CHAPTER 19

EQUITY VALUATION APPLICATIONS AND PROCESSES

1. (C) **the overall economy, growth of the industry, and the growth rate of Gold Star.**

   Explanation

   The top down model for valuation would begin with analysis of the overall economy and the expectation of the growth rate in the economy. Further, the impact of the expected growth rate of the economy on the oil industry needs to be ascertained. The second component is the analysis of the oil industry in which Gold Star operates. That involves the determination of the competitive forces in the industry and the future threats and opportunities faced by the industry. It also determines the variables that determine the future profitability of the entire oil industry. The analyst then forms future expectations of these variables given the expectations about the overall economy. The expectations of variables determining the growth and profitability of the oil industry are then used to determine the expectations of the overall growth of Gold Star. In the company analysis, the analyst reviews the quality of earnings, financial ratios, management and intangibles to ascertain the growth prospects for the company. The analyst then selects an appropriate model to value the company. Assumptions used in the valuation must be clearly spelled out and updated to reflect new information.

   (Module 19.1, LOS 19.e)

   Related Material

   SchweserNotes - Book 3

2. (B) **Absolute valuation.**

   Explanation

   Absolute valuation models or intrinsic value models such as the dividend growth rate model and the free cash flow model value a company independent of peer valuation. The valuation is based on the present value of cash-flows for the specific company. Relative valuation models such as P/E ratio compare the earnings multiple to that of similar companies to make a judgment about the valuation. If the P/E ratio is higher than peer company P/E ratio, it is said to be overvalued. Conversely, if the P/E ratio is lower than peer company P/E ratio, it is said to be undervalued. Caution should be taken to make sure that peer companies are indeed comparable. For the valuation of Gold Star, absolute valuation would be suitable since it is closely held and hence market valuation is not available.

   (Module 19.1, LOS 19.e)

   Related Material

   SchweserNotes - Book 3

3. (A) marketability, liquidity, and minority discounts in the valuation

Explanation

Since Gold Star is closely held, the investment is not easily marketable. Closely linked is the fact that the investment cannot be easily liquidated and the cost of selling the investment needs to be discounted from the value. Finally, since only 5% of the stock is being invested in, the control of the operations of the company still remains with the majority shareholders. This lack of control needs to be quantified and discounted from Gold Star's valuation.

(Module 19.1, LOS 19.e)

Related Material

SchweserNotes - Book 3

4. (C) Learn / understand the business.

Explanation

The valuation process consists of 5 steps:

1. Understanding the business.
2. Forecasting company performance.
3. Selecting a valuation model.
4. Complete the valuation.
5. Decision making.

(Module 19.1, LOS 19.e)

Related Material

SchweserNotes - Book 3

5. (B) Footnotes.

Explanation

A number of important disclosures regarding a firm's accounting practices and the basis on which income and expense are recognized are contained in the footnotes to the financial statements.

(Module 19.1, LOS 19.e)

Related Material

SchweserNotes - Book 3

6. (B) Valuations are based on the analyst's expectations.

Explanation

Valuation is based on expectations of future cash flows rather than known values. Each analyst will build expectations of cash flows from the fundamental data and from other factors, internal and external, that the analyst believes will affect the firm's performance.

(Module 19.1, LOS 19.a)

Related Material

SchweserNotes – Book

7. (B) reading the market.

Explanation

Asset valuation has many uses including stock selection, reading the market, projecting the value of corporate actions, issuing fairness opinions, and valuing private businesses. Reading the market entails detecting investor's expectations about the future value of the variables that affect a stock's price.

(Module 19.1, LOS 19.d)

Related Material

SchweserNotes - Book 3

8. (B) important information about the firm's accounting practices and basis of presentation.

Explanation

A number of important disclosures regarding a firm's accounting practices and the basis on which income and expense are recognized are contained in the footnotes to the financial statements. An overview by management of the company's past, present, and future can be found in the Management discussion and analysis (MD&A) section of a financial statement.

(Module 19.1, LOS 19.e)

Related Material

SchweserNotes - Book 3

9. (A) expected future cash flows.

Explanation

Valuation models used for equities require the analyst to estimate the required return applicable to the investment and to develop an expectation of future cash flows. While cash flows for fixed-income investments are stated, no such definition is available for equities.

(Module 19.1, LOS 19.a)

Related Material

SchweserNotes - Book 3

10. (C) Estimating inflation rates.

Explanation

Asset valuation has many uses including stock selection, reading the market, projecting the value of corporate actions, issuing fairness opinions, and valuing private businesses. Asset valuation is not used to project inflation rates.

(Module 19.1, LOS 19.d)

Related Material

SchweserNotes - Book 3

11. (A) going-concern value.

Explanation

The going-concern value is based on the assumption that the firm will continue to operate and the firm's value is the present value of its future dividends.

(Module 19.1, LOS 19.b)

Related Material

SchweserNotes - Book 3

12. (A) intrinsic value.

Explanation

For an analyst valuing public equities, the most relevant definition of value is generally intrinsic value. A value based on a going-concern assumption, rather than a liquidation assumption, is the appropriate choice for a company that will continue to produce and sell goods. Fair market value is the most relevant definition of value to use in an agreement between the owners of a private business regarding the price at which the owners can sell their ownership interest.

(Module 19.1, LOS 19.c)

Related Material

SchweserNotes - Book 3

13. (B) liquidation value.

Explanation

The liquidation value is based on the assumption that the firm will cease to operate and all of its assets will be sold to repay liabilities.

(Module 19.1, LOS 19.b)

Related Material

SchweserNotes - Book 3

14. (C) its sensitivity to changes in expectations.

Explanation

The results of valuation models can be very sensitive to changes in the expectations incorporated in the model. Analysis of a valuation's sensitivity to the expectations and a review of the confidence the analyst has in the expectations may lead to the use of a valuation range rather than a pin-point value.

(Module 19.1, LOS 19.a)

Related Material

SchweserNotes - Book 3

15. (B) **The gain on the sale of a plant was included in operating earnings.**

Explanation

The inclusion of gains from the sale of assets as operating income would cause the analyst to question the quality of the firm's earnings.

(Module 19.1, LOS 19.e)

Related Material

SchweserNotes - Book 3

16. (B) **relative valuation.**

Explanation

An approach using market multiples to establish the value of the subject firm in relation to similar firms is an example of a relative valuation approach.

(Module 19.1, LOS 19.f)

Related Material

SchweserNotes - Book 3

17. (A) **too high.**

Explanation

Using an estimate for a firm's growth rate that is too high would overstate the amount of future returns, resulting in a present value that is too high.

(Module 19.1, LOS 19.e)

Related Material

SchweserNotes - Book 3

18. (C) **relative valuation.**

Explanation

A relative valuation is a valuation based on comparing the firm to other firms with similar characteristics. Market multiples are commonly used as the basis of relative valuations.

(Module 19.1, LOS 19.f)

Related Material

SchweserNotes - Book 3

19. (C) **Is the model consistent with the investor's IPS?**

Explanation

Important considerations when choosing a valuation model include:

Does the model fit the characteristics of the company?

Is the model suitable given the purpose of the analysis?

Is the model appropriate based on the quality and availability of input data?

(Module 19.1, LOS 19.h)

Related Material

SchweserNotes - Book 3

Anna Heller, CFA, is a financial journalist and editor working for Money in the Morning, an online daily journal aimed at the investment industry. She is currently reviewing three articles, which staff writers have submitted to her for imminent publication. Heller has a few concerns with the articles, which she notes down as follows.

Article One–The Modern Equity Valuation Process

Introductory Paragraph:

"The Grossman-Stiglitz paradox states that if security prices are informationally efficient there would be no reward to collecting and analyzing information. If this is the case no investor would collect and analyze information and the market price could not reflect intrinsic value. Further works have shown the easier intrinsic value is to estimate the bigger the potential divergence between price and value will be."

Illustrative Example:

"Assume an analyst had performed a valuation exercise on security HTWO and come up with the following results:

Analyst Derived Intrinsic Value	$25.20
Market Price	$23.85

Clearly, the analyst has identified a potentially undervalued security. However, attaining a positive risk adjusted return is only possible if the analyst's intrinsic value is correct. If he or she has incorrectly calculated the intrinsic value, then the potential for positive risk adjusted returns may be reduced or eliminated."

Heller is enthusiastic about including this example, but would like to extend it. She will instruct the staff writer to detail the valuation error and the actual mispricing if the analyst had calculated an intrinsic value, which was $1.20 higher than the actual intrinsic value.

Article Two—I'm Going to Tell You My Concerns

Linpan Inc. Discussion:

"The blanket government ban of its new product line leads to a problem in deciding on an appropriate valuation for Linpan Inc. If the business is not a viable one then any kind of valuation based on free cash flow growth, or perhaps even more outrageously, dividend growth, is pointless.

Assuming that the business voluntarily winds down over the next year, as I believe it should, and gradually sells off its assets, I would suggest that the value of the security should be no more than the cash the asset sales would bring in net of the firm's liabilities."

Heller wants to the writer to name this suggested valuation method.

Toys to You Inc. Discussion:

"A brief review of the somewhat fanciful chairman's statement, and a comparison of a summary income statement of Toys to You Inc. (TTY) compared to a direct competitor demonstrates the problems with TTY's generic strategy:

Figure 1

Income Statement (extracts)	TTY Inc.	Competitor
Revenue	7.9	12. 3
Net income	1.1	1.9

Chairman's Statement (extract)

"I believe the future of Toys to You is a bright one, despite the difficulties encountered over a turbulent last 18 months. Our continued commitment to producing traditional toys which match our competitors on quality and price will ensure our loyal customer base is maintained, while our cutting edge production technology will maintain, while our cutting edge production technology will maintain our industry leading cost base and deliver superb returns to our investors."

Heller would like to add a conclusion regarding the problems with TTY's strategy.

20. (B) **The harder intrinsic value is to estimate the greater the potential divergence of market and intrinsic value.**

Explanation

Intrinsic value is the valuation of an asset by someone who has a perfect understanding of the asset or the firm. Intrinsic value is therefore the theoretical value the stock would take if it were perfectly valued and stock price contained all relevant information. The harder it is to establish the intrinsic value the bigger the potential divergence between market price and intrinsic value.

(Module 19.1, LOS 19.a)

Related Material

SchweserNotes - Book 3

21. (A) **\$1.20 \$0.15**

Explanation

Valuation error = $IV_{analyst} - IV_{actual}$ = 1.20

Actual mispricing = IV_{actual} – price = (25.20 – 1.20) – 23.85 = 0.15

(Module 19.1, LOS 19.a)

Related Material

SchweserNotes - Book 3

22. (C) Orderly Liquidation Value.

Explanation

The proceeds raised by selling assets over a longer period of time are likely to be larger than those raised in a rapid forced "fire sale." Hence, the term Orderly Liquidation Value is often used to differentiate from a forced liquidation value.

(Module 19.1, LOS 19.b)

Related Material

SchweserNotes - Book 3

23. (C) TTY is attempting a strategy of cost leadership by producing with the lowest cost base but appears to be failing as margins are lower than is competitor's.

Explanation

Product differentiation involves adding product features or services that increase the attractiveness of the firm's product. There is no suggestion that TTY is attempting to do this.

Cost leadership is a bid to produce at the lowest cost, a strategy that is evident from the chairperson's statement. However, it has resulted in a margin of only 13.9% compared to the competitor's 15.4%.

(Module 19.1, LOS 19.e)

Related Material

SchweserNotes - Book 3

24. (C) Due to cash flow issues Toys to You have been forced to halve the marketing and advertising budget compared to the previous financial year.

Explanation

Porter's Five Forces include risk of new entrants (A), supplier power (B), customer power, established rivals, and the risk of substitute offerings. Marketing and advertising budgetary constraints are not relevant.

(Module 19.1, LOS 19.e)

Related Material

SchweserNotes - Book 3

25. (A) quality of earnings analysis.

Explanation

The accuracy and level of detail disclosed in financial reports is referred to as the quality of earnings. When we say "quality of earnings analysis" we are generally referring to scrutinizing all a firm's financial statements (including the balance sheet) to try to determine not only the sustainability of the companies' performance but also how accurately the financial statements reflect economic reality.

(Module 19.1, LOS 19.e)

Related Material

SchweserNotes - Book 3

26. (C) **high amounts of loans to company insiders, and short tenure of senior management.**

Explanation

Quality of earnings looks at the relationship between accounting earnings and economic profit potential of the firm. An analyst is concerned about anything that would render accounting earnings less useful as a gauge of the firm's future expected economic earnings. Warning signals include late filings, unusually high amounts of loans to company insiders, and short tenure of senior management.

(Module 19.1, LOS 19.e)

Related Material

SchweserNotes - Book 3

27. (C) **going-concern value.**

Explanation

Going-concern value is the present worth of expected future cash flows generated by a business.

(Module 19.1, LOS 19.b)

Related Material

SchweserNotes - Book 3

28. (A) **cash generated by terminating a business, selling its assets, and repaying liabilities.**

Explanation

Liquidation value is the cash generated by terminating a business, selling all of its assets, and repaying liabilities.

(Module 19.1, LOS 19.b)

Related Material

SchweserNotes - Book 3

29. (A) **absolute valuation.**

Explanation

An absolute valuation approach attempts to determine the value of the firm based on its specific characteristics without regard to the market prices of other firms.

(Module 19.1, LOS 19.f)

Related Material

SchweserNotes - Book 3

30. (A) **liquidation value.**

Explanation

Sum-of-the-parts valuation totals the estimated values of each of the company's business divisions as independent going concerns. The value derived using a sum-of-the-parts valuation is also sometimes called the private market value or the breakup value, even when such a restructuring is not necessarily expected.

(Module 19.1, LOS 19.g)

Related Material

SchweserNotes - Book 3

31. (C) **intrinsic value.**

Explanation

Asset valuation based on the expected future cash flows is utilized to estimate an asset's intrinsic value, or the value derived from the asset's investment characteristics.

(Module 19.1, LOS 19.a)

Related Material

SchweserNotes - Book 3

32. (B) **equal to the present value of the expected continued operation of the firm.**

Explanation

It is not possible to state the relationship between the going-concern value and the liquidation value without examining the prospects for the firm and the current value of the assets. The going-concern value is equal to the present value of the expected dividends arising from continued operation.

(Module 19.1, LOS 19.b)

Related Material

SchweserNotes - Book 3

33. (C) **the ability to examine differences in estimated values can reveal how a model's assumptions and the perspective of the analysis are affecting the estimated values.**

Explanation

One thing to remember with respect to choice of a valuation model is that the analyst does not have to consider only one. Using multiple models and examining differences in estimated values can reveal how a model's assumptions and the perspective of the analysis are affecting the estimated values.

(Module 19.1, LOS 19.h)

Related Material

SchweserNotes - Book 3

34. (C) **Price-to-earnings and price-to-book.**

Explanation

Relative valuation looks at market-based ratios of comparable companies in the industry. Price-to-sales, price-to-book, price-to-earnings, and price-to-cash flow are examples of ratios used in relatives valuation analysis.

(Module 19.1, LOS 19.f)

Related Material

SchweserNotes - Book 3

35. (C) **cash flow model.**

Explanation

A controlling interest suggests a cash flow model may be most appropriate since the controlling interest would allow the purchaser to set dividend policy.

(Module 19.1, LOS 19.h)

Related Material

SchweserNotes - Book 3

36. (A) **accounting practices.**

Explanation

A number of important disclosures regarding a firm's accounting practices and the basis on which income and expense are recognized are contained in the footnotes to the financial statements. The profit and loss statement provides information on the operation of the firm. The statement of cash flows is the best source of data on a company's cash flow activities such as operating," investing and financing.

(Module 19.1, LOS 19.e)

Related Material

SchweserNotes

37. (A) **Assessing corporate governance.**

Explanation

The valuation process described by Pinto, Henry, Robinson, and Stowe consists of 5 steps:

1. Understanding the business.
2. Forecasting company performance.
3. Selecting a valuation model.
4. Complete a valuation.
5. Decision making.

Corporate governance is important, but is not one of the primary steps.

(Module 19.1, LOS 19.e)

Related Material

SchweserNotes - Book 3

38. (C) Assessing corporate governance.

Explanation

Equity valuation has many uses including stock selection, reading the market, projecting the value of corporate actions, issuing fairness opinions, and valuing private businesses. Equity valuation is not specifically related to corporate governance.

(Module 19.1, LOS 19.d)

Related Material

SchweserNotes - Book 3

39. (A) fairness opinion.

Explanation

Minority shareholders are often dependent upon an analyst's opinion about the fairness of a price to be received. Hence the term fairness opinion.

(Module 19.1, LOS 19.d)

Related Material