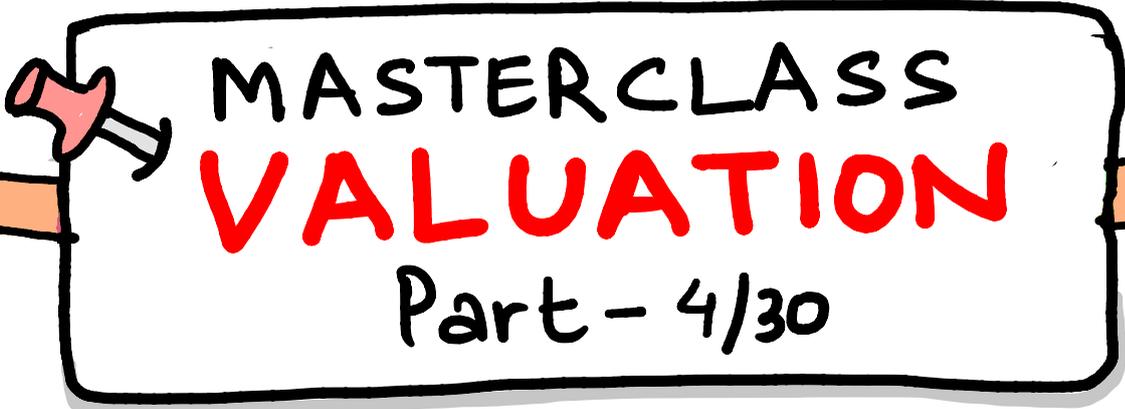




The Valuation School



MASTERCLASS
VALUATION
Part - 4/30

Dcf - Equity Risk Premium

Hey, Goodmorning!

- In part 3 of valuation masterclass series we have covered Risk free Rate.
- Today we will cover Equity Risk Premium in detail.
- cement one thing in your mind

$$ERP \neq (R_m - R_f)$$

What is Equity Risk Premium →

- In layman terms, ERP is the returns expected by Equity share-holders over & above Risk free Rate for the risk assumed by Investing in Equity Markets of a country → Remember ERP is country specific and not company specific.

→

Why ERP should not equal to $(R_m - R_f)$?

- Because it does not consider

(i) Equity default premium

(ii) Country Risk premium

(iii) Company's exposure to Country Risk.



How to calculate ERP?

- There are **three** ways to calculate ERP in CAPM formula

(i) Survey Approach

(ii) Actual Prem ($R_m - R_f$) in historical period.

(iii) Implied premium

Let's understand one by one

I. Survey Approach →

- Morningstar & Merrill Lynch do conduct survey with individual investors
But very few practitioners use this CO2

- Impractical to survey all investors
- since investors are not diversified they expect unreasonable returns
- Survey premiums are extremely volatile
- ————— all tend to be for short term.

2. Historical Prem Approach →

- MOST common Approach (Rm-Rf)
- But it is not advisable to use
CO2
 - How far you go back in history
 - Results are diff in Arithmetic
vs Geometric mean
 - High Standard Error ↑
 - This approach ignores country
Risk premium.

Wait for a minute →

- Do you struggle to Read stock charts?
- Don't know how to set logical stop loss & Targets?

The Valuation School is coming up with a 10 hour - 100% LIVE WORKSHOP

“Basics of Technical Analysis”

(check link in comments for details)

3. Implied ERP

- Let's say we want to calculate Implied ERP of NIFTY which is currently at '17000'
- we need to back calculate ERP

$$17000 = \frac{CF_1}{(1+r_1)} + \frac{CF_2}{(1+r_2)^2} + \dots + \frac{CF_n}{(1+r_n)^n}$$

↳ we will reverse calculate this r and then reduce Rf to get ERP

which ERP you should choose? →

If you assume

Prem to use

- Prem revert back to historical norms

- historical prem approach

- mkt is correct and our valuation is mkt neutral

- Implied ERP

- market makes mistake even in aggregate but is correct over-time

- Arg Implied ERP over time.

I know ERP is a tough nut
to crack

- It takes me 6 hours to explain this in valuation cohort.
- I tried my best to explain you in limited words
- You need to put efforts to understand this
- Ask your questions in comments below.

Meanwhile,

REPOST - This to help others

SAVE - Revise before Interview

FOLLOW - Your man 'PARTH' for
premium finance content
