Equity Valuation: Valuation Concepts

Test ID: 7440683

Question #1 of 76

Question ID: 462928

Morgan Bondillo, CFA, is attempting to calculate the value of Smith Sprockets. She is using a supply-side model to estimate the equity risk premium and a build-up model to estimate returns.

Based on the strategies Bondillo is using, Smith Sprockets is *least likely* to:

- ✗ **A)** **be closely held.**
- ✓ **B)** need its beta adjusted for drift.
- ✗ **C)** be located in a developed market.

Explanation

Supply-side models work best in developed countries, where public equities represent a significant share of the economy, suggesting that there is a relationship between macroeconomic variables and asset prices. The use of a supply-side model suggests Smith Sprockets is in a developed market. Build-up models are generally used for closely held companies for which betas are not easy to obtain. Bondillo's use of a build-up model suggests Smith Sprockets is probably closely held. Betas of public companies must be adjusted for drift. However, since the use of the build-up method suggests the company is closely held and has no beta available, beta drift is probably not relevant for Smith Sprockets.

Question #2 of 76

Question ID: 462946

Junior analyst Quentin Haggard is struggling with a required return calculation. His main concern is compensating for exchange rate fluctuations between the country where his company is based and the home country of a portfolio of stocks he is analyzing. Haggard should calculate the return in his home country's currency, then adjust:

- ✗ **A)** **for expected changes in the foreign country's inflation rate.**
- ✗ **B)** the beta to account for exchange-rate fluctuations.
- ✓ **C)** for expected changes in the foreign country's currency value.

Explanation

The proper method of compensating for changes in exchange rates is to calculate the required return in the home currency, then adjust the return using forecasts for changes in the exchange rate.

Questions #3-8 of 76

Jaden Hoyle is evaluating the MegaFood Market chain of grocery stores and Strinson Carburetors, a maker of automobile and industrial engine parts. MegaFood is publicly traded, while Strinson is a private company. Hoyle's firm, Janssen and Associates, is considering the purchase of a 50% equity stake in one or both of the companies, and may be willing to purchase the companies outright. Janssen only invests in companies with a weighted average cost of capital of less than 11%.

Hoyle has assembled the following data on the two companies:

	MegaFood Market	Strinson Carburetors
Beta	0.87	
Market value of equity	$173 million	$993 million
Market value of debt	$38 million	$567 million
Marginal tax rate	42.8%	31%
Target debt/equity ratio	35%	78%
Equity risk premium		4.6%
Required return on debt	9%	6.5%

The risk-free rate of return is 5.2%. Hoyle must make recommendations regarding both MegaFood Market and Strinson Carburetors.

Hoyle does not have all of the data she needs and knows she will have to estimate some values using the data she does possess. To help estimate the required return on equity for Strinson Carburetors, Hoyle takes three actions:

Action A: She selects a benchmark company, unlevers the beta of that company, then levers up the adjusted beta using Strinson's debt and equity allocation.

Action B: She calculates a risk premium, then adds that premium to the yield to maturity of the company's long-term debt.

Action C: She prepares a supply-side multifactor model considering expected inflation, expected GDP growth, and expected changes in P/E ratio.

Before she finishes her analysis of MegaFood Market and Strinson Carburetors, Hoyle must construct valuation models for two other companies, Halberd Hardware, a maker of hand tools, and the Jones Group, one of the world's largest consultants. She has assembled the following information about each company.

Halberd Hardware

- Gary Halberd, the founder, still owns 85% of the company, and all the rest is in the hands of company directors and friends of Halberd who bought stakes 20 years ago.
- Halberd Hardware has publicly traded debt.
- Historical data on equity returns is sparse, as there have been very few trades over the last two decades.
- Halberd Hardware is headquartered in New York City.
- The company plans to go public in the next six months, with Gary Halberd selling 30% of his ownership interest.

Jones Group

- Jones Group, one of the world's largest consulting companies, has been publicly traded for four years on the South Pittson Island stock market. Its ADR trades on the U.S. market.
- South Pittson Island is a small island nation in the Mediterranean known for its business-friendly tax code.

For her analysis of Halberd Hardware, Hoyle is considering three models to calculate the estimated return. But she has already decided to use the Gordon Growth model to calculate the equity risk premium.

As soon as Hoyle finishes determining which models are best suited to her purposes, her boss comes into the office and tells her to use the capital asset pricing model (CAPM) for all four of the companies she is reviewing. Hoyle is concerned about the effectiveness of the CAPM. With regards to Jones Group, her three main worries are:

Worry A: The need to use the country spread model to revise the equity risk premium.

Worry B: The CAPM's effectiveness because of Jones Group's ADR.
Worry C: The need to create a beta estimate using an unlevered beta.

Question #3 of 76

Question ID: 462931

Assuming MegaFood Market has a required return on equity (ROE) of 13.6% and Strinson Carburetors has a required ROE of 15.3%, what recommendation should Hoyle give her superiors at Janssen regarding each company?

		MegaFood Market	Strinson Carburetors
✗	**A)**	**Buy the company**	**Buy the company**
✓	**B)**	Don't buy the company	Buy the company
✗	**C)**	Don't buy the company	Don't buy the company

Explanation

To determine whether the investments fit Janssen's requirements, we must calculate the weighted average cost of capital. We have the target debt/equity ratio, from which we can derive the debt/capital ratio needed to calculate WACC. Debt/capital = (debt / equity) / (1+ debt / equity)

For MegaFood, the target debt/capital ratio is 25.93%. For Strinson, the target debt/capital ratio is 43.82%.
WACC = [debt / capital × required return on debt × (1 − tax rate)] + (equity / capital) × required return on equity.

MegaFood WACC = [(25.93% × 9% × (1 − 42.8%)] + (1 − 25.93%) × 13.6% = 11.41%.
Strinson WACC = [(43.82% × 6.5% × (1 − 31%)] + (1 − 43.82%) × 15.3% = 10.56%.

For MegaFood, WACC is 11.41%, higher than the Janssen's 11% target. For Strinson, WACC is 10.56%, below the target. Thus, Janssen should buy Strinson, but not MegaFood.

(Study Session 10, LOS 31.g)

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Question ID: 462932

Which of Strinson's actions is *least* helpful in the calculation of required return on equity for Strinson Carburetors?

✓ **A)** **Action C.**
✗ **B)** Action B.
✗ **C)** Action A.

Explanation

Action A is a useful method for calculating beta for private or thinly traded companies. With that estimated beta, Hoyle has all the pieces needed to calculate required return using the capital asset pricing model. Action B reflects the bond-yield plus risk premium method for calculating required return on equity for companies with publicly traded debt. This strategy would provide Hoyle with a target return. The model created in Action C is useful for estimating an equity risk premium. But Hoyle already has an equity risk premium. (Study Session 10, LOS 31.b)

Question #5 of 76

Question ID: 462933

Which of the following is the *best* model for calculating Strinson Carburetors' required return?

✗ **A)** **Fama-French model.**

✗ **B)** Capital asset pricing model.

✓ **C)** Pastor-Stambaugh model.

Explanation

Strinson is not publicly held, and its shares have little liquidity. The Fama-French model is useful for estimating returns, but the Pastor-Stambaugh model adds a liquidity factor to the Fama-French model. As such, the Pastor-Stambaugh model is probably better for a company like Stinson because it takes liquidity into account. The CAPM requires the estimation of beta and is likely to be less accurate than the other models. (Study Session 10, LOS 31.c)

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Question ID: 462934

Hoyle wants to calculate an expected return for Halberd Hardware and Jones Group. She has access to a variety of models, but her *best* option is:

	for Halberd	for Jones
✗ **A)**	**build-up method**	**country spread model**
✗ **B)**	build-up method	capital asset pricing model
✓ **C)**	bond-yield plus risk premium method	capital asset pricing model

Explanation

Both the build-up method and the bond-yield plus risk premium method work for thinly traded companies. But the build-up method relies on historical estimates, so it wouldn't work well for Halberd, which has minimal historical data. Thus, the bond-yield plus risk premium method is the best option. The country spread model is not designed to calculate an expected return, but instead to adjust data from emerging markets for comparison with data from developed markets. The question only provides two options, and the CAPM is the only model that would actually do the required job for Jones. (Study Session 10, LOS 31.c)

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Question ID: 462935

Hoyle wants to use a macroeconomic model to derive equity risk premiums for both Halberd Hardware and Jones Group. Such a model is appropriate for:

✓ **A)** **both Halberd Hardware and Jones Group.**

✗ **B)** Jones Group, but not Halberd Hardware, because macroeconomic models don't work for closely held companies.

✗ **C)** Halberd Hardware, but not Jones Group, because macroeconomic models don't work for nations like South Pittson Island.

Explanation

Macroeconomic models work for any market in which public equities represent a large enough share of the economy that analysts can reasonably infer a relationship between economic factors and asset prices. Since South Pittson Island is known as a tax haven, it is likely that many other companies are domiciled there for the same reason Jones Group is, and the financial industry is a large part of the economy. However, even if we don't want to assume that South Pittson Island's economy is suitable for such models, we have another argument. Jones Group is one of the world's largest consulting companies. Therefore, it is highly likely that it has significant operations in large, developed markets. Macroeconomic models can be constructed to reflect data from those markets - and in fact, any such model should reflect that data.

While Halberd is closely held, that status should not affect a macroeconomic model, which looks at broad factors that affect both public and private companies. We need not have a beta or historical trading data to use such a model. (Study Session 10, LOS 31.c)

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Question ID: 462936

Which of Hoyle's worries about using the CAPM for Jones Group is *most* justified?

- ✗ **A)** **Worry A.**
- ✗ **B)** Worry C.
- ✓ **C)** Worry B.

Explanation

Currency-translation issues are a concern for any company with operations in foreign countries. But the country spread model is designed to adjust results from emerging markets using data from developed markets, assigning the proper amount of extra risk for the emerging market. Most tax havens would not need to be treated as emerging markets. In addition, as one of the world's largest consultancies, Jones Group must do a lot of business in the U.S. and other developed markets. It is unlikely that results from a company like Jones Group would require the adjustments from the country spread model. Regarding beta: Since Jones is publicly traded, there is no need to extrapolate a beta using data from another company. Thus, there is no reason to unlever beta from a benchmark company, then relever it to reflect Jones' financial condition. The biggest concern is the overall effectiveness of the CAPM. The model should work for Jones Group, but it has weaknesses, most importantly its dependence on just one factor. Jones trades on at least two exchanges, and any model depending on just one market index is not going to reflect the whole picture. (Study Session 10, LOS 31.f)

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Question ID: 462895

Which of the following *least* accurately represents one of the primary steps of the equity valuation process described by Pinto, Henry, Robinson, and Stowe?

- ✓ **A)** **Assessing corporate governance.**
- ✗ **B)** Decision making.
- ✗ **C)** Selecting a valuation model.

Explanation

The valuation process described by Pinto, Henry, Robinson, and Stowe consists of 5 steps:

1. Understanding the business.
2. Forecasting company performance.
3. Selecting a valuation model.
4. Complete a valuation.
5. Decision making.

Corporate governance is important, but is not one of the primary steps.

Question #10 of 76

Question ID: 462886

Which of the following is *least likely* a use of equity valuation?

- ✗ A) **Projecting the value of corporate actions.**
- ✓ B) Assessing Corporate governance.
- ✗ C) Issuing fairness opinions.

Explanation

Equity valuation has many uses including stock selection, reading the market, projecting the value of corporate actions, issuing fairness opinions, and valuing private businesses. Equity valuation is not specifically related to corporate governance.

Question #11 of 76

Question ID: 462902

A valuation of a firm based on a review of other firms' price to earnings, price to sales, and price to return on investment ratios is an example of a:

- ✗ A) **broad-based valuation.**
- ✗ B) relative strength valuation.
- ✓ C) relative valuation.

Explanation

An approach using market multiples to establish the value of the subject firm in relation to similar firms is an example of a relative valuation approach.

Question #12 of 76

Question ID: 462950

Joe Bates, CFA, has prepared a schedule of real cash flows for his company's plant expansion. Bates generally uses the weighted average cost of capital to discount such cash flows, but in order to accurately determine the present value of those real cash flows, he should adjust the discount rate to reflect:

- ✗ A) **the company's cost of both debt and equity.**
- ✗ B) expected changes in the market growth rate.
- ✓ C) expected inflation.

Explanation

In the context of cash flows, "real" refers to inflation-adjusted cash flows. The weighted average cost of capital already takes the cost of both debt and equity into account, but this is a nominal, not a real, discount rate. The market's growth rate is rarely relevant to cash flows to the firm and is not part of the WACC calculation.

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Question ID: 462917

Laura's Chocolates, is a maker of nut-based toffees. The company holds shares in one of its suppliers, and wants to know what the holding period return was last year.

January 1 (purchase date)	$40
December 31	$45
Dividend paid (December 31)	$5
Cost of equity	11%
Cost of debt	8%
Debt : equity	1:3

What is the holding period return (ignore taxes)?

✓ **A)** **25.00%.**

✗ **B)** 12.50%.

✗ **C)** 22.50%.

Explanation

$$\frac{[(45 - 40) + 5]}{40} = 25\%$$

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Question ID: 462924

Types of estimates of the equity risk premium are *least likely* to include:

✗ **A)** **ex-ante estimates.**

✗ **B)** macroeconomic model estimates.

✓ **C)** extemporized estimates.

Explanation

There are four types of estimates of the equity risk premium: historical estimates, forward-looking (ex-ante) estimates, macroeconomic model estimates, and survey estimates.

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Question ID: 462923

Currently the market index stands at 1,190.45. Firms in the index are expected to pay cumulative dividends of 35.71 over the coming year. The consensus 5-year earnings growth forecast for these firms is expected to increase to 6.2% up from last year's forecast of 4.5%. The long-term government bond is yielding 5.0%. According to the Gordon growth model, what is the equity risk premium?

✗ **A)** **1.2%.**

✓ **B)** 4.2%.

✗ **C)** 2.5%.

Explanation

Equity risk premium = (35.71 / 1,190.45) + (6.2%) - 5.0% = 4.2%

Questions #16-21 of 76

Marko Larraza recently sold a majority stake in his business, Larraza Loaves, to a national food manufacturer, and has been looking to invest the proceeds in a portfolio of actively managed equities. Larraza hired Alhaadi Wewege, a portfolio manager to help him select appropriate companies for consideration.

Larraza has researched two publicly traded companies that he would like Wewege to analyze for potential inclusion in the portfolio: Generic Gems, a wholesaler of gemstones, and Consolidated Cereals, a breakfast food manufacturer. Larraza has provided Wewege with the following information about the two firms:

Table 1: Valuation Inputs

Company	*Price One Year Ago*	*Current Price*	*One-Year Target Price*	*Past Year's Dividend*	*Expected Dividend Next Year*
Generic Gems	29.00	32.50	35.00	\$0.70	\$0.75
Consolidated Cereals	14.00	14.25	15.00	\$1.00	\$1.25

Based on his knowledge of the market, Wewege believes that the required return for each company should equal the previous year's holding period return on the relevant industry index. The Jewelry & Gemstone index returned 11% last year, while the Food & Beverage index returned 7%.

Larraza questions Wewege's assumption about the appropriate return for Consolidated Cereals. "When I sold my bakery, I justified giving the buyer a discount on the price based on the lack of marketability and lack of liquidity since the shares aren't publicly traded." Wewege counters that the discount on the sale of Larraza Loaves was justified because the purchaser acquired a controlling interest, not because the shares were illiquid.

Wewege also points out that the valuation of Larraza Loaves was made using an asset-based model, which is an example of an absolute valuation model. He points out that using a liquidation value is inappropriate for a going concern. Larraza counters that Larraza Loaves was also valued using a dividend discount model, which is considered a relative valuation model. Larraza argues that a dividend discount model is an appropriate valuation approach for a going concern.

"Graham and Dodd first advanced the idea that the value of a stock could be determined by discounting future dividends," points out Larraza, in justification of a dividend discount approach. Wewege acknowledges that Graham and Dodd's investment valuation approach was the forerunner of the absolute valuation models of today.

Question #16 of 76

Question ID: 462906

Are Wewege and Larraza correct in their statements concerning the price discount on the sale of Larraza Loaves?

Wewege Larraza

✗ **A)**	**Correct**	**Correct**
✓ **B)**	Incorrect	Correct
✗ **C)**	Correct	Incorrect

Explanation

Wewege is incorrect because purchase of a controlling interest justifies a premium, not a discount. Larraza is correct that lack of marketability and lack of liquidity are both justifications for a discount in the value of a position. (Study Session 12, LOS 37.k)

Question #17 of 76

Question ID: 462907

An analyst is performing an equity valuation as part of the planning and execution phase of the portfolio management process. The results will also be useful for:

✓ **A) communication with analysts and investors.**

✗ **B)** benchmarking.

✗ **C)** technical analysis.

Explanation

Communication with analysts and investors is one of the common uses of an equity valuation. Technical analysis and benchmarking do not require equity valuation. (Study Session 10, LOS 30.d)

Question #18 of 76

Question ID: 462908

Are Wewege and Larraza correct in their statements concerning absolute and relative valuation models?

	Wewege	Larraza
✗ **A)**	**Incorrect**	**Incorrect**
✗ **B)**	Correct	Correct
✓ **C)**	Correct	Incorrect

Explanation

Wewege is correct that an asset-based model is an absolute valuation model. Larraza is incorrect because a dividend discount model is also considered an absolute, not a relative, valuation model. (Study Session 10, LOS 30.f)

Question #19 of 76

Question ID: 462909

Are Wewege and Larraza correct in their statements about appropriate valuation approaches for a going concern?

	Wewege	Larraza
✗ **A)**	**Incorrect**	**Correct**
✗ **B)**	Correct	Incorrect

✓ **C)** Correct Correct

Explanation

Wewege is correct that a liquidation valuation is an inappropriate method of valuing a going concern since liquidation value is based on the assumption that the firm will cease operation and its assets will be sold. Larraza is correct that a dividend discount model is an appropriate valuation approach for a going concern since the assumption is that the firm continues operating and the future dividends arise from its continued operations. (Study Session 10, LOS 30.b)

Question #20 of 76

Question ID: 462910

Which of the following quality of earnings issues is *least likely* to be directly addressed in the footnotes to accounting statements and other disclosures?

✗ **A)** **Choice of depreciation and amortization rates.**

✗ **B)** Reclassification of non-operating items as operating income.

✓ **C)** Sustainability of growth.

Explanation

Sustainability of growth is not an issue directly addressed in the footnotes to financial statements, although various disclosures may provide information that has indirect implications for sustainability of growth. Choice of depreciation and amortization rates and reclassification of non-operating items as operating income are both issues of management discretion that may be discerned through a detailed examination of the footnotes. (Study Session 10, LOS 30.e)

Question #21 of 76

Question ID: 462911

Are Wewege and Larraza correct in their statements about Graham and Dodd?

		Wewege	Larraza
✓	**A)**	**Incorrect**	**Incorrect**
✗	**B)**	Correct	Correct
✗	**C)**	Correct	Incorrect

Explanation

Larraza is incorrect because Graham and Dodd determined the value of a security based on an analysis of the firm's income statement and balance sheet. The dividend discount framework was advanced by John Burr Williams. Wewege is incorrect because the financial statement analysis approach put forth by Graham and Dodd is the forerunner of modern relative valuation models. Williams' approach provided the foundation for modern dividend discount and free cash flow models, which are absolute valuation models. (Study Session 10, LOS 33)

Question #22 of 76

Question ID: 462892

Overestimating the growth rate of a firm in using a valuation model would result in a value that is likely to be:

✗ **A)** **can't tell from this information.**

✓ **B)** too high.

✗ **C)** too low.

Explanation

Using an estimate for a firm's growth rate that is too high would overstate the amount of future returns, resulting in a present value that is too high.

Question #23 of 76

Question ID: 462882

Liquidation value is the:

✓ **A)** **cash generated by terminating a business, selling its assets, and repaying liabilities.**

✗ **B)** market value of the total assets less the market value of the total liabilities.

✗ **C)** present value of future cash flow less the possible liquidation cost.

Explanation

Liquidation value is the cash generated by terminating a business, selling all of its assets, and repaying liabilities.

Question #24 of 76

Question ID: 462891

Which of the following would cause an analyst to have concern about a firm's quality of earnings?

✓ **A)** **The gain on the sale of a plant was included in operating earnings.**

✗ **B)** The firm took a write off for a recently impaired asset.

✗ **C)** A firm books sales when orders are shipped.

Explanation

The inclusion of gains from the sale of assets as operating income would cause the analyst to question the quality of the firm's earnings.

Question #25 of 76

Question ID: 462919

In an efficient market, a mutual fund's required return is the same as the:

✓ **A)** **internal rate of return.**

✗ **B)** holding period return.

✗ **C)** net asset value return.

Explanation

The internal rate of return (IRR) is the rate that equates the value of the discounted cash flows to the current price of the security. In an efficient market, where securities are properly priced, the IRR and required return are the same.

Question #26 of 76

Question ID: 462918

To determine the present value of an investment based on a future estimate of the investment's value, an analyst should use the:

- ✗ **A) internal rate of return.**
- ✓ **B)** discount rate.
- ✗ **C)** required return.

Explanation

The discount rate is the rate used to find the present value of an investment.

Question #27 of 76

Question ID: 462889

What are three factors that would make a firm's accounting earnings less of a gauge of future economic performance? Late filings, unusually:

- ✓ **A) high amounts of loans to company insiders, and short tenure of senior management.**
- ✗ **B)** high amounts of loans to company insiders, and long tenure of senior management.
- ✗ **C)** low amounts of loans to company insiders, and short tenure of senior management.

Explanation

Quality of earnings looks at the relationship between accounting earnings and economic profit potential of the firm. An analyst is concerned about anything that would render accounting earnings less useful as a gauge of the firm's future expected economic earnings. Warning signals include late filings, unusually high amounts of loans to company insiders, and short tenure of senior management.

Question #28 of 76

Question ID: 462947

Marina Syltus, chief financial officer of Worcester Water Treatment, wants to know the cost of the company's capital so it can make wiser budgeting decisions. Syltus has assembled the following data:

- Worcester's long-term debt has a market value of $230 million.
- Worcester's shares have a total market value of $782 million.
- The marginal tax rate is 37%.
- The required return on equity is 14.6%.
- Worcester's long-term debt has a weighted average interest rate of 9.4%.

To calculate the weighted average cost of capital, Syltus needs:

- ✓ **A) both the required return on debt and the target debt/equity ratio.**
- ✗ **B)** the target debt/equity ratio.
- ✗ **C)** the required return on debt.

Explanation

The equation for the weighted average cost of capital is as follows:

Market value of debt / market value of debt and equity × required return on debt × (1 − tax rate) + market value of equity / market value of debt and equity × required return on equity.

As such, we need the required return on debt to determine the WACC. However, analysts normally assume debt and equity are at their target ratio to calculate the cost of capital. If the current capital allocation does not match the target weighting, we use the target weighting. Thus, we also need the target weights for debt and equity, which we can derive from a target debt/equity ratio.

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Question ID: 462951

To determine which rate of return to use as a discount rate, an analyst should consider the:

- ✗ **A)** **length of the holding period.**
- ✓ **B)** nature of the cash flows being discounted.
- ✗ **C)** likely return of the stock market over the next year.

Explanation

The discount rate should correspond to the type of cash flow being discounted. The holding period determines how we calculate the present value, but not the discount rate. Expected stock-market returns are a suitable discount rate for some investments, but not all.

Question #30 of 76

Question ID: 462922

Ben Jacobs, CFA, is attempting to calculate a historical equity risk premium. His first estimate uses geometric mean equity returns and long-term bond yields. His second estimate uses arithmetic mean returns and short-term bond yields. The effect of the changes in methodology in the second estimate, relative to the first, will:

- ✓ **A)** **both increase the size of the risk premium.**
- ✗ **B)** have offsetting effects.
- ✗ **C)** both decrease the size of the risk premium.

Explanation

Switching from a geometric mean to an arithmetic mean will increase the mean equity return. All else being equal, that will increase the estimated risk premium. When the yield curve slopes upward, short-term bonds yield less than long-term bonds. Thus, the equity risk premium estimate will be larger when short-term bond rates are used.

Questions #31-33 of 76

Joe Dentice has an opportunity to buy 5% of Gold Star Oil, Inc., a closely held oil company. He wants to value the company so as to be able to make a decision on the fair price to pay for the investment.

Question #31 of 76

Question ID: 462898

List the steps in the top down valuation approach as it is applicable for Gold Star investment. Forecast the growth of:

✗ **A)** **Gold Star, the growth of each firm in the industry, and then the growth of the oil industry.**

✗ **B)** each firm in the oil industry, the growth rate of the oil industry, and the growth rate of the economy.

✓ **C)** the overall economy, growth of the industry, and the growth rate of Gold Star.

Explanation

The top down model for valuation would begin with analysis of the overall economy and the expectation of the growth rate in the economy. Further, the impact of the expected growth rate of the economy on the oil industry needs to be ascertained. The second component is the analysis of the oil industry in which Gold Star operates. That involves the determination of the competitive forces in the industry and the future threats and opportunities faced by the industry. It also determines the variables that determine the future profitability of the entire oil industry. The analyst then forms future expectations of these variables given the expectations about the overall economy. The expectations of variables determining the growth and profitability of the oil industry are then used to determine the expectations of the overall growth of Gold Star. In the company analysis, the analyst reviews the quality of earnings, financial ratios, management and intangibles to ascertain the growth prospects for the company. The analyst then selects an appropriate model to value the company. Assumptions used in the valuation must be clearly spelled out and updated to reflect new information.

Question #32 of 76

Question ID: 462899

Which of the following models would be most suitable to value Gold Star?

✗ **A)** **Relative valuation.**

✗ **B)** Liquidation value.

✓ **C)** Absolute valuation.

Explanation

Absolute valuation models or intrinsic value models such as the dividend growth rate model and the free cash flow model value a company independent of peer valuation. The valuation is based on the present value of cash-flows for the specific company. Relative valuation models such as P/E ratio compare the earnings multiple to that of similar companies to make a judgment about the valuation. If the P/E ratio is higher than peer company P/E ratio, it is said to be overvalued. Conversely, if the P/E ratio is lower than peer company P/E ratio, it is said to be undervalued. Caution should be taken to make sure that peer companies are indeed comparable. For the valuation of Gold Star, absolute valuation would be suitable since it is closely held and hence market valuation is not available.

Question #33 of 76

Question ID: 462900

Which discounts must be taken into account while valuing the investment opportunity? Joe should take into account the:

✗ **A)** **marketability, liquidity, and control premium in the valuation.**

✗ **B)** marketability, liquidity, and majority discounts in the valuation.

✓ **C)** marketability, liquidity, and minority discounts in the valuation.

Explanation

Since Gold Star is closely held, the investment is not easily marketable. Closely linked is the fact that the investment cannot be easily liquidated and the cost of selling the investment needs to be discounted from the value. Finally, since only 5% of the stock is being invested in, the control of the operations of the company still remains with the majority shareholders. This lack of control needs to be quantified and discounted from Gold Star's valuation.

Question #34 of 76

Question ID: 462876

A wise analyst will examine a valuation to determine:

- ✗ **A)** **ways to enhance a client's valuation.**
- ✗ **B)** how well it will be received by the firm's management.
- ✓ **C)** its sensitivity to changes in expectations.

Explanation

The results of valuation models can be very sensitive to changes in the expectations incorporated in the model. Analysis of a valuation's sensitivity to the expectations and a review of the confidence the analyst has in the expectations may lead to the use of a valuation range rather than a pin-point value.

Question #35 of 76

Question ID: 462925

Analyst Charlie Howell, CFA, is trying to calculate the required return on equity for Yazz Jazz, a maker of saxophones. However, Yazz Jazz operates in a country with rapidly changing inflation rates. Which method should Howell use?

- ✗ **A)** **Build-up.**
- ✓ **B)** A multifactor model.
- ✗ **C)** Bond-yield plus risk premium.

Explanation

The build-up method assigns premiums based on company size and other company-specific factors. It is designed for use on closely held companies and does not take inflation changes into account. The bond-yield method adds a risk premium to the yield on the company's publicly traded debt. The bond yields will reflect inflation indirectly, but the model does not easily adjust for inflation changes. For taking rapid inflation changes into account, a multifactor model works the best.

Question #36 of 76

Question ID: 462878

A valuation of a firm based on the current market price of its assets - liabilities is referred to as the firm's:

- ✓ **A)** **liquidation value.**
- ✗ **B)** operating value.
- ✗ **C)** going-concern value.

Explanation

The liquidation value is based on the assumption that the firm will cease to operate and all of its assets will be sold to repay liabilities.

Question #37 of 76

Question ID: 462901

Which of the following two ratios are likely to be used for determining value as a function of company peer benchmarks?

- ✗ **A) Price-to-sales and debt/equity.**
- ✗ **B)** Return on equity and net profit margin.
- ✓ **C)** Price-to-earnings and price-to-book.

Explanation

Relative valuation looks at market-based ratios of comparable companies in the industry. Price-to-sales, price-to-book, price-to-earnings, and price-to-cash flow are examples of ratios used in relative valuation analysis.

Question #38 of 76

Question ID: 462952

Cash flows to the firm should be discounted at the:

- ✓ **A) firm's weighted average cost of capital.**
- ✗ **B)** rate determined by the capital asset pricing model.
- ✗ **C)** market's estimated rate of return.

Explanation

The weighted average cost of capital is the preferred discount rate for cash flows to the firm, as it reflects the cost of both debt and equity.

Question #39 of 76

Question ID: 472533

An analyst is *most likely* to review the footnotes to a firm's financial statements to find information about the firm's:

- ✗ **A) cash flow activities.**
- ✓ **B)** accounting practices.
- ✗ **C)** operation.

Explanation

A number of important disclosures regarding a firm's accounting practices and the basis on which income and expense are recognized are contained in the footnotes to the financial statements. The profit and loss statement provides information on the operation of the firm. The statement of cash flows is the best source of data on a company's cash flow activities such as operating, investing and financing.

Question #40 of 76

Question ID: 462884

Which of the following is NOT a use of asset valuation?

- ✓ **A) Estimating inflation rates.**

- ✗ **B)** Projecting the value of corporate actions.
- ✗ **C)** Issuing fairness opinions.

Explanation

Asset valuation has many uses including stock selection, reading the market, projecting the value of corporate actions, issuing fairness opinions, and valuing private businesses. Asset valuation is not used to project inflation rates.

Question #41 of 76

Question ID: 462949

Jaime Moreno, a new hire at the venture-capital fund Burkhart Partners, has been tasked with assessing the appeal of various potential equity investments. Moreno has been given the weighted average cost of capital (WACC) for each company. To determine the value of each company's equity, Moreno should:

- ✗ **A) calculate the equity value using the WACC, then incorporate the value of debt.**
- ✗ **B)** strip the effects of debt out of the WACC, then calculate the value of equity.
- ✓ **C)** calculate the firm value using the WACC, then strip out the value of debt.

Explanation

WACC is used to value an entire firm. To value the equity, use the WACC to calculate the firm's value, then subtract the market value of its long-term debt.

Question #42 of 76

Question ID: 462944

Candace Elwince is attempting to calculate the required return of Skeun Inc., a machine-tool manufacturer in a small Eastern European country. Elwince has solid data from the German market but is not sure how to account for the exchange-rate risk Skeun investors would face. Her *best* choice for creating a risk premium is the:

- ✗ **A) difference between the inflation rates of both markets.**
- ✗ **B)** Gordon Growth model.
- ✓ **C)** difference between the bond yields of both markets.

Explanation

The country spread model suggests an analyst can approximate the risk premium between a developed market and an emerging market by subtracting the bond yields in the developed market from yields in the emerging market.

Question #43 of 76

Question ID: 462941

Equity analyst Mason Kramer wants to calculate the return on equity for a number of stocks. Kramer values predictive power over all other factors and is in no hurry to finish the work. Which model is Kramer's *best* option?

- ✗ **A) Capital asset pricing.**
- ✗ **B)** Build-up.
- ✓ **C)** Multifactor.

Explanation

Multifactor models are more robust than the other alternatives. They are also more complex, but given Kramer's goals, a multifactor model makes the most sense.

Question #44 of 76

Question ID: 462929

Equity analyst Yasmine Cordova of Substantial Securities is trying to determine the investment appeal of shares of Maxwell Mincemeat, a small food company. Cordova has assembled the following data about the company:

- Internal rate of return: 9.4%.
- Maxwell's 20-year bond yield to maturity: 7.9%.
- Maxwell's two-year bond yield to maturity: 6.1%.
- Treasury bill yield: 3.4%.
- Maxwell's estimated beta: 2.1.
- Maxwell's 20-year bonds are priced at $102.65.
- Maxwell's two-year bonds are priced at $101.47.
- Estimated return of Russell 2000 Index: 12.3%.
- Substantial's credit analyst estimates that Maxwell's equity warrants a premium of 4.9% over its bonds.

Cordova wants to make sure her estimates are accurate, so she decides to calculate the estimated required return in two ways. She opts for the bond-yield plus risk premium method and the capital asset pricing model. To check her work, she wants to compare the estimates derived under each method. The difference between the required returns is *closest* to:

✗ **A) 5.30%.**

✗ **B)** 5.89%.

✓ **C)** 9.29%.

Explanation

The capital asset pricing model uses the following equation:

> Required return = risk-free rate + beta × equity risk premium

To calculate the required return under CAPM, use the Russell 2000 index return, the beta, and the risk-free rate.

> Required return = 3.4% + 2.1 × (12.3% − 3.4%) = 22.09%.

The bond-yield model uses the following equation:

> Required return = yield to maturity on long-term bonds + risk premium.

> Required return = 7.9% + 4.9% = 12.8%.

The difference between the two estimated required returns is 9.29%.

Question #45 of 76

Question ID: 462938

There is a multistep process used to estimate the beta of nonpublic companies. What extra step must be taken to use the process on thinly traded public companies?

- ✗ **A)** **Beta must be reduced using a liquidity factor.**
- ✓ **B)** No extra step must be taken.
- ✗ **C)** Beta must be adjusted to reflect debt and equity levels.

Explanation

The same procedure is used for both nonpublic and thinly traded public companies. Beta is adjusted to reflect debt and equity levels for both types of companies. The procedure for estimating beta for private or thinly traded public companies does not involve a liquidity factor.

Question #46 of 76

Question ID: 462904

A valuation of a firm based on the intrinsic value of the firm's investment characteristics is known as an:

- ✗ **A)** **asset based valuation.**
- ✓ **B)** absolute valuation.
- ✗ **C)** absolution valuation.

Explanation

An absolute valuation approach attempts to determine the value of the firm based on its specific characteristics without regard to the market prices of other firms.

Question #47 of 76

Question ID: 462913

Important considerations for choosing an appropriate approach for valuing a given company are *least likely* to include:

- ✓ **A)** **Is the model consistent with the investor's IPS?**
- ✗ **B)** Is the model appropriate based on the quality and availability of input data?
- ✗ **C)** Is the model suitable given the purpose of the analysis?

Explanation

Important considerations when choosing a valuation model include:
Does the model fit the characteristics of the company?
Is the model suitable given the purpose of the analysis?
Is the model appropriate based on the quality and availability of input data?

Question #48 of 76

Question ID: 462887

An analyst performing an asset valuation to detect investor's expectations about the future value of the variables that affect a stock's price is *most likely* using the valuation for:

- ✗ **A)** **projecting the value of corporate actions.**
- ✓ **B)** reading the market.
- ✗ **C)** generating a fairness opinion.

Explanation

Asset valuation has many uses including stock selection, reading the market, projecting the value of corporate actions, issuing fairness opinions, and valuing private businesses. Reading the market entails detecting investor's expectations about the future value of the variables that affect a stock's price.

Question #49 of 76

Question ID: 462939

In the process of estimating beta for a private company, unlevering the beta calculated for the publicly traded comparable company accomplishes what goal?

- ✓ **A)** **Isolating market risk.**
- ✗ **B)** Establishing a baseline level of leverage.
- ✗ **C)** Improving the accuracy of the estimate in the event that the private company's debt is of low quality.

Explanation

Market risk, also known as systematic risk, is the risk common to all assets within a certain class. Deleveraging the beta strips out the company-specific risk related to the target company's leverage, thereby isolating market risk. Beta calculations do not require a baseline level of leverage. The equation for calculating beta for private companies assumes the company in question has high-grade debt. The deleveraging process will not help if the assumption is incorrect.

Question #50 of 76

Question ID: 462920

The equity risk premium is the difference between:

- ✓ **A)** **the required equity return and the risk-free return.**
- ✗ **B)** estimated equity returns and estimated bond returns.
- ✗ **C)** the estimated equity return and the risk-free return.

Explanation

The equity risk premium reflects the return in excess of the risk-free rate that investors require for holding stocks. It is derived by subtracting the risk-free return from the required return.

Question #51 of 76

Question ID: 462880

A valuation of a firm based on the assumption that the firm will continue to operate is referred to as its:

✗ **A)** **status quo value.**

✗ **B)** operating value.

✓ **C)** going-concern value.

Explanation

The going-concern value is based on the assumption that the firm will continue to operate and the firm's value is the present value of its future dividends.

Question #52 of 76

Question ID: 462943

When attempting to build a risk premium into the required returns of stocks in a developing country, an analyst should use the:

✗ **A)** **country's weighted average cost of capital.**

✓ **B)** country spread model.

✗ **C)** modified Gordon Growth model.

Explanation

The country spread model uses data from a developed market, then adjusts it using the difference between the bond yields for the emerging and developed markets. Neither a modified Gordon Growth model nor a weighted average cost of capital will do this job.

Question #53 of 76

Question ID: 462912

The value of a conglomerate derived using a sum-of-the-parts valuation would *least accurately* be called the:

✓ **A)** **liquidation value.**

✗ **B)** breakup value.

✗ **C)** private market value.

Explanation

Sum-of-the-parts valuation totals the estimated values of each of the company's business divisions as independent going concerns. The value derived using a sum-of-the-parts valuation is also sometimes called the private market value or the breakup value, even when such a restructuring is not necessarily expected.

Question #54 of 76

Question ID: 462874

Valuation models for equities contain estimates of required returns and:

✓ **A)** **expected future cash flows.**

✗ **B)** an assumed continuation of past cash flows.

✗ **C)** known future cash flows.

Explanation

Valuation models used for equities require the analyst to estimate the required return applicable to the investment and to develop an expectation of future cash flows. While cash flows for fixed-income investments are stated, no such definition is available for equities.

Question #55 of 76

Question ID: 462877

How can we account for different valuations for the same firm from several analysts even if they use the same required returns?

- ✗ **A)** **Valuation models contain random errors.**
- ✓ **B)** Valuations are based on the analyst's expectations.
- ✗ **C)** The analysts may be biased with personal opinions about management.

Explanation

Valuation is based on *expectations* of future cash flows rather than known values. Each analyst will build expectations of cash flows from the fundamental data and from other factors, internal and external, that the analyst believes will affect the firm's performance.

Question #56 of 76

Question ID: 462942

Juliann Kellmann, CFA, wants to quickly and simply calculate the expected return of equity in a company with few shares outstanding. She should use:

- ✗ **A)** **the capital asset pricing model.**
- ✗ **B)** a multifactor model.
- ✓ **C)** a build-up model.

Explanation

Build-up models are very simple and apply to closely held companies. CAPM does not work well with such companies. A carefully assembled multifactor model can take liquidity issues into account, but the procedure is far more complex than that of a build-up model.

Question #57 of 76

Question ID: 462879

A comparison between a firm's going-concern valuation and its liquidation value will show that the going-concern value will always be:

- ✗ **A)** **less than the liquidation value.**
- ✗ **B)** greater than the liquidation value.
- ✓ **C)** equal to the present value of the expected continued operation of the firm.

Explanation

It is not possible to state the relationship between the going-concern value and the liquidation value without examining the prospects for the firm and the current value of the assets. The going-concern value is equal to the present value of the expected dividends arising from continued operation.

Question #58 of 76

Question ID: 462885

Minority shareholders often do not have control of the price at which the firm will be sold or merged with another firm. In order to safeguard their interests, minority shareholders will often seek an analyst's opinion of the value of the firm. This opinion is referred to as a:

✓ **A)** **fairness opinion.**

✗ **B)** second opinion.

✗ **C)** minority opinion.

Explanation

Minority shareholders are often dependent upon an analyst's opinion about the fairness of a price to be received. Hence the term *fairness opinion*.

Question #59 of 76

Question ID: 462940

If an analyst uses a build-up model to estimate a stock's return rather than using a multifactor model or the capital asset pricing model, the analyst is probably *least* concerned about:

✗ **A)** **simplicity.**

✓ **B)** timeliness.

✗ **C)** accuracy.

Explanation

The build-up model typically uses historical values as estimates. Historical data may no longer be relevant, so a user of the build-up model is probably not concerned with timeliness.

Question #60 of 76

Question ID: 462903

A valuation of a firm based on the comparison of the firm with the market value of other firms is known as a:

✗ **A)** **comparison valuation.**

✓ **B)** relative valuation.

✗ **C)** peer group valuation.

Explanation

A relative valuation is a valuation based on comparing the firm to other firms with similar characteristics. Market multiples are commonly used as the basis of relative valuations.

Question #61 of 76

Question ID: 462915

One justification for using multiple models to estimate firm value is:

✓ **A)** **the ability to examine differences in estimated values can reveal how a model's assumptions and the perspective of the analysis are affecting the estimated values.**

✗ **B)** the ability to learn from each successive model and to make improvements.

✗ **C)** the ability to streamline and economize the development process through repeated use of the same generic baseline.

Explanation

One thing to remember with respect to choice of a valuation model is that the analyst does not have to consider only one. Using multiple models and examining differences in estimated values can reveal how a model's assumptions and the perspective of the analysis are affecting the estimated values.

Question #62 of 76

Question ID: 462875

The goal of asset valuation, based on the expected future cash flows of an asset, is to establish an asset's:

✓ **A)** **intrinsic value.**

✗ **B)** relative value.

✗ **C)** market value.

Explanation

Asset valuation based on the expected future cash flows is utilized to estimate an asset's intrinsic value, or the value derived from the asset's investment characteristics.

Question #63 of 76

Question ID: 462948

For an analyst seeking to value an entire company, the *best* tool is the:

✓ **A)** **weighted average cost of capital.**

✗ **B)** capital asset pricing model.

✗ **C)** Pastor-Stambaugh model.

Explanation

The capital asset pricing model and Pastor-Stambaugh models are used to calculate the required return on equity. The weighted average cost of capital is used to value an entire company.

Question #64 of 76

Question ID: 462926

Analyst Charlie Howell, CFA, has constructed two models for determining the required return on equity for Yazz Jazz, a saxophone maker. One takes the company's size into account, the other takes the shares' liquidity into account. Which of the following pairs of equity-return models require the use of:

Size	Liquidity

✗ A)	**Build-up**	**Fama-French**
✓ B)	Build-up	Pastor-Stambaugh
✗ C)	Capital asset pricing model	Fama-French

Explanation

The build-up method takes into account a company's size and is usually applied to closely held companies for which beta is not available. The Pastor-Stambaugh method is a modified version of the Fama-French factor model that considers liquidity.

Question #65 of 76

Question ID: 462883

For an analyst valuing public equities, the relevant concept of value is *most likely* to be:

✗ A) **fair market value.**

✗ B) orderly liquidation value.

✓ C) intrinsic value.

Explanation

For an analyst valuing public equities, the most relevant definition of value is generally intrinsic value. A value based on a going-concern assumption, rather than a liquidation assumption, is the appropriate choice for a company that will continue to produce and sell goods. Fair market value is the most relevant definition of value to use in an agreement between the owners of a private business regarding the price at which the owners can sell their ownership interest.

Question #66 of 76

Question ID: 462945

The country risk rating model:

✓ A) **determines a risk premium for an emerging market.**

✗ B) depends on forecasts of exchange rates.

✗ C) determines a risk premium for any foreign market.

Explanation

The country risk rating model begins with a model from a developed country, then modifies that model with inputs from an emerging market to derive a risk premium for the emerging market. Forecasts of exchange rates may well be part of the model, but they are not a requirement.

Question #67 of 76

Question ID: 462881

The present value of expected future cash flows is the firm's:

✓ A) **going-concern value.**

✗ B) terminal value.

✗ **C)** liquidation value.

Explanation

Going-concern value is the present worth of expected future cash flows generated by a business.

Question #68 of 76

Question ID: 462914

An ownership perspective can be important for an analyst determining the value of a share position. A controlling interest suggests the most appropriate model is a:

✗ **A)** **time series model.**

✗ **B)** dividend discount model.

✓ **C)** cash flow model.

Explanation

A controlling interest suggests a cash flow model may be most appropriate since the controlling interest would allow the purchaser to set dividend policy.

Question #69 of 76

Question ID: 462927

Senior analyst James Matin is instructing a room full of new hires in the finer points of equity valuation. He makes two statements:

Statement 1:	"When the return you expect for a stock doesn't match the required return, make sure you calculate a convergence yield and build that into your valuation model."
Statement 2:	"When you estimate the equity return of a thinly traded company, the Pastor-Stambaugh model is a better option than the Fama-French model."

Do the statements represent good advice?

	Statement 1	Statement 2
✗ **A)**	**Yes**	**No**
✓ **B)**	No	Yes
✗ **C)**	Yes	Yes

Explanation

Statement 1 is not good advice because in some cases market inefficiencies will prevent the price from converging with intrinsic value. As such, Matin's advice is not sound. Statement 2 is good advice, as the Pastor-Stambaugh model adds a liquidity factor to the traditional Fama-French model. Such a liquidity factor would be useful in the analysis of a thinly traded stock.

Question #70 of 76

Question ID: 462937

Adjusted beta for public companies compensates for:

✓ **A)** **drift.**

✗ **B)** leverage.

✗ **C)** changes in the market's growth rate.

Explanation

An adjusted beta is a weighted average of the estimated beta and either 1.0 (the average for all stocks) or a peer mean (the beta of similar firms). The objective of an adjusted beta measure is to compensate for beta drift, or the tendency of beta to revert to 1.0 (or the industry average).

Question #71 of 76

Question ID: 462890

Notes to financial statements contain:

✗ **A)** **little useful information for the analyst relative to the actual financial statements.**

✗ **B)** statements by auditors.

✓ **C)** important information about the firm's accounting practices and basis of presentation.

Explanation

A number of important disclosures regarding a firm's accounting practices and the basis on which income and expense are recognized are contained in the footnotes to the financial statements.

Question #72 of 76

Question ID: 462894

Financial Analyst Davey Jarvis, CFA, is evaluating Laura's Chocolates, Inc., which processes nut-based toffee for world-wide distribution. Which of the following steps is Jarvis *most likely* to take as part of the top-down valuation process?

✗ **A)** **Evaluate price performance on an ongoing basis.**

✗ **B)** Perform momentum-based technical analysis.

✓ **C)** Learn / understand the business.

Explanation

The valuation process consists of 5 steps:

1. Understanding the business.
2. Forecasting company performance.
3. Selecting a valuation model.
4. Complete the valuation.
5. Decision making.

Question #73 of 76

Question ID: 462893

When using a firm's reported financial information as inputs into a security valuation model, it is important for the analyst to have confidence that the reported information accurately reflects the operations of the firm. This concern is referred to as:

✓ **A) the quality of earnings.**

✗ **B)** a confidence factor.

✗ **C)** the transparency of earnings.

Explanation

The accuracy and level of detail disclosed in financial reports is referred to as the quality of earnings. Efforts of management to obscure the true operating performance of the firm can leave an analyst with little confidence in the security valuation.

Question #74 of 76

Question ID: 462896

Disclosures of accounting practices and basis are often made in what part of a firm's financial reports?

✗ **A) Income statement.**

✗ **B)** Cash flow statement.

✓ **C)** Footnotes to the financial statements.

Explanation

A number of important disclosures regarding a firm's accounting practices and the basis on which income and expense are recognized are contained in the footnotes to the financial statements.

Question #75 of 76

Question ID: 462916

If an investor had determined that an asset's market price was too high, (implying that it will soon fall) the expected holding period return (HPR) would be:

✗ **A) equal to the required return.**

✓ **B)** lower than the required return.

✗ **C)** higher than the required return.

Explanation

If the investor determined that the asset's price was too high, then the expected HPR would be less than the required return, and the asset would have a negative alpha.

Question #76 of 76

Question ID: 462921

An analyst attempting to derive the equity risk premium for a stock starting from the required return for that stock would find which of the following statistics *least* useful?

✓ **A) The stock's estimated return.**

✗ **B)** The stock's beta.

✗ **C)** Historical 10-year Treasury bond rates.

Explanation

The required return for a stock is equal to the risk-free return plus beta times the equity risk premium. An analyst starting from the required return would need beta and a risk-free rate. Historical 10-year T-bond rates can be used as an estimate of the risk-free rate. Since the analyst is starting with the required return, estimated returns are not needed.