

Sprint Nextel—Valuing Firm Equity

Learning Objectives

- Learn to apply income-based valuation method.
- Develop a parsimonious multi-period forecast of operating profit and assets.
- Explain the concept of residual income and how it relates to fair value.
- Apply the residual income model to estimate fair value of a firm.
- Understand how SFAS 157 Level 2 and Level 3 inputs can affect estimated fair values.

Read the “Sprint Nextel—Valuing Equity Background Reading” and refer to the company’s 2006 financial statements (included below).

Concepts

- a. Explain when the use of an equity valuation model is appropriate to determine fair value of a share of a firm’s common stock.
- b. Briefly describe the steps involved in valuing a firm’s equity using Level 2 and Level 3 inputs. Recall that Level 2 inputs are observable inputs other than quoted prices, such as interest rates and volatilities. And Level 3 inputs are unobservable inputs that reflect assumptions about what market participants would use to price the asset or liability (including risk).
- c. In general, what assumptions are implicit in equity valuation models?
- d. The residual operating income valuation model uses residual operating profit as a basic input. Explain the concept of residual operating profit and how it differs from net income.

Analysis

- e. Use the table below to forecast Sprint Nextel’s Sales, Net Operating Profit After Tax (NOPAT) and Net Operating Assets (NOA), for a four-year forecast horizon (2007 to 2010) and for the terminal period (2011 and beyond). Sprint Nextel’s actual 2006 Sales, NOPAT, and NOA are already shown in the table. (See the Appendix for details on how these values were determined.)

To forecast Sales, assume that sales will grow by 20% annually through the forecast horizon and then by 3% each year in the terminal period.

To forecast NOPAT, assume that the company will earn 7.5¢ of net operating profit after tax for each dollar of sales during the forecast horizon and in the terminal period.

To forecast NOA, assume that the company will grow its net operating assets by 5% each year.

(\$millions)	Current	Forecast Horizon				Terminal Period
	Year	2007	2008	2009	2010	
Sales	\$41,028					
NOPAT	\$1,540					
NOA at end of year	\$75,270					

- f. Use your forecasts of NOA and NOPAT from the table in part e. above, to estimate expected and residual operating profit for each year in the forecast horizon and for the terminal period. Then calculate the present value of the ROPI that you estimate. Assume a discount rate (weighted average cost of capital) of 8.07%.

Recall that to calculate the present value of the terminal period ROPI, we use Sprint Nextel's expected long-term growth rate, g , (in this case 3%) and the company's weighted average cost of capital, r , (8.07%) in the following equation:

$$\frac{ROPI}{(r - g)(1 + r)^t}$$

	2007	2008	2009	2010	Terminal Period
NOA at beginning of year	\$75,270				
Expected operating profit = (NOA at beginning of year \times 8.07%)					
Residual operating profit = NOPAT - Expected operating profit					
Present value of residual operating profit					

- g. Complete the table below to determine the value of a share of Sprint Nextel stock. At December 31, 2006 Sprint Nextel had Debt, net of marketable securities of \$22,139 million and had 2,897 million shares outstanding.

Cumulative Present value of residual operating profit	
Plus NOA at end of 2006	\$75,270
Less Debt, net of marketable securities	
= Estimated Fair Value of Equity	
Shares outstanding (millions)	
Stock Price per share	

- h. Use an online investment site (such as <http://finance.yahoo.com/>) to find the December 31, 2006 value of Sprint Nextel (ticker: S). Compare that to your stock-price estimate. What might account for any difference? In particular, consider the Level 2 and Level 3 inputs you used in the residual operating income valuation model. What is the price of Sprint Nextel today?

**SPRINT NEXTEL CORPORATION
CONSOLIDATED BALANCE SHEETS**

December 31,
2006 **2005**
(in millions, except share data)

ASSETS		
Current assets		
Cash and cash equivalents	\$ 2,046	\$ 8,903
Marketable securities	15	1,763
Accounts receivable, net	4,595	4,166
Inventories	1,176	776
Deferred tax assets	923	1,789
Prepaid expenses and other current assets	1,549	779
Current assets of discontinued operations	—	916
Total current assets	<u>10,304</u>	<u>19,092</u>
Investments	253	2,543
Property, plant and equipment, net	25,868	23,329
Intangible assets		
Goodwill	30,904	21,288
FCC licenses	19,519	18,023
Customer relationships, net	7,256	8,651
Other intangible assets, net	2,378	1,345
Other assets	679	632
Non-current assets of discontinued operations	—	7,857
	<u>\$97,161</u>	<u>\$102,760</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable	\$ 3,463	\$ 3,562
Accrued expenses and other liabilities	5,192	4,622
Current portion of long-term debt and capital lease obligations	1,143	5,045
Current liabilities of discontinued operations	—	822
Total current liabilities	<u>9,798</u>	<u>14,051</u>
Long-term debt and capital lease obligations	21,011	19,969
Deferred tax liabilities	10,095	10,405
Pension and other postretirement benefit obligations	244	1,385
Other liabilities	2,882	2,753
Non-current liabilities of discontinued operations	—	2,013
Total liabilities	<u>44,030</u>	<u>50,576</u>
Commitments and contingencies		
Seventh series redeemable preferred shares	—	247
Shareholders' equity		
Common shares		
Voting, par value \$2.00 per share, 6.500 billion shares authorized, 2.951 billion shares issued and 2.897 billion shares outstanding and 2.923 billion shares issued and outstanding	5,902	5,846
Non-voting, par value \$0.01 per share, 100 million shares authorized, 0 shares issued and outstanding and 38 million shares issued and outstanding	—	—
Paid-in capital	46,664	46,136
Retained earnings	1,638	681
Treasury shares, at cost	(925)	—
Accumulated other comprehensive loss	(148)	(726)
Total shareholders' equity	<u>53,131</u>	<u>51,937</u>
	<u>\$97,161</u>	<u>\$102,760</u>

SPRINT NEXTEL CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	2006	2005	2004
	<i>(in millions, except per share amounts)</i>		
Net operating revenues	\$41,028	\$28,789	\$21,647
Operating expenses			
Costs of services and products (exclusive of depreciation included below)	16,567	12,489	9,838
Selling, general and administrative	12,178	8,916	6,459
Severance, lease exit costs and asset impairments	207	43	3,691
Depreciation	5,738	3,864	3,651
Amortization	3,854	1,336	7
	<u>38,544</u>	<u>26,648</u>	<u>23,646</u>
Operating income (loss)	<u>2,484</u>	<u>2,141</u>	<u>(1,999)</u>
Other income (expense)			
Interest expense	(1,533)	(1,294)	(1,218)
Interest income	301	236	60
Equity in (losses) earnings of unconsolidated investees, net	(6)	107	(41)
Realized gain on sale or exchange of investments	205	62	15
Other, net	32	39	(61)
	<u>(1,001)</u>	<u>(850)</u>	<u>(1,245)</u>
Income (loss) from continuing operations before income taxes	1,483	1,291	(3,244)
Income tax (expense) benefit	<u>(488)</u>	<u>(470)</u>	<u>1,238</u>
Income (loss) from continuing operations	995	821	(2,006)
Discontinued operations, net	334	980	994
Cumulative effect of change in accounting principle, net	<u>—</u>	<u>(16)</u>	<u>—</u>
Net income (loss)	1,329	1,785	(1,012)
Earnings allocated to participating securities	—	—	(9)
Preferred shares dividends	(2)	(7)	(7)
Income (loss) available to common shareholders	<u>\$ 1,327</u>	<u>\$ 1,778</u>	<u>\$ (1,028)</u>
Basic earnings (loss) per common share			
Continuing operations	\$ 0.34	\$ 0.40	\$ (1.40)
Discontinued operations	0.11	0.48	0.69
Cumulative effect of change in accounting principle	<u>—</u>	<u>(0.01)</u>	<u>—</u>
Total	<u>\$ 0.45</u>	<u>\$ 0.87</u>	<u>\$ (0.71)</u>
Basic weighted average common shares outstanding	<u>2,950</u>	<u>2,033</u>	<u>1,443</u>

SPRINT NEXTEL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2006	2005	2004
	(in millions)		
Cash flows from operating activities			
Net income (loss)	\$ 1,329	\$ 1,785	\$(1,012)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Income from discontinued operations	(334)	(980)	(994)
Provision for losses on accounts receivable	656	388	318
Depreciation and amortization	9,592	5,200	3,658
Deferred income taxes	468	798	(749)
Share-based compensation expense	338	254	85
Gain on sale or exchange of equity investments	(205)	(62)	(15)
Losses on impairment of assets	69	44	3,538
Other, net	(70)	108	249
Changes in assets and liabilities, net of effects of acquisitions:			
Accounts receivable	(582)	(364)	(540)
Inventories and other current assets	(254)	23	(86)
Accounts payable and other current liabilities	(1,024)	380	7
Increase in communications towers lease liability	—	1,195	—
Non-current assets and liabilities, net	72	(114)	19
Net cash provided by continuing operations	10,055	8,655	4,478
Net cash provided by discontinued operations	903	2,024	2,155
Net cash provided by operating activities	10,958	10,679	6,633
Cash flows from investing activities			
Capital expenditures	(7,556)	(5,057)	(3,980)
Expenditures relating to FCC licenses and other intangibles	(822)	(150)	(35)
Proceeds from spin-off of local communications business, net	1,821	—	—
Proceeds from sale of Embarq notes	4,447	—	—
Cash acquired in Nextel merger, net of cash paid	—	1,183	—
Acquisitions, net of cash acquired	(10,481)	(1,371)	—
Purchases of marketable securities	(527)	(821)	(542)
Cash collateral for securities loan agreements	(866)	—	—
Proceeds from maturities and sales of marketable securities	1,657	808	444
Proceeds from sales of assets and investments	842	648	77
Distributions from unconsolidated investees, net	—	167	(20)
Other, net	93	(131)	—
Net cash used in investing activities	(11,392)	(4,724)	(4,056)
Cash flows from financing activities			
Borrowings under bank credit facilities	—	3,200	—
Retirement of bank credit facilities	(3,700)	(3,200)	—
Purchase and retirements of debt	(4,342)	(1,170)	(1,884)
Proceeds from issuance of debt securities	1,992	—	—
Net issuances and maturities of commercial paper	514	—	—
Proceeds from securities loan agreements	866	—	—
Retirement of redeemable preferred shares	(247)	—	—
Purchase of common shares	(1,643)	—	—
Proceeds from issuance of common shares	405	432	1,874
Dividends paid	(296)	(525)	(670)
Other, net	28	35	—
Net cash used in financing activities	(6,423)	(1,228)	(680)
Net (decrease) increase in cash and cash equivalents	(6,857)	4,727	1,897
Cash and cash equivalents, beginning of period	8,903	4,176	2,279
Cash and cash equivalents, end of period	\$ 2,046	\$ 8,903	\$ 4,176

SPRINT NEXTEL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 9. Long-Term Debt, Capital Lease Obligations, and Seventh Series Redeemable Preferred Shares

(excerpts only)

	<u>December 31, 2005</u>	<u>Acquired Debt⁽¹⁾ and Borrowings</u>	<u>Retirements and Repayments of Principal and Other</u>	<u>December 31, 2006</u>
	<i>(in millions)</i>			
Senior notes due 2006 to 2032				
1.5% to 13.625%, including fair value hedge adjustments of \$(17) and \$(25), deferred premiums of \$337 and \$390 and unamortized discounts of \$70 and \$35	\$ 21,639	\$ 4,291	\$ (4,396)	\$ 21,534
Bank credit facilities				
5.338% and 6.85%	3,215	500	(3,715)	—
Commercial paper 4.87% to 5.53%	—	4,618	(4,104)	514
Capital lease obligations and other				
4.11% to 11.174%	160	51	(105)	106
	<u>25,014</u>	<u>\$ 9,460</u>	<u>\$ (12,320)</u>	<u>22,154</u>
Current maturities of long-term debt	<u>(5,045)</u>			<u>(1,143)</u>
Long-term debt and capital lease obligations	<u>\$ 19,969</u>			<u>\$ 21,011</u>

(1) Includes debt acquired in connection with the PCS Affiliate and Nextel Partners acquisitions as discussed in note 3.

Our weighted average effective interest rate related to our senior notes was 7.1% in 2006 and 2005. The effective interest rate includes the effect of interest rate swap agreements accounted for as fair value hedges. See note 10 for more details regarding interest rate swaps.

As of December 31, 2006, we had \$514 million of commercial paper outstanding, net of discounts, included in the current maturities of long-term debt with a weighted average interest rate of 5.515% and a weighted average maturity of about 47 days.