FIN 366: Investments
Critical Thinking & Conceptual Questions

Chapter 13:

1. What does the *intrinsic* value of an equity share represent?
2. How should the relationship of the intrinsic value and the stock's price inform our investing decisions?
3. Why would it make sense to buy a share that is "undervalued" or short a share that is "overvalued"? What is our expectation for an undervalued stock's price in the future? What is our expectation for an overvalued stock's price in the future?
4. In what way are the DDM and FCFE models similar in their methodology?
5. Why do we use the CAPM as our discount rate?
6. We can determine the value of a share by taking the present value of an indefinite series of dividends. If we do this, why don't we need to know what the stock price is in the future?
7. A younger firm has experienced a high rate of dividend growth recently, though this is expected to fall to a steadier rate in the future. Do you think a (1) dividends over a discrete period model, (2) constant growth model, or (3) multistage growth model of the DDM would be best to value this company?
8. A mature firm has a history of steady dividends over the past several years. Do you think the (1) dividends over a discrete period model, (2) constant growth model, or (3) multistage growth model of the DDM would be best to value this company?
9. In the multistage growth model, we may substitute the constant growth formula as the price of the stock P_H in the future. Why do we do this?
10. The constant growth DDM requires that k be greater than g. Why? What would happen if k were less than g?
11. Why do we discount *free cash flow* to equity holders instead of a firm's earnings or net income when determining the intrinsic value of a share?
12. Why do we "add back" the depreciation expense when calculating the free cash flow to equity holders?

13. When is the DDM model appropriate relative to the FCFE model?
14. By the DDM and FCFE valuation methods, will the intrinsic value of a share increase or decrease in each of the following situations (assume everything else held constant):
    a. Forecasted dividends increase
    b. Forecasted free cash flow to equity holders increases
    c. k increases
    d. You forecast a higher P_H
    e. You forecast a higher g
15. What are examples of value stocks? Growth stocks? How do we identify and classify stocks as either value or growth?
16. Why would an investor be willing to pay $150 for a share if the company's earnings per share last quarter was only $25?
17. The P/E ratio relies on the earnings per share. How might EPS be manipulated?
18. A firm reports an EPS of $2.50, but they didn't include a large "restructuring charge" in their computation of the earnings. If they had included this "restructuring charge", what would happen to the EPS? What would happen to their P/E ratio (assuming the price per share is held constant)?
19. A firm "repurchases" some of its shares on the open market, reducing the number of shares outstanding from 10 million to 8 million. What happens to this firm's EPS, everything else held constant? What happens to the P/E ratio?
20. How might we determine if a firm is engaging in inappropriate earnings management?
21. Why are P/E ratios, PEG ratios, ROA, and ROE imperfect measures of a firm's value?
22. Several ratios consider "book" values in their computation. What is "book" value and how does it differ from the "market" value?
23. Why is DuPont analysis useful when interpreting a firm's ROE?
24. How do we determine if a ratio or valuation measure is at an acceptable level for the firm?
25. Why does the liquidation value not represent an appropriate measure of a firm's value in most circumstances?