This study session focuses on financial modeling including the development of forecast model inputs using available industry and corporate information. Approaches for analyzing key balance sheet, income, and cash flow statement items are presented. Other factors affecting financial forecasts such as competition, inflation, deflation, and technology are considered. An example using pro forma financial statements to build a financial model is shown. The session ends with coverage of discounted cash flow (DCF) valuation models and an emphasis on the dividend discount model (DDM).

**READING ASSIGNMENTS**

**Reading 28**
Industry and Company Analysis
by Matthew L. Coffina, CFA, Anthony M. Fiore, CFA, and Antonius J. van Ooijen, CFA

**Reading 29**
Discounted Dividend Valuation
by Jerald E. Pinto, PhD, CFA, Elaine Henry, PhD, CFA, Thomas R. Robinson, PhD, CFA, and John D. Stowe, PhD, CFA

**LEARNING OUTCOMES**

**READING 28. INDUSTRY AND COMPANY ANALYSIS**

The candidate should be able to:

a. compare top-down, bottom-up, and hybrid approaches for developing inputs to equity valuation models;

b. compare “growth relative to GDP growth” and “market growth and market share” approaches to forecasting revenue;
c. evaluate whether economies of scale are present in an industry by analyzing operating margins and sales levels;

d. forecast the following costs: cost of goods sold, selling general and administrative costs, financing costs, and income taxes;

e. describe approaches to balance sheet modeling;

f. describe the relationship between return on invested capital and competitive advantage;

g. explain how competitive factors affect prices and costs;

h. judge the competitive position of a company based on a Porter’s five forces analysis;

i. explain how to forecast industry and company sales and costs when they are subject to price inflation or deflation;

j. evaluate the effects of technological developments on demand, selling prices, costs, and margins;

k. explain considerations in the choice of an explicit forecast horizon;

l. explain an analyst’s choices in developing projections beyond the short-term forecast horizon;

m. demonstrate the development of a sales-based pro forma company model.

**READING 29. DISCOUNTED DIVIDEND VALUATION**

The candidate should be able to:

a. compare dividends, free cash flow, and residual income as inputs to discounted cash flow models and identify investment situations for which each measure is suitable;

b. calculate and interpret the value of a common stock using the dividend discount model (DDM) for single and multiple holding periods;

c. calculate the value of a common stock using the Gordon growth model and explain the model’s underlying assumptions;

d. calculate and interpret the implied growth rate of dividends using the Gordon growth model and current stock price;

e. calculate and interpret the present value of growth opportunities (PVGO) and the component of the leading price-to-earnings ratio (P/E) related to PVGO;

f. calculate and interpret the justified leading and trailing P/Es using the Gordon growth model;

g. calculate the value of noncallable fixed-rate perpetual preferred stock;

h. describe strengths and limitations of the Gordon growth model and justify its selection to value a company’s common shares;

i. explain the assumptions and justify the selection of the two-stage DDM, the H-model, the three-stage DDM, or spreadsheet modeling to value a company’s common shares;

j. explain the growth phase, transition phase, and maturity phase of a business;

k. describe terminal value and explain alternative approaches to determining the terminal value in a DDM;

l. calculate and interpret the value of common shares using the two-stage DDM, the H-model, and the three-stage DDM;
m estimate a required return based on any DDM, including the Gordon growth model and the H-model;

n explain the use of spreadsheet modeling to forecast dividends and to value common shares;

o calculate and interpret the sustainable growth rate of a company and demonstrate the use of DuPont analysis to estimate a company’s sustainable growth rate;

p evaluate whether a stock is overvalued, fairly valued, or undervalued by the market based on a DDM estimate of value.