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AHEAD OF THE TAPE

Pasta -- and Meatballs

By **JESSE EISINGER** Staff Reporter of The Wall Street Journal
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In the 1990s, analysts learned to value companies using the "Solve for X" method: Get a price target for the stock and then work backward. Bear Stearns may have just brought it back.

Last week, Bear Stearns analyst [redacted] came out with a big report on American Italian Pasta, a small NYSE-listed pasta maker.

The report contained, as many do, a discounted-cash-flow model, which estimates how much free cash flow a company will generate over time. That's used to come up with a current value for the share price. The model came up with a present value of $58.49 a share. Not bad, since the stock was trading at $43.65.

But the analysts made a simple, honest -- though massive -- math error, reported by TheStreet.com's Herb Greenberg. Instead of subtracting capital expenditure from operating cash flow, the analysts added it. If the capex were subtracted, the discounted-cash-flow model spits out a drastically different present value: a little over $19.

So, what to do? One answer, of course, is to cop, red-faced, to the goof and admit the company's value may be less than you had hoped for. Indeed, Bear Stearns

admitted the mistake and came out with a new model. Funny thing is, Bear Stearns suddenly thinks American Italian is a lot less risky and will be a lot more profitable.

In last week's old, erroneous model, the company was forecast to generate $70.4 million in 2003 operating cash flow, defined as net income plus depreciation and amortization. This week? They use a different definition and, pesto-chango, it's $82.4 million in cash flow from operations. That boosts the free cash flow estimate through the next decade.

But that alone wouldn't be good enough to get to an attractive price target. The analysts also needed to use a different discount rate of 10%, rather than 15% and assume the market would pay a higher multiple in a decade.

The new model says the company isn't worth $58, but $68. What good news that the analyst had a chance to revisit the issue. In his defense, Bear noted a DCF model wasn't the primary tool the analyst used to value the company.

Nevertheless, maybe the analyst needs 10 lashes with a wet noodle.

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