

LOS.50.a

SS 11

Describe how inflation affects the estimation of cash flows for a company domiciled in an emerging market.

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LOS.50.b

SS 11

Calculate nominal and real-term financial projections in order to prepare a discounted cash flow valuation of an emerging market company.

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LOS.50.a

Cash flow forecasting for emerging market companies is challenging because emerging markets tend to experience high inflation levels, which makes the distinction between real and nominal cash flows and discount rates very important.

Three issues that require particular attention are:

- *Income taxes* are paid based on nominal earnings, not real earnings.
- The real cash outflow from NWC is *not* equal to the change in real NWC.
- Nominal *capital expenditures* are difficult to forecast using an assumed relationship between nominal sales and nominal capital expenditures because the relationship is not constant when inflation is high.

LOS.50.b

The steps in valuing an emerging markets company on a real and nominal basis are:

1. Forecast real revenue, EBITDA, invested capital, and EBITA.
2. Forecast nominal revenue, EBITDA, invested capital, and NOPLAT.
3. Forecast real NOPLAT.
4. Forecast nominal and real free cash flows.
5. Estimate firm value using a free cash flow model in both real and nominal terms by discounting real cash flows at the real WACC and nominal cash flows at the nominal WACC.