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

$$ERP \neq (Rm - Rf)$$

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 (Rm − Rf) ?

- 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 (Rm-Rf) in historical period.

  (iii) Implied premium

Let's understand one by one

1. Survey Approach →

- Morningstar & Merill Lynch do conduct survey with Individual Investors But very few practioners use this CO2

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

2. Historical Prem Approach →

- Most comman Approach (Rm-Rf)
- But it is not advisable to use

  Coz
  - How far you go back in history
  - Results are diff in Arthematic v/s 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

$$17000 = \frac{Cf_1}{(1+r_1)^1} + \frac{Cf_2}{(1+r_2)^2} + \cdots\cdots \frac{Cf_n}{(1+r_n)^n}$$

↳ 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	– Avg 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 unders -tand this — Ask your Questions in comments below.

Meanwhile,

REPOST – This to help others

SAVE – Revise before Interview

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