19 EQUITY VALUATION APPLICATIONS AND PROCESSES

1. Which discounts must be taken into account while valuing the investment opportunity? Joe should take into account the:
   (A) marketability, liquidity, and minority discounts in the valuation
   (B) marketability, liquidity, and majority discounts in the valuation
   (C) marketability, liquidity, and control premium in the valuation.

2. Disclosures of accounting practices and basis are most likely to be made in which part of a firm's financial reports?
   (A) The audit report.
   (B) Footnotes.
   (C) Management's discussion and analysis (MD&A).

3. Consider the steps in the top down valuation approach as it is applicable for Gold Star. Dentice should forecast the growth of:
   (A) Gold Star, the growth of the oil industry, and then the growth of the overall economy.
   (B) each firm in the oil industry, the growth rate of the oil industry, and the growth rate of the economy.
   (C) the overall economy, growth of the industry, and the growth rate of Gold Star.

4. An analyst performing an asset valuation to detect investor's expectations about the future value of the variables that affect a stock's price is most likely using the valuation for:
   (A) projecting the value of corporate actions.
   (B) reading the market.
   (C) generating a fairness opinion.

5. Notes to financial statements contain:
   (A) discussion of the firm's accounting practices and basis of presentation.
   (B) important information about the firm's accounting practices and basis of presentation.
   (C) a description of the firm's financial condition and future prospects.

6. Valuation models for equities contain estimates of required returns and:
   (A) expected future cash flows.
   (B) known future cash flows.

(C) an assumed continuation of past cash flows.

7. Which of the following is NOT a use of asset valuation?
   (A) Issuing fairness opinions.
   (B) Projecting the value of corporate actions.
   (C) Estimating inflation rates.

8. A valuation of a firm based on the assumption that the firm will continue to operate is referred to as its:
   (A) going-concern value.
   (B) operating value.
   (C) status quo value.

9. For an analyst valuing public equities, the relevant concept of value is most likely to be:
   (A) intrinsic value.
   (B) fair market value.
   (C) orderly liquidation value.

10. A valuation of a firm based on the current market price of its assets - liabilities is referred to as the firm's:
   (A) operating value.
   (B) liquidation value.
   (C) going-concern value.

11. A wise analyst will examine a valuation to determine:
   (A) ways to enhance a client's valuation.
   (B) how well it will be received by the firm's management.
   (C) its sensitivity to changes in expectations.

12. Which of the following would cause an analyst to have concern about a firm's quality of earnings?
   (A) A firm books sales when orders are shipped.
   (B) The gain on the sale of a plant was included in operating earnings.
   (C) The firm took a write off for a recently impaired asset.

13. A valuation of a firm based on a review of other firms' price to earnings, price to sales, and price to return on investment ratios is an example of a:
   (A) fundamental valuation.
   (B) relative valuation.

(C) broad-based valuation.

14. Overestimating the growth rate of a firm in using a valuation model would result in a value that is likely to be:
    (A) too high.
    (B) can't tell from this information.
    (C) too low.

15. A valuation of a firm based on the comparison of the firm with the market value of other firms is known as a:
    (A) peer group valuation.
    (B) comparison valuation.
    (C) relative valuation.

16. Important considerations for choosing an appropriate approach for valuing a given company are least likely to include:
    (A) Is the model suitable given the purpose of the analysis?
    (B) Is the model appropriate based on the quality and availability of input data?
    (C) Is the model consistent with the investor's IPS?

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.

17. Why is the introductory paragraph in Article One incorrect?

(A) Most analysts believe that at some point intrinsic and market value will converge.

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

(C) Markets cannot be constantly informationally efficient as this would mean that intrinsic and market price would always be identical.

18. Using Heller's suggestion of an analyst intrinsic value which is $1.20 too high in the illustrative example for Article One, calculate the valuation error and the actual mispricing:

	Valuation error	Actual mispricing
(A)	$1.20	$0.15
(B)	$1.35	$0.15
(C)	$0.15	$1.20

19. In response to Heller's point regarding the Linpan discussion in Article Two, which of the following correctly identifies the suggested valuation method?
(A) Going Concern Valuation.
(B) Liquidation Value.
(C) Orderly Liquidation Value.

20. In the Toys to You Inc. (TTY) discussion in Article Two, which of the following would be the most appropriate conclusion for the writer to add?
(A) TTY is attempting a strategy of product differentiation by committing to high quality products but appears to be failing as revenues are lower than its competitors.
(B) TTY is attempting a strategy of cost leadership by keeping prices equal to or lower than its competitors but appears to be failing as margins are lower than its competitor's.
(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.

21. Which of the following would not be an example of one of Michael Porter's 5 competitive forces applicable to Toys to You?
(A) A new chain of toy stores, Games & Goodies, has opened up in key Toys to You territories.
(B) Toys to You's biggest supplier have 'due to unforeseen market conditions' added a 15% premium to key product lines.
(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.

22. When an analyst scrutinizes a firm's financial statements to try to discern how accurately the reported information reflects economic reality, and to evaluate the sustainability of the company's performance, the process is most likely to be referred to as a:
(A) quality of earnings analysis.
(B) reasonable assurance analysis.
(C) comprehensive basis of accounting analysis.

23. What are three factors that would make a firm's accounting earnings less of a gauge of future economic performance? Late filings, unusually:
    (A) high amounts of loans to company insiders, and long tenure of senior management.
    (B) low amounts of loans to company insiders, and short tenure of senior management.
    (C) high amounts of loans to company insiders, and short tenure of senior management.

24. The present value of expected future cash flows is the firm's:
    (A) terminal value.
    (B) liquidation value.
    (C) going-concern value.

25. Liquidation value is the:
    (A) cash generated by terminating a business, selling its assets, and repaying liabilities.
    (B) present value of future cash flow less the possible liquidation cost.
    (C) market value of the total assets less the market value of the total liabilities.

26. A valuation of a firm based on the intrinsic value of the firm's investment characteristics is known as an:
    (A) absolute valuation.
    (B) asset based valuation.
    (C) absolution valuation.

27. The value of a conglomerate derived using a sum-of-the-parts valuation would least accurately be called the:
    (A) liquidation value.
    (B) breakup value.
    (C) private market value.

28. A comparison between a firm's going-concern valuation and its liquidation value will show that the going-concern value will always be:
    (A) greater than the liquidation value.
    (B) equal to the present value of the expected continued operation of the firm.
    (C) less than the liquidation value.

29. Which of the following two ratios are likely to be used for determining value as a function of company peer benchmarks?
    (A) Price-to-sales and debt/equity.
    (B) Return on equity and net profit margin.
    (C) Price-to-earnings and price-to-book.

30. An analyst is most likely to review the footnotes to a firm's financial statements to find information about the firm's:
    (A) accounting practices.
    (B) cash flow activities.
    (C) operation.

31. Which of the following least accurately represents one of the primary steps of the equity valuation process described by Pinto, Henry, Robinson, and Stowe?
    (A) Assessing corporate governance.
    (B) Decision making.
    (C) Selecting a valuation model.

32. Which of the following is least likely a use of equity valuation?
    (A) Issuing fairness opinions.
    (B) Projecting the value of corporate actions.
    (C) Assessing corporate governance.

33. Minority shareholders often do not have control of the price at which the firm will be sold or merged with another firm. In order to safeguard their interests, minority shareholders will often seek an analyst's opinion of the value of the firm. This opinion is referred to as a:
    (A) fairness opinion.
    (B) second opinion.
    (C) minority opinion.

34. Which of the following models would be most suitable to value Gold Star?
    (A) Relative valuation.
    (B) Absolute valuation.
    (C) Liquidation value.

35. Financial Analyst Davey Jarvis, CFA, is evaluating Laura's Chocolates, Inc., which processes nut-based toffee for world-wide distribution. Which of the following steps is Jarvis most likely to take as part of the top-down valuation process?
    (A) Perform momentum-based technical analysis.
    (B) Evaluate price performance on an ongoing basis.
    (C) Learn / understand the business.

36. How can we account for different valuations for the same firm from several analysts even if they use the same required returns?
    (A) The analysts may be biased with personal opinions about management.
    (B) Valuations are based on the analyst's expectations.
    (C) Valuation models contain random errors.

37. One justification for using multiple models to estimate firm value is:
    (A) the ability to learn from each successive model and to make improvements.

(B) the ability to streamline and economize the development process through repeated use of the same generic baseline.

(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.

38. The goal of asset valuation, based on the expected future cash flows of an asset, is to establish an asset's:

(A) relative value.

(B) market value.

(C) intrinsic value.

39. An ownership perspective can be important for an analyst determining the value of a share position. A controlling interest suggests the most appropriate model is a:

(A) time series model.

(B) dividend discount model.

(C) cash flow model.