Volume 3, Section 1 – McShane, Cost of Capital

Q. (page 54, lines 1442-1446, and Appendix D, page 2) Please justify the assertions that, after some initial period, mature industries and mature utilities will grow at the same rate, in perpetuity, as the overall economy, when new/emerging industries, firms, and utilities indisputably grow faster than the overall economy, necessitating that mature industries, firms, and utilities grow somewhat slower, on average, than the overall economy.

A. The growth component of a DCF model is intended to be an estimate of what investors expect the long-term growth to be and thus build into the prices they are willing to pay (and thus is embedded in the dividend yield component of the model). Ms. McShane's use of forecast long-term growth in the economy as a reasonable estimate of investors' expectations for long-term growth in earnings for mature industries is based on the link between corporate profits and GDP growth in the long-term. The two primary determinants of profit growth are growth in nominal GDP and unit labour costs. Nominal GDP measures the current dollar value of the goods and services produced in the economy. Simplistically, GDP less payments to labour, depreciation, plus income from abroad equals corporate profits. As long as labour costs are contained, increases in economic growth will be reflected in growth in profits. To Ms. McShane's knowledge, the conclusion that corporate profit growth will track GDP growth in the long-term is not contested.

However, industries and companies go through life cycles. During the different phases of the cycle, growth would reasonably be expected to differ from the long-term average. The phases of the life cycle include introduction (or initial growth), rapid growth, maturity and as well as decline. In the first two phases, industry growth would be expected to outpace growth in the economy as a whole, and then in maturity stabilize at level similar to that of the general economy. Decline is characterized by falling demand for the industry's products and/or services. As there are industries that are in decline as well as industries whose growth is outpacing that of mature industries, it does not follow that mature industries necessarily grow at a rate slower than that of the overall economy.

The FERC relies on GDP growth to estimate expected long-term growth in its standard DCF models for gas and oil pipelines. The development of their model was in part validated by the valuation practices of Merrill Lynch and Prudential Securities who relied on the growth in the economy as their estimate of long-term growth for all firms, including regulated firms.