

**CHAPTER 19****EQUITY VALUATION APPLICATIONS  
AND PROCESSES****1. (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)

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**2. (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)

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**3. (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)

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**4. (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)

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**5. (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)

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**6. (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)

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**7. (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)

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**8. (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)

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**9. (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)

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**10. (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)

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**11. (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)

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**12. (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)

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**13. (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)

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**14. (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)

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**15. (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)

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**16. (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)

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**17. (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)

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**18. (A) \$1.20\$0.15****Explanation**

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

Actual mispricing =  $IV_{\text{actual}} - \text{price} = (25.20 - 1.20) - 23.85 = 0.15$

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**19. (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)

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**20. (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 its 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)

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21. (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)

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22. (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)

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23. (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)

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**24. (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**

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**25. (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)

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**26. (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)

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**27. (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)

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**28. (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)

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**29. (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 relative valuation analysis.

(Module 19.1, LOS 19.f)

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**30. (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)

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**31. (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)

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**32. (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)

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**33. (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)

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**34. (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)

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**35. (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)

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36. (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**

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37. (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)

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38. (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)

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39. (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)

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