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**Under Construction Right Now. Do Not Use!**

# Pro Formas

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How embarrassing—I never managed to cover this chapter, even though it is a key part of the book.

Fortunately, because there is an assigned class project of a pro format, virtually every student read this chapter on pro formas for themselves voluntarily, as they worked the class project.

The following is therefore pretty mediocre.

# Financial Modeling (Pro-Formas)

Financial Modeling *usually* starts with a set of sales projections, and then develops other financial components, many with respect to the sales projections. Then, it does the same cash flow statement construction, but using projected figures, that we have done here with historic numbers.

This will be a major part of the class project. Read the material in the book for a taste.

- Very difficult.
- Very idiosyncratic.
- Application of all finance-related subjects: forecasting, capital budgeting, investments (cost of capital), capital structure, corporate governance.

# Terminal Value

20-2

- Think of it as sale value of the firm in this year.
- Often reasonably far in the future (10 years?), so that the lumping from year 11 to infinity is discounted.
- Based on last detailed projection—the cause of much uncertainty.
- Usually done via growing perpetuity—uncertainty in  $g$ !

Limited by limited economic rents.

- How long before barriers erode?
- before the competition mimicks you?
- before your suppliers, customers, employees, etc., will squeeze you?

(This is expected and built into the price today!)

# Detailed Projection Phase

20-3

- You need to know the business well.
- You need to make smart forecasts — there is no “recipe” for this.
- Usually start off sales projections.
- Remaining financial items are off the sales projections and your insight about how the business operates.

# Cost of Capital

20-4

- Comparables (as elsewhere, too)!
- CAPM.
- “Calibration, perhaps”

## Accuracy?

20-5

- Usually very inaccurate!!
- Calibrate to existing valuation — that is, fudge numbers so that they match the current value.
- **You should do multiple scenarios!**—do not forget full failure!
- The Emperor’s New Clothes—can look very professional. Don’t believe it!

PS: The book has some guidance on how, in an average Fortune company, each item is variable cost or fixed cost. It is rather unreliable, and should only be seen as modest guidance if you are otherwise absolutely clueless.