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Laura Martin: Real Options

Cox Communication

Background

Multiple Analysis

Benefits

Negatives

Valuation Methods

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

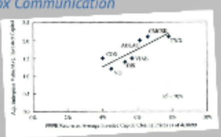
Inputs into Multiples

- 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

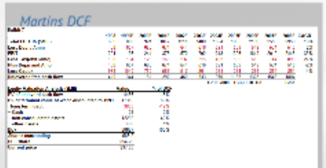
Advantages

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



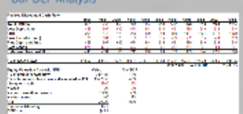
How realistic are Martins DCF assumptions?

- Very high stock valuation of $64.29
- 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?

"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".

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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