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Academy of Professional Finance 专业金融学院

CFA Level II

Equity Valuation Application and Processes

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CFA Exam Topic Area Weights

Topic Area	Level I	Level II	Level III
Ethical and Professional Standards (total)	15	10	10
Investment Tools (total)	50	30-60	0
Corporate Finance	8	5-15	0
Economics*	10	5-10	0
Financial Reporting and Analysis	20	15-25	0
Quantitative Methods	12	5-10	0
Asset Classes (total)	30	35-75	35-45
Alternative Investments	3	5-15	5-15
Derivatives	5	5-15	5-15
Equity Investments	10	20-30	5-15
Fixed Income	12	5-15	10-20
Portfolio Management and Wealth Planning (total)	5	5-15	45-55
Total	100	100	100

Reading 30 Summary

- Valuation, intrinsic value, sources of mispricing
- Going concern assumption, liquidation value
- Different definitions of value
- Applications of equity valuation
- Industry and competitive analysis
- Absolute and relative valuation models
- Sum-of-the-parts valuation, conglomerate discount
- Criteria in choosing valuation approach

Learning Outcome Statement 30

LOS 30.a: Define valuation and intrinsic value, and explain sources of perceived mispricing.

- Valuation is the process of determining the value of an asset.
- Intrinsic value (IV). The valuation of an asset or security by someone who has complete understanding of the characteristics of the asset or issuing firm.

Learning Outcome Statement 30

LOS 30.a: Define valuation and intrinsic value, and explain sources of perceived mispricing.

$$IV_{analyst} - price = (IV_{actual} - price) + (IV_{analyst} - IV_{actual})$$

❑ Two sources of perceived mispricing:

1. actual mispricing. The difference between market price and the intrinsic value.
2. valuation error. The difference between the analyst's estimate of intrinsic value and actual intrinsic value.

Learning Outcome Statement 30

LOS 30.b: Explain the going concern assumption and contrast a going concern value to a liquidation value.

- Going concern assumption: a firm will continue to operate as a business.
- Liquidation value: the estimate of what the assets of the firm would bring if sold separately, net of the company's liabilities.

Learning Outcome Statement 30

LOS 30.c: Describe definitions of value, and justify which definition of value is most relevant to public company valuation.

- Fair market value: the price that is agreed upon by informed, able buyers and sellers.
- Investment value: dependent on the buyer's specific characteristics.
- Intrinsic value is usually the most relevant concept of value.

Learning Outcome Statement 30

LOS 30.d: Describe applications of equity valuation.

- Valuation process generally falls into two categories:
  (1) pricing model;
  (2) benchmark.

Learning Outcome Statement 30

LOS 30.d: Describe applications of equity valuation.

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Learning Outcome Statement 30

LOS 30.d: Describe applications of equity valuation.

❑ Valuation process can help us with the following:

1. Stock selection;
2. Reading the market;
3. Projecting the value of corporate actions;
4. Fairness opinions;
5. Planning and consulting;
6. Communication with analysts and investors;
7. Valuation of private business;
8. Portfolio management

Learning Outcome Statement 30

LOS 30.d: Describe applications of equity valuation.

- The investment process usually includes three parts: planning, execution and evaluation of results. Equity valuation is a primary concern in the first two of these steps.
- Planning: define investment objectives and constraints, communicate investment strategy.
- Execution: the implementation of an investment plan.

Learning Outcome Statement 30

LOS 30.e: Describe questions that should be addressed in conducting an industry and competitive analysis.

❑ Porter's five forces:

1. Threat of new entrants in the industry.
2. Threat of substitutes.
3. Bargaining power of buyers.
4. Bargaining power of suppliers.
5. Rivalry among existing competitors.

Learning Outcome Statement 30

LOS 30.e: Describe questions that should be addressed in conducting an industry and competitive analysis.

❑ Three strategies firms can use to compete against each other:

1. Cost leadership: lowest-cost manufacturer.
2. Product differentiation: add attractive product features or provide better services.
3. Focus: use one of the previous two strategies within a particular segment of the market.

Learning Outcome Statement 30

LOS 30.e: Describe questions that should be addressed in conducting an industry and competitive analysis.

❑ Firm behaviors that may compromise the quality of financial Statement information:

1. Accelerating or premature recognition of income;
2. Reclassifying gains and non-operating income;
3. Delaying the recognition of expenses and losses;
4. Discretion in amortization, depreciation, and discount rate;
5. Using off-balance-sheet items to mislead investors.

Learning Outcome Statement 30

LOS 30.f: Contrast absolute and relative valuation models, and describe examples of each type of model.

- Absolute valuation models – estimate an asset's intrinsic value without regard to the value of alternative assets, e.g., dividend discount models, asset – based models, free cash flow approach and the residual income approach.
- Relative valuation models – determine the value of an asset in relation to the values of other assets, e.g., P/E ratio

Learning Outcome Statement 30

LOS 30.g: Describe sum-of-parts valuation, and explain a conglomerate discount.

- Sum-of-parts valuation: value a firm's divisions individually and then use the sum of all divisions' value as the firm's value.
- Sum-of-the-parts value, or breakup value or private market value are interchangeable.

Learning Outcome Statement 30

LOS 30.g: Describe sum-of-parts valuation, and explain a conglomerate discount.

- Conglomerate discount: A reference to the tendency of the stock market to undervalue the stocks of conglomerate businesses.
- Conglomerate discount is calculated by adding an estimation of the intrinsic value of each of the divsion in a conglomerate and subtracting the conglomerate's market capitalization from that value.

Learning Outcome Statement 30

LOS 30.g: Describe sum-of-parts valuation, and explain a conglomerate discount.

- Explanations for conglomerate discounts:

1. Internal capital inefficiency;
2. Endogenous factors;
3. Research measurement errors.

Learning Outcome Statement 30

LOS 30.h: Explain broad criteria for choosing an appropriate approach for valuing a given company.

- ❑ Selecting valuation models:

1. Fits the characteristics of the company;
2. Input data is available and reliable;
3. Suitable for the analysis purpose.

- ❑ Using multiple modes and comparing their results can reveal how a model’s assumptions and the perspective of the analysis can affect the results.

Practice Questions

Susan Weiber, CFA, has noted that even her best estimates of a stock's intrinsic value can differ significantly from the current market price. The *least likely* explanation is:

A. differences between her estimate and the actual intrinsic value.

B. differences between the actual intrinsic value and the market price.

C. differences between the intrinsic value and the going concern value.

- **The correct answer is C.**

Practice Questions

Tom Walder has been instructed to use absolute valuation models, and not relative valuation models, in his analysis. Which of the following is *least likely* to be an example of an absolute valuation model? The:

A. dividend discount model.

B. price-to-earnings market multiple model.

C. residual income model.

- **The correct answer is B.**

Practice Questions

Sun Pharma is a large pharmaceutical company based in Sri Lanka that manufactures prescription drugs under license from large multinational pharmaceutical companies. Delenga Mahamurthy, CEO of Sun Pharma, is evaluating a potential acquisition of Island Cookware, a small manufacturing company that produces cooking utensils.

Mahamurthy feels that Sun Pharma's excellent distribution network could add value to Island Cookware. Sun Pharma plans to acquire Island Cookware for cash. Several days later, Sun Pharma announces that they have acquired Island Cookware at market price.

7. Sun Pharma's *most appropriate* valuation for Island Cookware is its:
   A. sum-of-the-parts value.
   B. investment value.
   C. liquidation value.

8. Upon announcement of the merger, the market price of Sun Pharma drops. This is *most likely* a result of the:
   A. unrelated business effect.
   B. tax effect.
   C. conglomerate discount.

The correct answers are B, C.

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Thank You!