Equity Valuation

LEARNING OUTCOMES

Equity Valuation: Applications and Processes

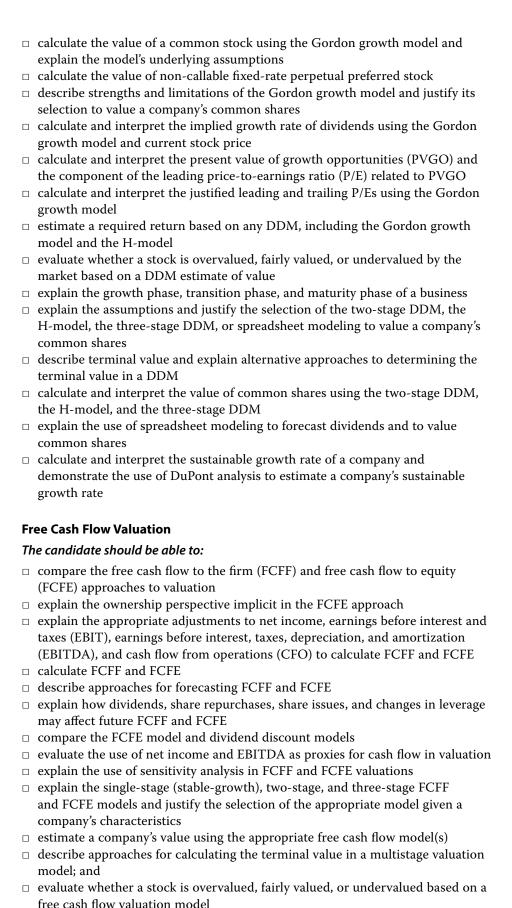
The candidate should be able to:

- □ define valuation and intrinsic value and explain sources of perceived mispricing
- □ explain the going concern assumption and contrast a going concern value to a liquidation value
- □ describe definitions of value and justify which definition of value is most relevant to public company valuation
- □ describe applications of equity valuation
- □ describe questions that should be addressed in conducting an industry and competitive analysis
- $\hfill\Box$ contrast absolute and relative valuation models and describe examples of each type of model
- □ describe sum-of-the-parts valuation and conglomerate discounts
- explain broad criteria for choosing an appropriate approach for valuing a given company

Discounted Dividend Valuation

The candidate should be able to:

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



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Market-Based Valuation: Price and Enterprise Value Multiples

The candidate should be able to:

- contrast the method of comparables and the method based on forecasted fundamentals as approaches to using price multiples in valuation and explain economic rationales for each approach
- □ calculate and interpret a justified price multiple
- □ describe rationales for and possible drawbacks to using alternative price multiples and dividend yield in valuation
- □ calculate and interpret alternative price multiples and dividend yield
- □ calculate and interpret underlying earnings, explain methods of normalizing earnings per share (EPS), and calculate normalized EPS
- \Box explain and justify the use of earnings yield (E/P)
- describe fundamental factors that influence alternative price multiples and dividend yield
- □ calculate and interpret a predicted P/E, given a cross-sectional regression on fundamentals, and explain limitations to the cross-sectional regression methodology
- □ calculate and interpret the justified price-to-earnings ratio (P/E), price-to-book ratio (P/B), and price-to-sales ratio (P/S) for a stock, based on forecasted fundamentals
- $\hfill\Box$ calculate and interpret the P/E-to-growth (PEG) ratio and explain its use in relative valuation
- □ calculate and explain the use of price multiples in determining terminal value in a multistage discounted cash flow (DCF) model
- $\hfill\Box$ evaluate whether a stock is overvalued, fairly valued, or undervalued based on comparisons of multiples
- evaluate a stock by the method of comparables and explain the importance of fundamentals in using the method of comparables
- □ explain alternative definitions of cash flow used in price and enterprise value (EV) multiples and describe limitations of each definition
- □ calculate and interpret EV multiples and evaluate the use of EV/EBITDA
- □ explain sources of differences in cross-border valuation comparisons
- □ describe momentum indicators and their use in valuation
- $\ \square$ explain the use of the arithmetic mean, the harmonic mean, the weighted harmonic mean, and the median to describe the central tendency of a group of multiples

Residual Income Valuation

The candidate should be able to:

- $\hfill\Box$ calculate and interpret residual income, economic value added, and market value added
- □ describe the uses of residual income models
- □ calculate the intrinsic value of a common stock using the residual income model and compare value recognition in residual income and other present value models
- □ explain fundamental determinants of residual income
- explain the relation between residual income valuation and the justified price-to-book ratio based on forecasted fundamentals
- □ calculate and interpret the intrinsic value of a common stock using single-stage (constant-growth) and multistage residual income models
- □ calculate the implied growth rate in residual income, given the market price-to-book ratio and an estimate of the required rate of return on equity

- □ explain continuing residual income and justify an estimate of continuing residual income at the forecast horizon, given company and industry prospects
- □ compare residual income models to dividend discount and free cash flow models
- □ explain strengths and weaknesses of residual income models and justify the selection of a residual income model to value a company's common stock
- □ describe accounting issues in applying residual income models

Private Company Valuation

The candidate should be able to:

- □ contrast important public and private company features for valuation purposes
- $\hfill\Box$ describe uses of private business valuation and explain key areas of focus for financial analysts
- □ explain cash flow estimation issues related to private companies and adjustments required to estimate normalized earnings
- □ explain factors that require adjustment when estimating the discount rate for private companies
- □ compare models used to estimate the required rate of return to private company equity (for example, the CAPM, the expanded CAPM, and the build-up approach)
- explain and evaluate the effects on private company valuations of discounts and premiums based on control and marketability
- □ explain the income, market, and asset-based approaches to private company valuation and factors relevant to the selection of each approach
- □ calculate the value of a private company using income-based methods
- □ calculate the value of a private company using market-based methods and describe the advantages and disadvantages of each method