Common Stock Valuation

Chapter 6

Security Analysis: Be Careful Out There

Fundamental analysis
Examination of a firm’s accounting statements and other financial and economic information to assess the economic value of a company’s stock.

• The basic idea is to identify “undervalued” stocks to buy and “overvalued” stocks to sell.
• In practice however, such stocks may in fact be correctly priced for reasons not immediately apparent to the analyst.

Growth Rates

• Know the Dividend Discount Models (constant growth, constant perpetual growth, 2-stage, etc)

• The growth rate in dividends (g) can be estimated in a number of ways.
  ❶ Using the company’s historical average growth rate.
  ❷ Using an industry median or average growth rate.
  ❸ Using the sustainable growth rate.

The Dividend Discount Model (growth)

Sustainable growth rate = ROE × Retention ratio

Return on equity (ROE) = Net income / Equity
Retention ratio = 1 – Payout ratio

Price Ratio Analysis

• Price-earnings ratio (P/E ratio)
  – Current stock price divided by annual earnings per share (EPS).

• Earnings yield
  – Inverse of the P/E ratio: earnings divided by price (E/P).

• High-P/E stocks are often referred to as growth stocks, while low-P/E stocks are often referred to as value stocks.

Price Ratio Analysis

• Price-cash flow ratio (P/CF ratio)
  – Current stock price divided by current cash flow per share.
  – In this context, cash flow is usually taken to be net income plus depreciation.

• Most analysts agree that in examining a company’s financial performance, cash flow can be more informative than net income.

• Earnings and cash flows that are far from each other may be a signal of poor quality earnings.
<table>
<thead>
<tr>
<th>Price Ratio Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Price-sales ratio (P/S ratio)</strong></td>
</tr>
<tr>
<td>- Current stock price divided by annual sales per share.</td>
</tr>
<tr>
<td>- A high P/S ratio suggests high sales growth, while a low P/S ratio suggests sluggish sales growth.</td>
</tr>
<tr>
<td><strong>Price-book ratio (P/B ratio)</strong></td>
</tr>
<tr>
<td>- Market value of a company’s common stock divided by its book (accounting) value of equity.</td>
</tr>
<tr>
<td>- A ratio bigger than 1.0 indicates that the firm is creating value for its stockholders.</td>
</tr>
</tbody>
</table>