

STUDY SESSION

8

Equity Valuation (1)

This study session introduces essential equity valuation concepts. The various definitions of value and the application of equity valuation techniques to solve everyday problems are first discussed. A five-step equity valuation process is then described with the three main categories of equity valuation models (absolute, relative, total entity) presented in step three. Key return measures including the equity risk premium and derivation of the equity required return using various models (CAPM, multifactor, build up) conclude the session.

READING ASSIGNMENTS

Reading 20	Equity Valuation: Applications and Processes by Jerald E. Pinto, PhD, CFA, Elaine Henry, PhD, CFA, Thomas R. Robinson, PhD, CFA, CAIA, and John D. Stowe, PhD, CFA
Reading 21	Return Concepts by Jerald E. Pinto, PhD, CFA, Elaine Henry, PhD, CFA, Thomas R. Robinson, PhD, CFA, CAIA, and John D. Stowe, PhD, CFA

LEARNING OUTCOMES

READING 20. EQUITY VALUATION: APPLICATIONS AND PROCESSES

The candidate should be able to:

- a** define valuation and intrinsic value and explain sources of perceived mispricing;

- b** explain the going concern assumption and contrast a going concern value to a liquidation value;
- c** describe definitions of value and justify which definition of value is most relevant to public company valuation;
- d** describe applications of equity valuation;
- e** describe questions that should be addressed in conducting an industry and competitive analysis;
- f** contrast absolute and relative valuation models and describe examples of each type of model;
- g** describe sum-of-the-parts valuation and conglomerate discounts;
- h** explain broad criteria for choosing an appropriate approach for valuing a given company.

READING 21. RETURN CONCEPTS

The candidate should be able to:

- a** contrast realized holding period return, expected holding period return, required return, return from convergence of price to intrinsic value, discount rate, and internal rate of return;
- b** calculate and interpret an equity risk premium using historical and forward-looking estimation approaches;
- c** determine the required return on an equity investment using the capital asset pricing model, the Fama–French model, the Pastor–Stambaugh model, macro-economic multifactor models, and the build-up method (e.g., bond yield plus risk premium);
- d** explain beta estimation for public companies, thinly traded public companies, and non-public companies;
- e** describe strengths and weaknesses of methods used to estimate the required return on an equity investment;
- f** explain international considerations in required return estimation;
- g** explain and calculate the weighted average cost of capital for a company;
- h** evaluate the appropriateness of using a particular rate of return as a discount rate, given a description of the cash flow to be discounted and other relevant facts.