FIN 366: INVESTMENTS
BRIEFING

Chapters 13: Equity Valuation

The **intrinsic value** of a share is the *present value* of all the share's payments to the investor, including dividends and proceeds from the sale of the stock. Often, the CAPM will be used to compute this discount rate to obtain the present value. A stock with an intrinsic value equal to the price it trades at is **fairly priced**. A stock with an intrinsic value less than (greater than) its price is **overvalued** (**undervalued**). An investor might consider buying undervalued stocks and shorting overvalued stocks if they believe the stock will eventually reach its intrinsic value. The **dividend discount model** assumes that the intrinsic value of a share equals the present value of its future dividends. Given that some firms do not pay dividends, we can use the **free cash flow to equity model** that discounts the cash flows to which equity holders are entitled to obtain the intrinsic value of a share. Investors can also do **valuation by comparables**, or determine how certain ratios of a stock compare to its competitors or industry averages. The **P/E Ratio** is the price per share of the company's share divided by its net income or earnings per share. Companies with a low P/E ratio are considered **value stocks** while firms with high P/E ratios are considered **growth stocks**. These terms "value" and "growth" may also refer to different ratios (such as book-to-market ratios.) The **PEG Ratio** is the "price to earnings growth" ratio, or the P/E ratio divided by the expected earnings per share growth rate. A PEG under 1 may be considered undervalued while a PEG over 1 may be considered overvalued. These ratios are estimates and do not consistently identify alpha-generating trading strategies. The **return on assets (ROA)** and **return on equity (ROE)** of a firm provide measures of profitability and a firm's profits relative to its equity. The **ROE** may be decomposed in a process known as **DuPont analysis**, which separately shows the profit margin, asset turnover, and leverage of the firm. The net income or **EBITDA** (earnings before interest taxes depreciation, and amortization) can be influenced by firms through **earnings management**. This occurs when a firm takes advantage of flexibility in accounting rules to manipulate the apparent profitability of the firm.