CHAPTER SUMMARY

- *CHAPTER 1 - THE EQUITY EVALUATION PROCES*
- **Valuation** – the estimation of an assets value based on
  - » Variables, perceived to be related to future returns
  - » Comparison with similar assets
  - » When relevant; estimate of immediate liquidation proceed.
- Valuation process pages 7-28 read through text for explanations on the 5 steps
  - » 1. understanding the business
  - » 2. forecasting company performance
  - » 3. selecting the appropriate valuation model
  - » 4. converting forecasts to a valuation
  - » 5. applying the valuation conclusion.

- **Intrinsic value** – the value of an asset given a hypothetical complete understanding of the asset's investment characteristics
- **Alpha** – excess adjusted return
- **Mispricing** – any departure from the estimated intrinsic value

- READ SUMMARY ON pages 33-35

ADDITIONAL QUESTIONS

Chapter 1

Select the correct answer

- Mispricing is
  1. any departure from the estimated intrinsic value
  2. All departure from the estimated intrinsic value
  3. Some departure from the estimated intrinsic value

- Which one of the following is **least likely a correct** description of a type of an absolute valuation model?
  1. Discounted cash flow model
  2. Present value model
  3. Expected dividends model

•Which one of the following statements is **most likely correct,** with regards to steps and activities/actions in the equity valuation process?

1. An analyst applies the valuation conclusions by choosing the FCFE model.
2. To convert his forecast into a valuation an analyst carried out a sensitivity analysis.
3. To understand the business an analyst helped the firm he is evaluating compile their financial statements.

Also do questions 1-4 and 6 on pages 35-36

CHAPTER SUMMARY

- *CHAPTER 2 – RETURN CONCEPTS*

- Return on investment is a fundamental element in asset valuation (page 37)
  - Investors
    - Compare expected return to fair given return
  - Analysts
    - Discount future cash flow

NOTE: only some of the concepts are highlighted in these slides, by no means does this indicate that you must exclude the concepts not highlighted.

- **HPR (holding period return)**
  - The return earned from investing in an asset over a specified time period.
  - It is the dividend yield + price appreciation return page 38

$$r = \frac{D_H + P_H}{P_0} - 1$$

$$= \frac{D_H}{P_0} + \frac{P_H - P_0}{P_0}$$

- Example: a share is worth R50 when you buy it, you expect to receive a dividend of R1 in two months. After receiving the dividend you then decide to sell it because of the new market price of R52. what was your HPR?
  - r=(1+52/ 50) – 1 =6%

- **Required return on equity**
  - The minimum level of expected return that an investor requires in the asset in order to invest in the asset over a specified time period, given the asset's risk.
  - Can be calculated using CAPM

$$E(R_i) = R_F + \beta_i \left[E(R_M) - R_F \right]$$

  - **Expected alpha = expected return- required return**
    = HPR – CAPM (required return)
  - The risk-free rate can also be presented in two ways
    - Long-term government bond return
    - Short-term government debt instrument (treasury bill) return

- **<u>Other measures of required return on equity</u>**
  - Fama-french model
    - Refer to pages 65-67 and example 2-7.
  - Macroeconomic models
    - Refer to pages 70-71
  - Bond yield plus risk premium
    - Refer to pages 73-74
  - Do example 2-9 pages 74-75.

- **Weighted average cost of capital**
  - The overall required rate of return of a company's suppliers of capital
  - Also referred to as company's cost of capital
  - Estimated using
    - Company's after-tax weighted cost of capital
    - Or weighted average cost of capital (WACC)

$$WACC = \frac{MV(debt)}{MV(debt)+MV(equity)} r_d(1-\text{tax rate}) + \frac{\text{MV(equity)}}{MV(debt)+MV(equity)} r$$

- Do example 2-10 pages 77-78

- READ THROUGH SUMMARY pg 78-80

- **ADDITIONAL QUESTION**
  - Refer to pages 80-82
    - Question 1,2,3 (a only), 4, 5 and 6