

STUDY SESSION

12

Equity Investments (2)

This study session focuses on the characteristics, analysis, and valuation of equity securities. Various equity types including public and private equities are described. The various industry classification approaches for global equities and useful frameworks for conducting industry and individual company analysis are presented. Coverage of the three main equity valuation approaches (present value, multiplier, and asset based) conclude the session.

READING ASSIGNMENTS

Reading 36	Overview of Equity Securities by Ryan C. Fuhrmann, CFA, and Asjeet S. Lamba, PhD, CFA
Reading 37	Introduction to Industry and Company Analysis by Patrick W. Dorsey, CFA, Anthony M. Fiore, CFA, and Ian Rossa O'Reilly, CFA
Reading 38	Equity Valuation: Concepts and Basic Tools by John J. Nagorniak, CFA, and Stephen E. Wilcox, PhD, CFA

LEARNING OUTCOMES

READING 36. OVERVIEW OF EQUITY SECURITIES

The candidate should be able to:

- a** describe characteristics of types of equity securities;
- b** describe differences in voting rights and other ownership characteristics among different equity classes;

- c compare and contrast public and private equity securities;
- d describe methods for investing in non-domestic equity securities;
- e compare the risk and return characteristics of different types of equity securities;
- f explain the role of equity securities in the financing of a company's assets;
- g contrast the market value and book value of equity securities;
- h compare a company's cost of equity, its (accounting) return on equity, and investors' required rates of return.

READING 37. INTRODUCTION TO INDUSTRY AND COMPANY ANALYSIS

The candidate should be able to:

- a explain uses of industry analysis and the relation of industry analysis to company analysis;
- b compare methods by which companies can be grouped;
- c explain the factors that affect the sensitivity of a company to the business cycle and the uses and limitations of industry and company descriptors such as "growth," "defensive," and "cyclical";
- d describe current industry classification systems, and identify how a company should be classified, given a description of its activities and the classification system;
- e explain how a company's industry classification can be used to identify a potential "peer group" for equity valuation;
- f describe the elements that need to be covered in a thorough industry analysis;
- g describe the principles of strategic analysis of an industry;
- h explain the effects of barriers to entry, industry concentration, industry capacity, and market share stability on pricing power and price competition;
- i describe industry life-cycle models, classify an industry as to life-cycle stage, and describe limitations of the life-cycle concept in forecasting industry performance;
- j describe macroeconomic, technological, demographic, governmental, social, and environmental influences on industry growth, profitability, and risk;
- k compare characteristics of representative industries from the various economic sectors;
- l describe the elements that should be covered in a thorough company analysis.

READING 38. EQUITY VALUATION: CONCEPTS AND BASIC TOOLS

The candidate should be able to:

- a evaluate whether a security, given its current market price and a value estimate, is overvalued, fairly valued, or undervalued by the market;
- b describe major categories of equity valuation models;
- c describe regular cash dividends, extra dividends, stock dividends, stock splits, reverse stock splits, and share repurchases;

- d** describe dividend payment chronology;
- e** explain the rationale for using present value models to value equity and describe the dividend discount and free-cash-flow-to-equity models;
- f** calculate the intrinsic value of a non-callable, non-convertible preferred stock;
- g** calculate and interpret the intrinsic value of an equity security based on the Gordon (constant) growth dividend discount model or a two-stage dividend discount model, as appropriate;
- h** identify characteristics of companies for which the constant growth or a multi-stage dividend discount model is appropriate;
- i** explain the rationale for using price multiples to value equity, how the price to earnings multiple relates to fundamentals, and the use of multiples based on comparables;
- j** calculate and interpret the following multiples: price to earnings, price to an estimate of operating cash flow, price to sales, and price to book value;
- k** describe enterprise value multiples and their use in estimating equity value;
- l** describe asset-based valuation models and their use in estimating equity value;
- m** explain advantages and disadvantages of each category of valuation model.