins Assumptions

- Revenue growth would accelerate and diversify: From 1998 to 2003 at a CAGR of 14.3%
- Capital Spending would slow and nature of investments change: From 2000 it would decrease at average CAGR of -6.5%
- Falling risk for investors as change from non-revenue upgrades and maintenance to revenue linked CAPEX
- Digital revenue streams earn higher return on capital: Higher marginal ROIC (excluding cost of upgrade of cable plant) 45% - 65% compared to 1998E ROIC of 5% for COX.

Martins DCF



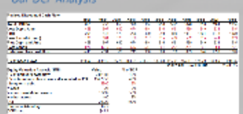
How realistic are Martins DCF assumptions?

- Very high stock valuation of $54.29
- EBITDA growth rate of 16% over the next 10years. We have recalculated this to a more conservative 13.77%
- Perpetual growth rate of 4.4% is realistic assumption by Martin
- Concern over CAPEX decreasing as capital will depreciate to nothing over time.

Revised Inputs

- Capital structure remains unchanged, debt to capital ratio of 18%
- Risk free rate has increased, cost of equity increases to 10.69%
- Increases the WACC to 9.42%

Our DCF Analysis



Our Valuation Results

- Cox Communication is still undervalued
- New DCF valuation Stock value of $41.30, 9.6% premium over market price
- Martin was too optimistic in her assumptions
- With only DCF considered we recommend Cox as a buy.

Cable Company Infrastructure

"Stealth Tier"

- 102MHz of unused capacity
- Invisible revenue streams
- Not Valueless
- could include services such as
  - Video telephone
  - interactive e-commerce
  - interactive games
- Enormous bandwidth

How is the "stealth tier" incorporated into the DCF and multiples analysis?

DCF Valuation

Multiples Analysis

"Stealth Tier" as a call option

- Firm has a choice, but not the obligation to exercise the use of the additional bandwidth
- Most closely equates to American style option, where options can be exercised at any time.

The Underlying Asset

The value of the asset is based upon two variables
- Quantity Available
- Price of resource

Underlying Asset – Each individual cable

Strike Price

The strike price is the individual cost to light up 1 out of the 17 channels available in the "stealth tier".

Martin makes the assumption that technological costs will be zero.

We believe barriers to entry of a new channel would cause this cost to not be zero

This leads to us believing the strike price being considered as the opportunity cost of not "lighting" up the fiber.

Our Recommendation

- We find Martin's valuations too optimistic.
- Our own conservative DCF valuation is $41.30 per share.
- 9.6% above the current share price of Cox Communications
- Expect positive changes to occur in cable industry

Recommend to 'BUY' Cox Communications.

Thank you for your time.

Any questions?

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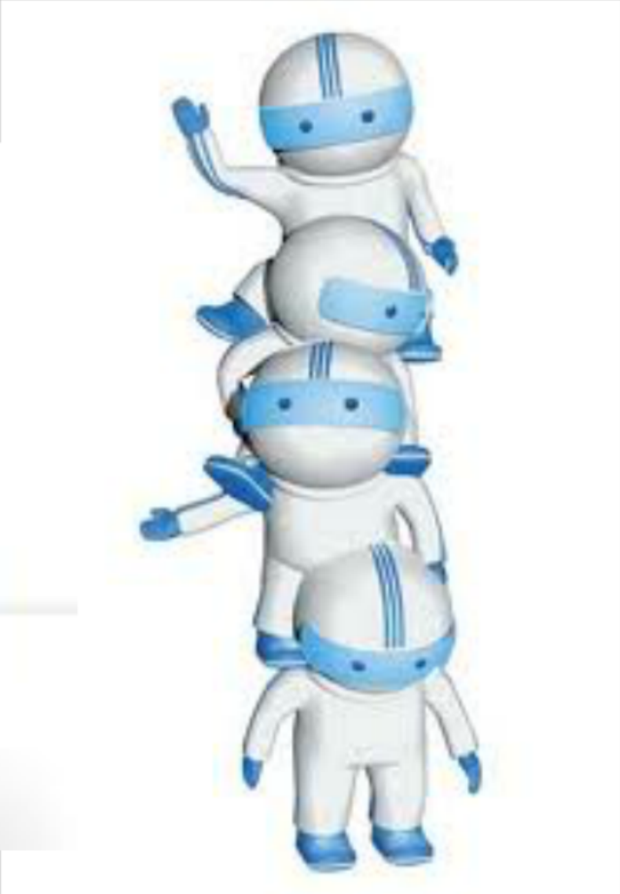
Cox Communication



Background

Cable Industry

- Cable television early 1950s: Community Antenna Television systems
- Started in rural areas, expansion to suburban systems and urban areas.
- 1978: cables through 26.8 million households
- 1999: cables through 97 million households = 97% households in country
- Historically primary revenue through analogue video
- Today: digital video, cable technology and internet speed

The Firm: Cox Communications

- Privately owned subsidiary of Cox Enterprise
- Digital cable, television, telecommunications, wireless services
- 3rd largest cable entertainment and broadband service provider in the USA

Three main businesses:

- Cable programming services: 2.9 mill subscribers
- Internet: 3.5 subscribers
- Telephony: 3.2 million digital telephone subscribers: 7th largest telephone carrier in US

Key Value Drivers

- Revenue growth would accelerate and diversify
- Capital spending would slow and the nature of investments would change
- The digital revenue streams would yield higher returns on invested capital.

Equity Analysts

- Gather and evaluate information, generate forecasts,
- Make recommendations that lead to buying or selling of the
- Buy side and sell side analysts.

Sell Side vs Buy Side

Sell side:

- Work for brokerage firm
- Follow a list of companies, provide regular in depth reports
- Distribute/sell research to buy side clients

Buy side:

- Employed by asset management companies
- Internal recommendations and forecasts to money managers
- Research distributed to firm that employed analyst

What Constituencies do they serve?

Sell side:

Martin's three main constituencies central to her work

- The companies she covered
- The buy-side firms the advised
- The internal CSFB constituencies.

Buy side:

- Investment banks
- Money management firms

Incentives:

Sell side:

- Accumulate unique, in-depth, quality information
- Good relationship with businesses

Laura martin's two primary drivers of compensation:

- Her annual ranking in institutional investor magazine
- Her revenues linked to corporate financial deals

Buy side:

- Take correct position on stocks
- Value firms as accurately as possible
- Maximizing value of portfolio.

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