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Review paper

INVESTMENT COUNTRY RISK PREMIUM INFLUENCE ON AN ENTERPRISE ESTIMATED VALUE

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Abstract. Many business decisions are brought according to enterprise estimated value. Determinants that govern the value of an enterprise, being estimated according to discounted cash flows, are objective assumptions on cash flow movements in the future period, a constant rate of the enterprise growth in residual period of time and a discount rate. While calculating the discount rate, it is necessary to take into consideration the investment country risk premium which depends on the mark of investment country political stability, its legal system, tax rates, stability of the currency and other parameters. In that way, the investment country risk premium influences the result of estimation and consequently, the business decision of an investor. Different ways of investment country risk premium determination shall be introduced in this work, as well as their advantages, limitations and the way in which the risk premium fluctuation influences the estimated value of an enterprise. In determination of the investment country risk premium influence on the value of an estimated enterprise by cash flow discounting, we will give an overview of legislation and methodology for performing estimation of the values of enterprises in the Republic of Serbia.

Key Words: investment country risk premium, yield rate of the own capital, enterprise value, discounting, cash flows.

1 INTRODUCTION

Estimation of value of the part or total property of an enterprise represents a precondition for bringing important business decisions, such as the purchase or selling of some parts or the entire enterprise, merging, demerging, issue of shares, insurance of property, credit, etc. The result of that estimation influences the choice of business decision. Therefore, it is very important to perform that estimation objectively and competently in order

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to get the result as real as possible; it implies consideration of issues which may impact the final value of the estimated enterprise.

An enterprise value estimation methodology by discounting the cash flow will be introduced in this work, and a special problem that shall be researched in the work is determination of investment country risk premium influence on the result of the estimation. The investment country risk premium represents a component of the own capital yield rate which is to be built into the model of estimation. Therefore, it is very important to examine the ways of the investment country risk premium determination. The main goal of this researching is to determine the ways which allow the investment country risk premium determination, their advantages and limitations in the estimation model application, as well as an impact of the investment country risk premium to the enterprise estimated value.

2. ENTERPRISE VALUE ESTIMATION METHODOLOGY BY CASH VALUE DISCOUNTING

The cash flow discounting represents a yield method of estimation which estimates the enterprise value according to future benefits that will be created in the enterprise. Discounting may be done by the cash flow before (free cash flow to the firm) and after the debts servicing (free cash flow to equity). When the cash flows after the debts servicing are observed, we will find those assets being available to the holders of own capital, while the cash flows before the debts servicing are the assets being available to both, to the holders of own capital and to the owners of borrowed capital i.e. creditors and the owners of securities (Stowe, Robinson, Pinto & MeLeavy, 2002). The Regulation on Methodology for Estimation of Property and Capital Value in the Republic of Serbia does not allow any choice between those two approaches for estimation; there is a possibility of cash flow application after the debts servicing exclusively. Hence, the cash flow discounting method shall be used in this work for estimation of the enterprise, considering that the enterprise value is obtained according to determination of expected future cash flow current value after the debts servicing. The enterprise value estimation methodology may be presented in several steps, as follows (Rodić & Filipović, 2010):

- 1) Projecting of the cash flow after the debts servicing
- 2) Discount rate calculation (own capital yield rate)
- 3) Reducing projected cash flows to the current value
- 4) Growth rate determination
- 5) Calculation of the enterprise residual value
- 6) Enterprise residual value reduction to current value and
- 7) Summation of projected cash flows current value and enterprise residual value current value in order to get the value of own capital.

1. A quality foresight of cash flows requires the enterprise business analysis performed according to financial reports from the previous years, then an overview of position of the enterprise in corresponding branch of economy, as well as an overview of macroeconomic data. While projecting the cash flows, it is necessary to foresee correctly the scope and dynamics of business activities, payment obligations dynamics, as well as a collection of receivables, to determine the price for raw materials procurement, the price for selling the products etc. According to projected items of balance sheet and income statement, the cash flow after the debts servicing may be calculated in the following way (Damodaran, 2002):

Cash flow after debt servicing = net yield

+amortization -investment into basic assets (capital expense) -change in net working capital +new credits -repayment of existed credits

Net income and amortization increase the cash assets. Apart from that, each increase of liabilities position and each decrease of assets position leads to the cash assets increase, while each decrease of liabilities position and each increase of assets position leads to the cash flows decrease.

2. Direct method of enterprise value estimation by discounting the cash flows, requires the usage of the cash flow after the debts servicing. The stated cash flow has been left free to be used by the owners of enterprises and, as such, for discounting the estimated future cash flows it requires a discount rate, representing the rate of yield to the own capital.

In conditions of the developed market of capital, the most used model for calculation of the yield rate to the own capital is CAPM (Capital Asset Pricing Model). In the enterprise not constituted as a public limited company or which does business in conditions of underdeveloped market of capital, it is not possible to reach any relevant data on the share prices of the given enterprise, related to an entire market portfolio, based on which the own capital yield rate shall be calculated by the CAPM. As an alternative in those conditions, there is a model of building¹ to be used, consisting of three levels of risk and whose summation gives the rate of yield of the own capital:

• Real rate of yield to the investments with no risk

• Risk premium to the investments in the enterprise to be estimated and

• The investment country risk rate.

In choosing the non-risk rate of yield, the appraiser chooses the yield rate for shortterm government securities (treasury bills) or for yield rate up to maturity to long-term securities, issued by the government (long-term government bonds). It is necessary to take into consideration that the choice of the rate is tailored to the time period in which the cash flows to be discounted, while estimating, become due. Thus, the non-risk rate is the rate of non-interest government bond that corresponds to the time frame of analyzed cash flow (Damodaran, 2007). The Agency for Privatization imposes some restrictions related to the stipulated rate of yield on the investments with no risk, according to Provision on Methodology for Capital and Property Value Estimation in the Republic of Serbia, obliging that it will publish the size of rate at the six months level. However, the Agency for Privatization published the size of this rate only for the first six-month-period in the amount of 4.5%, (The real rate of return on risk-free investments for the period

¹ By the Regulation on Methodology for Estimation the Value of Capital and Property in the Republic of Serbia it is stipulated that the building method calculates the rate of yield to own capital, in the way we bring in this work. However, it is necessary to underline that stated Regulation regulates the Enterprise Value Estimation Methodology, as well as the same methodology for other legal entities with social or government capital that are to come into the process of privatization or are the object of status changes. Estimation of the enterprise capital or value for some other purposes has not been regulated by the Republic of Serbia by any legal act.

between October 2001 and April 2002, 2001), and the rate was neither determined nor published in the following period of time.

While determining the investment risk rate in a specific enterprise, we should recognize the risk levels and the way of risk quantification. In its business, the enterprise meets the business and financial risk. Summation of individual risk rates being estimated for the following elements gives the rate of risk for investment in a specific enterprise, where the risks are to be determined for the enterprise size, quality of organization, management and staff, financial position, production and selling potential and possibility of reliable business predictions (Regulation on the methodology for property and capital value estimation, 2001, article 7, paragraph 1).

The Regulation on Methodology for Property and Capital Value Estimation in the Republic of Serbia determines that every element may generate the risk rate of up to 5%, and a total rate must not be smaller than 5 % i.e. max rate of investment risk in an enterprise may be 25%.

Apart from the yield rate of the risk-free investments, and the rate of investment risk in estimated enterprise, in order to calculate the yield rate to the own capital according to the Regulation on Methodology for Property and Capital Value Estimation in the Republic of Serbia, it is necessary to determine the investment state risk premium. Here, the Regulation also imposes some restrictions requiring the estimators that for the investment country risk rate overtake the rate stipulated by the Agency for Privatization at the 6 months level. However, like in stipulation the real rate of yield to the non-risk investments, the investment country risk rate is published for the period of time from October 2000 until April 2001, in the amount of 7% (The risk premium on investment in SRJ for the period between October 2000 and April 2001, 2001), and in the following period, it has not been determined nor published.

3. The third step in the enterprise estimation represents a discount i.e. restriction of cash flows projected to the present value. Discounting the cash flows is performed by projected cash flows multiplying with discount factor which is calculated with the following formula (Rodic & Filipovic, 2010, p.67)

Discount factor
$$=\frac{1}{(1+r)^n}$$
 (1)

where:

r – rate of return on equity

 $n-\mbox{number}$ of years from the day of estimation up to the day of projected net cash flow realization

For each projected cash flow, a suitable discount factor is to be calculated and then multiplied by the anticipated future cash flows. In that case, we reach the present value of the projected cash flows.

4. One of the most important inputs for the enterprise value estimation process models based on discounting the cash flows is the rate of growth of the enterprise itself, i.e. its income, profit, dividends, cash flow and other fundamental parameters. There are three basic ways for growth rate determination. The first method is based on historical growth of profit allowing determination of the so-called historical rate of growth. The second method is based on the rates of growth being determined by a certain number of the analysts who follow the business of some enterprise. The third method is based on

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fundamental indicators of the enterprise, taking into consideration that the growth of enterprise is determined by the rate of reinvesting, i.e. by the profit amount to be reinvested in the enterprise, as well as by those investments quality (Damodaran, 2002).

5. The principle of permanence in business suggests that the enterprise shall continue with business in unlimited period of time. Taking into consideration that an estimator can not predict the cash flow indefinitely, while estimating the enterprise, the cash flow is projected for a certain number of years n, after the debts servicing. After the last projected cash flow in the year n, a residual value of the enterprise is also to be projected, representing the enterprise residual value, we need to increase the cash flow from the last projected year for projected rate of growth and to divide an obtained amount by the difference between the rate of growth to the own capital and the rate of growth, showed by the formula 2:

Residual value =
$$\frac{\operatorname{Cash flow}(n)(1+g)}{(r-g)}$$
 (2)

where

g – growth rate

r-rate of return on equity

6. Taking into consideration that discounting of each cash flow is done per year of projection in order to get the enterprise value, there is also a need for the residual value discounting. There are different opinions in literature on the topic whether the discount factor should be calculated by the last projection year graduation or on the basis of the number of projections plus one year. However, in literature it is more common to find the view point that the discount factor should be determined on the basis of the number of projections plus one (Rodic & Filipovic, 2010, p.68), as showed by formula 3:

Discount factor
$$=\frac{1}{(1+r)^{(n+1)}}$$
 (3)

where:

r – rate of return on equity

n – number of years of projections

Multiplying the calculated residual value by a suitable discount factor gives the current value of the residual value.

7. The estimated enterprise own capital value is to be obtained by summation of the current value of projected cash flows and current value of residual period. One share value of the enterprise is obtained by multiplying the estimated value of own capital with the number of issued shares.

3. INVESTMENT COUNTRY RISK PREMIUM DETERMINATION

Underlining the need for determination and involvement of the country risk premium into the procedure of enterprise value estimation has divided the scientists. Some domestic authors (Dimitrijevic, 2006: Poznanic & Cvijanovic, 2011) think that only if an in-

vestment is pointed to another country i.e. if the foreign investors invest in the enterprises being placed, let's say, in the territory of the Republic of Serbia, while calculating the discount rate (the rate of yield to the own capital), it is necessary to correct the sum of yield rate to investments with no risk and the investment risk rate in the estimated enterprise for an amount of the investment country risk premium. If the given condition is not fulfilled, the yield rate to own capital – calculated by the method of building – does not take into consideration any investment country risk premium.

On the other side, Damodaran thinks that the investment country risk premium is to be added to the yield rate to own capital if the risk of country can not be diversified based on global investments of the investors. Even in the case that the investor invests at the global level, in order to skip any consideration of the risk of a concrete country, it is necessary that low correlation between different markets exists. There are some theorists who consider that in traditional CAPM model may be incorporated the country risk rate correcting bigger beta for more risky markets. But, the practice proved that beta is not capable to absorb the country risk among all other risks at the macro level. The third argument on the need of special measuring of the country risk that separated the scientists is that, while projecting the cash flow, the country risk is also to be involved. Damodaran finds that this is a wrong assumption because it is required to correct all future corrections for a possible country risk, as a possibility of expected cash flow realization (Damodaran, 2012, p.38-43).

The investment country risk premium may be determined in different ways. Concretely, by the Regulation on Methodology for Property and Capital Value Estimation in the Republic of Serbia, the premium that should be used by the estimators is imposed, and it is determined by the Agency for Privatization.

As one of the ways for investment country risk premium determination, we may use an estimation of certain kinds of risk (Poznanic, & Cvijanovic 2011, p.84):

- Risks related to assets policy of expropriation; policy of nationalization; possibility of financing; contract security;
- Risks of business surrounding political stability; relationship towards foreign investments, legal system; resistance to privatization; availability of manpower; connection with adjacent countries; the role of syndicates; local competition;
- Financial risks convertibility of the currency; currency stability; capital flows restrictions; prices control; size of the market; an approach to the EU market; economic trends; indebtedness; tax rates; rates of inflation; needs for foreign capital.

Determined risks are marked 1-10; taking into consideration that it means every mark more than one - risk is to be increased.

The mark of risk is to be based on professional court of the estimators. Thereby, there are some risks of subjectivity, incompetence of the estimators and insufficient information that may influence an unreal determination of the investment country risk premium, and with that – the result of estimation.

Premium to the risk of the country may be determined in one of the following three approaches (Damodaran, 2012, p.51-60):

- Premium of risks to the government bonds is the simplest way to determinate the country risk premium, based on the ratings, given to the country's debt by the Rating Agency (Moody Investor's Service, Standard and Poor's and Fitch);
- Relative standard deviation of the market of capital puts into relation a standard deviation of observed country and a standard deviation of the USA. A higher stand-

ard deviation shows the highest risk to which the observed country is exposed. Depending on diversification of the structure of a market, it is possible to run into some problems in application of this approach;

- Premium of risks to the state bonds plus relative standard deviation is an approach that estimates the country risk in the most real way. The risk premium to the government bonds is to be corrected for country capital market variability in relation to variability of the government bond.
- In order to determine the premium to the risk of the Republic of Serbia by the last described approach, we need the following data:
- Credit rating of the Republic of Serbia for borrowing in domestic currency was estimated by the rating agency (Standard and Poor's) with BB- (Standard and Poor's Rating Services, 2013). Estimated credit rating describes Serbia as capable of settling due liabilities, followed by the remark that credit risk is present, as well as the risk of business climate with negative chances.
- The country risk premium, based on estimated credit rating amounts to 3.25% (Damodaran, 2013) and
- Relationship between standard deviation of the market of capital and standard deviation of government bonds. Damodaran used an average of relative standard deviation for the markets in emerging of 1.5 which means that other markets of capital are 1.5 times more unstable in relation to the market of bonds (Damodaran 2013).

Thus, the risk premium of the Republic of Serbia amounts to: $3.25\% \times 1.5 = 4.88\%$.

Determination of the risk premium in the described way in relation to individual quantifying of the risk, deletes a subjective assessment of the estimators of certain kinds of risks. The estimator relates to the court of specialized agencies determining a credit rating of the country. Also, according to specialized agencies, a total market of one country shall be taken into consideration by measuring stability of the market of capital, in relation to the market of bonds.

As for the way of risk premium determination, by the Agency for Privatization, as stipulated by the Regulation on Methodology for Property and Capital Value Estimation in the Republic of Serbia, it is required to respect the provision of the Regulation which reads that the risk premium is to be determined every 6 months. Also, it is important that the Agency for Privatization underlines the procedure used in determining the investment country risk premium.

4. ANALYSIS OF INVESTMENT COUNTRY RISK PREMIUM AND ENTERPRISE ESTIMATED VALUE

According to presented methodology for enterprise value estimation by cash discounting after the debt servicing, as an example of one enterprise, we will show estimation of value of one enterprise by different discount rates. In order to overview the influence of the investment country risk premium on the estimated value of the enterprise, and in that an importance of its determination, we will use two different risk premiums, as follows:

- The risk premium determined by the Agency for Privatization in the amount of 7% and
- The risk premium being determined in the work based on risk premium to government bonds and relative standard deviation, amounting to 4.88%

In this work, there are no suggestions which made an influence on projected net cash flow, nor the mark of risks which made an influence on the yield rate of that specific enterprise. Discount rate being applied to the cash flow has been calculated by the method of building and consists of the rate of yield of concrete enterprise (8.5%), the rate of yield to investment with no risk (4.5%) and of the investment country risk premium (7%). The rate of growth of 1% and the discount rate of 20% are used. Cash flows are projected for the next 5 years. The current value of the projected cash flows has been calculated in the table 1 after which we calculate the current value of residual and the final yield value of the enterprise:

 Table 1 Calculation of present value of cash flow at investment country risk premium of 7%

			In thousands of RSD
Year	Cash flow (I)	Discount factor (II)	Current value (I×II)
1	188,085	0.8333333	156,737
2	453,660	0.6944444	315,042
3	501,168	0.5787037	290,028
4	552,495	0.4822531	266,443
5	572,278	0.4018776	229,986

Current value of net cash flow (1+2+3+4+5) = 1,258,235

Residual value =
$$\frac{572.278 \times 1,01}{0,20 - 0,01} = 3.042.108$$

Current value of residual = $3,042,108 \times 0.334898 = 1,018,796$

Yield value of the enterprise = 1,258,235+1,018,769=2,277,031, i.e. 2,277,031.00 RSD

If the enterprise value is estimated by applying the risk premium, being calculated based on risk premium of government bonds and relative standard deviation (4.88%), followed by non-changing the rest of inputs, the enterprise yield value will be increased.

Rate of return on equity = 4.5% + 8.5% + 4.88% = 17.88%

Projected cash flows discount, done by the rate of 17.88% is showed in table 2, after which the current value of residual and the enterprise yield value are calculated:

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 Table 2 Calculation of cash flow current value at investment country risk premium of 4.88%

			In thousands of RSD
Year	Cash flow (I)	Discount factor (II)	Current value (I×II)
1	188,085	0.8483203	159,556
2	453,660	0.7196474	326,475
3	501,168	0.6104915	305,959
4	552,495	0.5178923	286,133
5	572,278	0.4393386	251,424

Current value of net cash flow (1+2+3+4+5) = 1,329,547

Residual value =
$$\frac{572.278 \times 1.01}{0.1788 - 0.01} = 3.424.175$$

Current value of residual = $3,424,175 \times 0.3726999 = 1,276,190$ Yield value of the enterprise = 1,329,547 + 1,276,190 = 2,605,737, i.e. 2,605,737 RSD

By increasing the investment country risk premium, a required rate of the share holders and investors is also to be increased, which clearly decreases the estimated enterprise value.

5. CONCLUSIONS

The enterprise property value estimation may be done in different ways. In this work, the enterprise value estimation is based on cash flows discount after the debts servicing. According to the explanation of all elements required for realization of enterprise value estimation by cash flow discount after the debts are serviced, it is to conclude that the value of estimated enterprise depends on an amount of projected cash flows, own capital yield rate and the enterprise growth rate. As this work also relates to an influence of the investment country risk rate (being a consisted element of own capital yield rate) to the result of estimated enterprise, our attention will be focused precisely on that element.

In this work we introduce different ways for calculating investment country risk premium. Whether we talk about individual estimation of certain kinds of risk, or determination of the investment country risk premium according to risk premium to the government bonds, relative standard deviation or the risk premium synthesis to the government bonds and standard deviation, mostly we get different rates estimating the risk of country which is to be invested in. The estimator has been left with an important task of risk premium determination because the chosen way of the investment country risk premium influences the final value of estimated enterprise.

Estimation of certain kinds of risk related to assets, business surrounding and finance by the estimators, depends on the objectivity and competence of the estimator and it is very possible that at the same moment, two estimators determine different risk premiums of the same country. In order to avoid that, the estimators may use one of three approaches that relates to marks of professional agencies. Those agencies follow different factors that influence the stability of a country put it in a certain category characterized by an adequate degree of risk. In certain cases (while estimating the enterprises and other legal entities with social or state capital going into the process of capitalization or if they are the object of status changes) by the Regulation on Methodology for Property and Capital Value Estimation in the Republic of Serbia, the amount of investment country risk premium has been determined. In order to make this way acceptable, it is required that the Agency for Privatization, which stipulates that premium, underlines the way of its determination, as well as that every change of factor leading to change of the country risk stability, does its harmonization and publication.

In the estimated enterprise example, using the risk premium published by the Agency for Privatization in the amount of 7%, less value of the enterprise has been estimated than using the risk premium of 4.88%, calculated according to the risk premium of government bonds and standard deviation. Because of increased risk, the investors require a higher rate of yield which is reflected to decreasing of the enterprise value. Estimated value should reflect that value which is the most probably acceptable to both, the buyer and the seller, depending on expected yield and taken risk but can't be the same as the price according to which buying and selling will be done. Lower estimated value may provide the seller to buy or overtake the estimated enterprise at lower cost. However, there is a question to be left if the higher risk premium influenced the real estimated value or it favorized the position of buyer with that.

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UTICAJ PREMIJE RIZIKA ZEMLJE ULAGANJA NA VREDNOST PROCENJENOG PREDUZEĆA

Mnoge poslovne odluke se donose na osnovu procenjene vrednosti preduzeća. Determinante koje određuju vrednost preduzeća procenjenog na osnovu diskontovanih novčanih tokova su objektivne pretpostavke o kretanju novčanih tokova u budućem periodu, konstantna stopa rasta preduzeća u rezidualnom periodu i diskontna stopa. Prilikom izračunavanja diskontne stope potrebno je uzeti u obzir i premiju rizika zemlje ulaganja, koja zavisi od ocene političke stabilnosti zemlje ulaganja, njenog pravnog sistema, poreskih stopa, stabilnosti valute i drugih parametara. Kao takva, premija rizika zemlje ulaganja ima uticaj na rezultat procene, a time i na poslovnu odluku investitora. U radu će biti predstavljeni različiti načini određivanja premije rizika zemlje ulaganja, njihove prednosti i ograničenja, kao i to na koji način fluktuacije premije rizika utiču na procenjenu vrednost preduzeća. Pri utvrđivanju uticaja premije rizika zemlje ulaganja na vrednost procenjenog preduzeća diskontovanjem novčanih tokova, napraviće se osvrt na zakonske propise o metodologiji procene vrednosti preduzeća u Republici Srbiji.

Ključne reči: premija rizika zemlje ulaganja, stopa prinosa sopstvenog kapitala, vrednost preduzeća, diskontovanje, novčani tokovi.