UNIVERSITA' DEGLI STUDI DI TRENTO
DIPARTIMENTO DI INFORMATICA E STUDI AZIENDALI
Via Inama, 5 - 38100 TRENTO - Tel. 0461/882126 - Fax 0461/882124 - Email: disa@cs.unitn.it - Web: http//www.cs.unitn.it

DISA Seminari

Levered-Equity Discount Rates

Prof. Richard J. Sweeney

McDonough School of Business – Georgetown University – Washington, Dc

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Sala riunioni Disa

Levered-equity discount rates are typically found from the Modigliani and Miller (1958) approach. With MM discount rates, present value calculations for expected dividends do not have standard properties: the discounted dividend model gives the correct value of the overall dividends stream, but in general gives an incorrect value for any subset of the stream. Intuitively, using MM discount rates undervalues early dividends and overvalues later dividends, with the errors exactly cancelling for the whole stream. The MM discount rates are found by applying value additivity to the overall value of the firm. In this paper's alternative approach, value additivity is applied in each period. In this single-period-value-additivity approach, discount rates are found by forcing discounted dividends to have standard present-value properties. The MM and SPVA approaches give the same value for the overall dividends stream, but in general give very different values for subsets of the stream. MM and SPVA discount rates have very different term structures. Related, as a given, positive expected dividend payment recedes into the future, its SPVA present value eventually becomes negative, and asymptotically goes to zero from below.

Referente:

Prof. Luca Erzegovesi (tel. 0461/882130 e mail: lerzegov@cs.unitn.it)