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TOPIC 5 - DETERMINATION OF TERMINAL VALUE

1. INTRODUCTION AND OBJECTIVE

This article attempts to discuss on some basic principles that should be considered in addressing the determination of Terminal Value (TV) which is a source of input in FCFE / FCFF. Generally, the determination of TV is **less important** when discounted cash flow is used as method of valuation in the valuation of independent power plant. The reasons being that:-

- (i) The nature of IPP is that the contractual arrangement between the energy producer (seller of electricity) and the buyer of electricity is governed by terms of the Power Purchase Agreement (PPA) and lasted for 25 years to 30 years, coincides with the life of the plant. Hence, the terminal value could be ascertained based on the estimated value of the residual plant.
- (ii) Conventional methods to determine the TV based on assumption of steady state cash flow and multiples applied n forecasted earnings are **not** used.

Conventional methods of determining TV, which is **NOT** relevant in determination of equity values of independent power plants:-

METHOD 1

	Conventional methods for determining TV which is NOT applicable for valuation of power plants.
Free Cash Flow to Equity (FCFE)	$TV_n = \frac{FCFE_{n+1}}{r - g}$ <p>g is equivalent to steady state growth rate.</p>
Free Cash Flow to Firm (FCFF)	$TV_n = \frac{FCFF_{n+1}}{WACC - g}$ <p>g is equivalent to steady state growth rate.</p>

METHOD 2

Application on multiples applied on projected earnings, net assets or enterprise value / EBITDA.

THANKS FOR READING.

This article is prepared by Ong Tee Chin, CFA, FRM, and represents the view of the author. He can be contacted at ong@atlantiscapital.org for any further enquiries on the contents of this article.

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