

Question 1

L2EQ-TBX101-1502

LOS: LOS-7890

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: easy

Residual income models are best described as which of the following types of valuation process?

- ☒ Absolute.
- ☐ Asset-based.
- ☐ Relative.

Rationale

This Answer is Correct

Residual income models are based on accounting earnings in excess of the opportunity cost of generating those earnings and valuing the company as the current book value plus the present value of residual income. As such, residual income models are absolute valuation models.

Question 2

L2R29TB-AC023-1512

LOS: LOS-7890

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

Companies A and B operate in the same industry. Using only the data below, which company is the *most* attractively valued on an absolute value basis?

| | Company A | Company B |
|-------------------------|-----------|-----------|
| P/E | 17.3 | 14.9 |
| Enterprise value/EBITDA | 4.2 | 2.5 |

- ☐ Company A.
- ☐ Company B.
- ☒ Cannot be determined based on data provided.

Rationale

Company A.

Using relative valuation methods, Company B is more attractive. But, the question was asking which was more attractive on an absolute valuation basis. No data is provided to answer which is more attractive based on absolute valuation and it is not appropriate to assume that the attractiveness based on relative valuations is an indication of the attractiveness based on absolute valuations.

Rationale

Company B.

Using relative valuation methods, Company B is more attractive. But, the question was asking which was more attractive on an absolute valuation basis. No data is provided to answer which is more attractive based on absolute valuation and it is not appropriate to assume that the attractiveness based on relative valuations is an indication of the attractiveness based on absolute valuations.

Rationale

Cannot be determined based on data provided.

Using relative valuation methods, Company B is more attractive. But, the question was asking which was more attractive on an absolute valuation basis. No data is provided to answer which is more attractive based on absolute valuation and it is not appropriate to assume that the attractiveness based on relative valuations is an indication of the attractiveness based on absolute valuations.

Question 3

L2R29TB-AC021-1512

LOS: LOS-7880

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

Kirt Jones, an analyst, plans to review Time Warner Cable's historical strategy and execution in order to better understand the business. To do this, he should *most likely* start out by:

- ☒ reading past annual reports and filings.
- ☐ attempting to interview senior management.
- ☐ extrapolating past performance into the future.

Rationale

☒ **reading past annual reports and filings.**

To understand a company's business, an analyst should review how well the company has carried out its strategy in the past in order to assess its prospects for future strategic execution. Jones should start by reading historical financial reports.

Rationale

☐ **attempting to interview senior management.**

To understand a company's business, an analyst should review how well the company has carried out its strategy in the past in order to assess its prospects for future strategic execution. Jones should start by reading historical financial reports.

Rationale

☐ **extrapolating past performance into the future.**

To understand a company's business, an analyst should review how well the company has carried out its strategy in the past in order to assess its prospects for future strategic execution. Jones should start by reading historical financial reports.

Question 4

L2EQ-TBB201-1412

LOS: LOS-7870

Lesson Reference: Lesson 1: Value Definitions and Valuation Applications

Difficulty: medium

Neil Viebig, CFA, is a fixed-income analyst who is considering moving into the equity analysis side of his firm's business. He meets with Thorston Brealey, CFA, an equity analyst, to find out a little more about the applications of equity valuation. During the course of their meeting, Brealey makes the following two statements:

Statement 1:

“Equity valuation has a wide variety of applications, from individual stock selection to evaluating corporate event such as mergers, spin-offs, or IPOs.”

Statement 2:

“An issue with equity valuation is the number of inputs required to carry out the valuation. If one of the inputs to the valuation process relating to the future performance of the company is missing, it is impossible to carry out any application of equity valuation techniques.”

How many of Brealey's comments are likely to be correct?

- ☐ None.
- ☒ One.
- ☐ Two.

Rationale

This Answer is Correct

Statement 1 is true; all the listed applications are genuine applications of equity valuation. Statement 2 is not true—an analyst can extract current market expectations of a company's future performance from a valuation model by solving for which value of the fundamental of interest gives a model value equal to the current actual market price of the shares.

Question 5

L2EQ-TB0002-1412

LOS: LOS-7850

Lesson Reference: Lesson 1: Value Definitions and Valuation Applications

Difficulty: medium

Bob Bernard, CFA, is an equity analyst who has been asked to review the equity valuation process at his firm. In particular, the investment committee of the firm has requested that Bernard explain the concept of going-concern value and liquidation value. Bernard makes the following statement to the committee: "Going-concern value for a company makes the assumption that the company will continue its business activities into the foreseeable future. Liquidation value is the value of the company if it were dissolved and its assets sold individually. The focus of valuation models should be the liquidation value since this will be a conservative estimate of value which is usually less than the going-concern value." Bernard's statement is:

- ☐ Correct.
- ☐ Incorrect since going-concern value will usually be less than liquidation value.
- ☒ Incorrect since models should focus on going-concern value to better reflect the economic value of the company.

Rationale

This Answer is Correct

The definitions of going-concern value and liquidation value are correct. Valuation models should be based on going-concern value since the assumption is that the company will keep operating into the foreseeable future.

Question 6

L2R29TB-AC024-1512

LOS: LOS-7890

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

Which of the following statements is *most* accurate? Relative valuation models:

- ☐ are not useful when cash flows are unpredictable.
- ☒ are preferred when financial data is difficult to obtain.
- ☐ cannot be used in situations where both stocks being compared are overvalued.

Rationale

 **are not useful when cash flows are unpredictable.**

Relative valuation models are more appropriate than absolute valuation models in situations where financial and operating information are not accurate or available.

Rationale

 **are preferred when financial data is difficult to obtain.**

Relative valuation models are more appropriate than absolute valuation models in situations where financial and operating information are not accurate or available.

Rationale

 **cannot be used in situations where both stocks being compared are overvalued.**

Relative valuation models are more appropriate than absolute valuation models in situations where financial and operating information are not accurate or available.

Question 7

L200-PQ0021-1412

LOS: LOS-7850

Lesson Reference: Lesson 1: Value Definitions and Valuation Applications

Difficulty: medium

Sarah is an equity analyst who follows Eastern Railroad and is researching the possibility of a merger/acquisition with Western Railroad and potential cash flows if this occurs. What application of equity valuations is she *most* likely using?

- ☐ Inferring market expectations
- ☐ Evaluating business strategies and models
- ☒ Evaluating corporate events

Rationale

This Answer is Correct

Corporate events such as mergers and acquisitions have an impact on a company's future cash flows. Analysts use valuation tools to evaluate the impact of such events on the value of equity or the appropriateness of a given merger/acquisition.

Question 8

L2R29TB-AC018-1512

LOS: LOS-7860

Lesson Reference: Lesson 1: Value Definitions and Valuation Applications

Difficulty: medium

A price agreed to by a willing buyer and seller, both of whom are acting with free will and all available information, is *most likely* a:

- ☒ fair market value.
- ☐ investment value.
- ☐ break-up value.

Rationale

☒ **fair market value.**

A fair market value is defined in the question. One might also think the answer could be an investment value, but that term applies when an investment is worth more than fair market value to a particular buyer.

Rationale

☐ **investment value.**

A fair market value is defined in the question. One might also think the answer could be an investment value, but that term applies when an investment is worth more than fair market value to a particular buyer.

Rationale

☐ **break-up value.**

A fair market value is defined in the question. One might also think the answer could be an investment value, but that term applies when an investment is worth more than fair market value to a particular buyer.

Question 9

L2CF-PQ2804-1411

LOS: LOS-7900

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

Which of the following is *least likely* a reason for applying conglomerate discounts?

- ☐ A lack of focus
- ☒ Efficiencies in allocation of capital across business divisions
- ☐ Endogenous factors

Rationale

This Answer is Correct

Discounts should be applied when valuing conglomerates due to potential inefficiencies in allocation of capital across business divisions.

Question 10

L2R29TB-AC028-1512

LOS: LOS-7870

Lesson Reference: Lesson 1: Value Definitions and Valuation Applications

Difficulty: medium

In addition to stock selection, equity valuations are also useful for:

- ☒ executive compensation plans.
- ☐ financial statement analysis.
- ☐ valuing derivatives.

Rationale

☒ **executive compensation plans.**

Executive compensation plans that include share-based compensation such as restricted stock would require a valuation method. Equity valuations are also useful in deducing market expectations, appraising corporate events, writing fairness opinions, assessing business strategies, and valuing private companies.

Rationale

☐ **financial statement analysis.**

Executive compensation plans that include share-based compensation such as restricted stock would require a valuation method. Equity valuations are also useful in deducing market expectations, appraising corporate events, writing fairness opinions, assessing business strategies, and valuing private companies.

Rationale

☐ **valuing derivatives.**

Executive compensation plans that include share-based compensation such as restricted stock would require a valuation method. Equity valuations are also useful in deducing market expectations, appraising corporate events, writing fairness opinions, assessing business strategies, and valuing private companies.

Question 11

L2R29TB-AC029-1512

LOS: LOS-7880

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

Which of the following statements *most accurately* describes a force affecting industry profitability?

- ☐ Attracting new entrants expands the “pie” and thus increases profitability.
- ☒ When there are many suppliers of product inputs, profitability is higher.
- ☐ Increasing the number of buyers decreases profitability.

Rationale

✗ Attracting new entrants expands the “pie” and thus increases profitability.

When there are a large number of input suppliers, they lack the ability to increase their component prices. Thus, the producer of the final product enjoys higher profitability than if suppliers were fewer.

Rationale

✓ When there are many suppliers of product inputs, profitability is higher.

When there are a large number of input suppliers, they lack the ability to increase their component prices. Thus, the producer of the final product enjoys higher profitability than if suppliers were fewer.

Rationale

✗ Increasing the number of buyers decreases profitability.

When there are a large number of input suppliers, they lack the ability to increase their component prices. Thus, the producer of the final product enjoys higher profitability than if suppliers were fewer.

Question 12

L2R29TB-AC017-1512

LOS: LOS-7870

Lesson Reference: Lesson 1: Value Definitions and Valuation Applications

Difficulty: medium

To consistently select stocks which outperform the market, an investor *most likely* must:

- ☐ have the patience to weather temporary market turmoil.
- ☒ forecast inputs better than the overall market does.
- ☐ become adept in the use of a particular model.

Rationale

 **have the patience to weather temporary market turmoil.**

Investors who are successful over the long run routinely make superior predictions of model inputs. The choice of model is also important.

Rationale

 **forecast inputs better than the overall market does.**

Investors who are successful over the long run routinely make superior predictions of model inputs. The choice of model is also important.

Rationale

 **become adept in the use of a particular model.**

Investors who are successful over the long run routinely make superior predictions of model inputs. The choice of model is also important.

Question 13

L2R29TB-AC009-1512

LOS: LOS-7880

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

Analyst Katherine Bryson is considering recommending the stock of Moosewood, a regional coffee shop chain. She should *most likely* begin her research by examining:

- ☐ minimum wage pressures.
- ☒ Moosewood's market share.
- ☐ retail rental rates in relevant markets.

Rationale

minimum wage pressures.

To learn about a business, an analyst should research industry dynamics, as well as the company's competitive position and strategy. Knowing Moosewood's market share percentage, and whether it is rising or falling, is valuable in understanding its competitive position.

Rationale

Moosewood's market share.

To learn about a business, an analyst should research industry dynamics, as well as the company's competitive position and strategy. Knowing Moosewood's market share percentage, and whether it is rising or falling, is valuable in understanding its competitive position.

Rationale

retail rental rates in relevant markets.

To learn about a business, an analyst should research industry dynamics, as well as the company's competitive position and strategy. Knowing Moosewood's market share percentage, and whether it is rising or falling, is valuable in understanding its competitive position.

Question 14

L2CF-PQ2802-1411

LOS: LOS-7890

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

Which of the following valuation models is *most likely* a relative valuation model?

- ☒ Enterprise multiples
- ☐ Asset-based valuation models
- ☐ Dividend discount models

Rationale

This Answer is Correct

Enterprise multiples are examples of relative valuation models. Dividend discount models and asset-based valuation models are absolute valuation models.

Question 15

L2R29TB-AC013-1512

LOS: LOS-7910

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

Famous Brothers, a publicly-traded movie production company, has had a volatile earnings history for several reasons. Some movies and years were highly profitable, but in some years the company's films did poorly and the company lost money. An analyst attempting to calculate a price target for Famous Brothers *most likely* will have difficulty due to:

- ☒ her lack of confidence in predicting Famous Brothers' future film successes.
- ☐ an increasing influx of films made by international movie studios.
- ☐ a shortage of reliable data.

Rationale

This Answer is Correct

The analyst will most likely find it difficult to predict the success of future movies when calculating a target price due to the potential volatility of earnings.

Question 16

L2R29TB-AC020-1512

LOS: LOS-7880

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

Google Inc. has created a form of computer-embedded eyewear known as Google Glass. The competitive strategy behind this innovation could *most likely* be categorized in Porter's model as:

- ☐ cost leadership.
- ☐ differentiation.
- ☒ focus.

Rationale

cost leadership.

Porter identifies the three generic corporate strategies given as answer choices for companies who excel. Focus is applying either cost leadership or differentiation within a particular division of an industry. Google Glass would be an example of differentiation focus.

Rationale

differentiation.

Porter identifies the three generic corporate strategies given as answer choices for companies who excel. Focus is applying either cost leadership or differentiation within a particular division of an industry. Google Glass would be an example of differentiation focus.

Rationale

focus.

Porter identifies the three generic corporate strategies given as answer choices for companies who excel. Focus is applying either cost leadership or differentiation within a particular division of an industry. Google Glass would be an example of differentiation focus.

Question 17

L2CF-PQ2803-1411

LOS: LOS-7910

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

Publicly-traded stocks that have low market volumes should *most likely* be discounted to reflect:

- ☒ Lack of liquidity
- ☐ Lack of marketability
- ☐ Lack of liquidity and lack of marketability

Rationale

This Answer is Correct

Publicly-traded stocks that have low market volumes should most likely be discounted to reflect lack of liquidity. Since they are traded publicly, there is no need for a discount for lack of marketability.

Question 18

L2R29TB-AC010-1512

LOS: LOS-7890

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

Investor Clare Tobin has access to a wealth of brokerage research reports through the investment company which holds her IRA. She is considering the purchase of United Technologies Corp. (NYSE: UTX). Tobin read one research report that derived a target price based on an asset-based calculation. A second report derived a target price based on a dividend discount model. Both analysts' predicted values are examples of:

- ☒ absolute value.
- ☐ relative value.
- ☐ comparable value.

Rationale

☒ **absolute value.**

Present value models, such as the dividend discount model, and asset based valuations are both absolute value models. Absolute value models produce an estimated value, which is a price that can then be compared to the market price to assess attractiveness.

Rationale

☒ **relative value.**

Present value models, such as the dividend discount model, and asset based valuations are both absolute value models. Absolute value models produce an estimated value, which is a price that can then be compared to the market price to assess attractiveness.

Rationale

☒ **comparable value.**

Present value models, such as the dividend discount model, and asset based valuations are both absolute value models. Absolute value models produce an estimated value, which is a price that can then be compared to the market price to assess attractiveness.

Question 19

L2R29TB-AC012-1512

LOS: LOS-7900

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

Two large U.S. companies both have a large number of business segments. Company A's portfolio of business units is much more diverse than that of Company B. When comparing their sum-of-the-parts valuations, Company A trades at a significant discount relative to Company B. This is *most likely* because Company A:

- ☐ lacks strategic leadership.
- ☐ employs a higher-cost labor force.
- ☒ inefficiently allocates its investment capital among units.

Rationale

 **lacks strategic leadership.**

Conglomerate discounts occur for three possible reasons. One of those reasons is inefficient allocation of investment capital among the company's various segments. Such poor allocation can diminish shareholder value.

Rationale

 **employs a higher-cost labor force.**

Conglomerate discounts occur for three possible reasons. One of those reasons is inefficient allocation of investment capital among the company's various segments. Such poor allocation can diminish shareholder value.

Rationale

 **inefficiently allocates its investment capital among units.**

Conglomerate discounts occur for three possible reasons. One of those reasons is inefficient allocation of investment capital among the company's various segments. Such poor allocation can diminish shareholder value.

Question 20

L2R29TB-AC007-1512

LOS: LOS-7840

Lesson Reference: Lesson 1: Value Definitions and Valuation Applications

Difficulty: medium

Perceived mispricings arise in the computation of:

- ☐ market prices.
- ☒ analyst estimates.
- ☐ conglomerate discounts.

Rationale

market prices.

A perceived mispricing is the difference between an analyst's estimate of intrinsic value and market price. This difference can be further broken down into two components: the difference between the intrinsic value and the market price, and the difference between an analyst's estimate and intrinsic value.

Rationale

analyst estimates.

A perceived mispricing is the difference between an analyst's estimate of intrinsic value and market price. This difference can be further broken down into two components: the difference between the intrinsic value and the market price, and the difference between an analyst's estimate and intrinsic value.

Rationale

conglomerate discounts.

A perceived mispricing is the difference between an analyst's estimate of intrinsic value and market price. This difference can be further broken down into two components: the difference between the intrinsic value and the market price, and the difference between an analyst's estimate and intrinsic value.

Question 21

L2R29TB-AC015-1512

LOS: LOS-7850

Lesson Reference: Lesson 1: Value Definitions and Valuation Applications

Difficulty: medium

The assets and operating units of a company are being liquidated. The company's owners will *most likely* obtain the greatest value at the auction if:

- ☐ buyers seek to retain senior management.
- ☒ the assets can be sold in an orderly fashion.
- ☐ multiple operating units are purchased by the same buyer.

Rationale

 **buyers seek to retain senior management.**

The company's units are being sold at auction, thus the company is being liquidated. Assets liquidated in an orderly fashion tend to yield better prices than those which must be sold quickly.

Rationale

 **the assets can be sold in an orderly fashion.**

The company's units are being sold at auction, thus the company is being liquidated. Assets liquidated in an orderly fashion tend to yield better prices than those which must be sold quickly.

Rationale

 **multiple operating units are purchased by the same buyer.**

The company's units are being sold at auction, thus the company is being liquidated. Assets liquidated in an orderly fashion tend to yield better prices than those which must be sold quickly.

Question 22

L2R29TB-ITEMSET-AC004-1512

LOS: LOS-7880

LOS: LOS-7910

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

Use the following information to answer the next 3 questions:

Thomas Barbee, CFA, has just been hired as an analyst by Alexander and Alexander, a firm that offers a variety of funds. In his training, Barbee is instructed on Alexander and Alexander's protocol for selecting stocks. His instructor, William Randolph, outlines the steps the firm requires before an analyst can recommend a stock for one of the mutual funds. Randolph states: "You must adhere to the five steps program: First, understand everything there is to know about a business, then construct a forecast for the company's future performance. Next, select the most appropriate valuation model and calculate a predicted value. Last, you will take your report and make a recommendation to the fund's investment committee."

Barbee responds:

"Yes, I have reviewed the Alexander and Alexander training information. I know that in order to understand the industry, I must be knowledgeable about a business's position within an industry, as well as the company's profitability and market share profile."

Moving to the next step, the two discuss how to create an accurate forecast for a company's future performance. Barbee tells Randolph: "I am very comfortable learning everything about a company's structure, operations, and profitability, but I don't have any confidence in forecasting the health or performance of the overall economy."

Randolph reassures Barbee that his comfort level will grow with experience.

For the third step, Randolph quizzes Barbee about the extent of his knowledge in selecting the appropriate valuation model. Barbee replies: "I know that the chosen model should be a good match for the characteristics of the company, and for how available and good the company information is. Seems like there is one more thing..."

Randolph tells Barbee that he has much to learn, and sends him off to again review Alexander and Alexander's training materials.

i.

The third item that Barbee needs to assess in step 1, understanding the business, is:

- ☐ whether the company's shares have outperformed the market in the past.
- ☐ whether the company's shares are trading at a discount or premium to the market.
- ☒ how well has the company's strategy been executed, and how well will it be in the future.

Rationale

✔ **This Answer is Correct**

For the “understand the business step,” Barbee should have included an assessment that addresses past and future prospects for the execution of a company's competitive strategy.

Rationale

✔ **This Answer is Correct**

For the “understand the business step,” Barbee should have included an assessment that addresses past and future prospects for the execution of a company's competitive strategy.

Rationale

✔ **This Answer is Correct**

For the “understand the business step,” Barbee should have included an assessment that addresses past and future prospects for the execution of a company's competitive strategy.

ii.

To arrive at a company forecast, Barbee is *most likely* to be more comfortable performing a:

- ☐ top-down forecast.
- ☒ bottom-up forecast.
- ☐ sum-of-the-parts forecast.

Rationale

✘ **This Answer is Incorrect**

A bottom-up forecast begins with predicting results at the micro level, which add to yield a company-total perspective. Barbee states that he is comfortable at the micro level, but not at the macro level, which would be where one would begin a top-down forecast.

Rationale

✘ **This Answer is Incorrect**

A bottom-up forecast begins with predicting results at the micro level, which add to yield a company-total perspective. Barbee states that he is comfortable at the micro level, but not at the macro level, which would be where one would begin a top-down forecast.

Rationale

✘ **This Answer is Incorrect**

A bottom-up forecast begins with predicting results at the micro level, which add to yield a company-total perspective. Barbee states that he is comfortable at the micro level, but not at the macro level, which would be where one would begin a top-down forecast.

iii.

Regarding criteria for selecting a valuation model, the one criteria Barbee *most likely* omitted is ensuring that the model chosen should:

- ☒ be consistent with the purpose of the valuation and the analyst's viewpoint.
- ☐ consider control premiums and marketability discounts.
- ☐ be able to withstand due diligence procedures.

Rationale

This Answer is Incorrect

In choosing a model, the purpose of the valuation and the analyst's perspective should be considered. For example, if a prospective buyer of a company planned to break the company up, they might be most interested in a sum-of-the-parts valuation.

Rationale

This Answer is Incorrect

In choosing a model, the purpose of the valuation and the analyst's perspective should be considered. For example, if a prospective buyer of a company planned to break the company up, they might be most interested in a sum-of-the-parts valuation.

Rationale

This Answer is Incorrect

In choosing a model, the purpose of the valuation and the analyst's perspective should be considered. For example, if a prospective buyer of a company planned to break the company up, they might be most interested in a sum-of-the-parts valuation.

Question 23

L2R29TB-AC014-1512

LOS: LOS-7880

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

An analyst is attempting to assess the common stock value of Allstate Corp., a property/casualty insurer. She would *most likely* also want to initially research:

- ☒ Allstate's competitors.
- ☐ hurricane forecasts for the upcoming storm season.
- ☐ the likely future direction of interest rates relevant to Allstate's investment portfolio.

Rationale

☒ **Allstate's competitors.**

The analyst will want to study Allstate's competitors, and learn about the property/casualty industry. An investment asset's value can be assessed either by predicting variables that are important to future returns, or making comparisons to similar assets.

Rationale

☐ **hurricane forecasts for the upcoming storm season.**

The analyst will want to study Allstate's competitors, and learn about the property/casualty industry. An investment asset's value can be assessed either by predicting variables that are important to future returns, or making comparisons to similar assets.

Rationale

☐ **the likely future direction of interest rates relevant to Allstate's investment portfolio.**

The analyst will want to study Allstate's competitors, and learn about the property/casualty industry. An investment asset's value can be assessed either by predicting variables that are important to future returns, or making comparisons to similar assets.

Question 24

L2R29TB-AC008-1512

LOS: LOS-7850

Lesson Reference: Lesson 1: Value Definitions and Valuation Applications

Difficulty: medium

Kelly and Hank Carmichael have been married for 15 years and have co-owned and operated a successful residential real estate company for 12 years. They are divorcing amicably and agree that Hank will buy Kelly's half of the firm. Thus, they are seeking a value for their company from a third party advisor. The *most likely* type of value they desire is a(n):

- ☐ orderly liquidation.
- ☒ fair market.
- ☐ investment.

Rationale

orderly liquidation.

A fair market value is a value on which willing buyers and sellers can agree. It is assumed that neither party is under any pressure to transact, and both parties are well informed as to all material information.

Rationale

fair market.

A fair market value is a value on which willing buyers and sellers can agree. It is assumed that neither party is under any pressure to transact, and both parties are well informed as to all material information.

Rationale

investment.

A fair market value is a value on which willing buyers and sellers can agree. It is assumed that neither party is under any pressure to transact, and both parties are well informed as to all material information.

Question 25

L2R29TB-AC027-1512

LOS: LOS-7910

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

When selecting a valuation model, one criterion is that the model should be:

- ☐ consistent with a going-concern assumption.
- ☐ chosen without regard to the analyst's biases.
- ☒ a good fit with the company's characteristics.

Rationale

consistent with a going-concern assumption.

Three criteria for selecting a valuation model are that the model: is consistent with the company's characteristics, appropriate for the amount and quality of data available, and compatible with the analyst's motivation for performing the valuation.

Rationale

chosen without regard to the analyst's biases.

Three criteria for selecting a valuation model are that the model: is consistent with the company's characteristics, appropriate for the amount and quality of data available, and compatible with the analyst's motivation for performing the valuation.

Rationale

a good fit with the company's characteristics.

Three criteria for selecting a valuation model are that the model: is consistent with the company's characteristics, appropriate for the amount and quality of data available, and compatible with the analyst's motivation for performing the valuation.

Question 26

L200-PQ0020-1412

LOS: LOS-7840

Lesson Reference: Lesson 1: Value Definitions and Valuation Applications

Difficulty: medium

If the stock price for U.S. Furnishings is \$25 a share and the intrinsic value per share is \$30, what is the true mispricing?

- ☒ +\$5
- ☐ -\$5
- ☐ 0

Rationale

This Answer is Correct

A true mispricing exists when there is a difference between the intrinsic value and the observed market price. So, in this instance, the true mispricing is \$5 (intrinsic value minus stock price).

Question 27

L2R29TB-ITEMSET-AC001-1512

LOS: LOS-7840

LOS: LOS-7850

LOS: LOS-7860

Lesson Reference: Lesson 1: Value Definitions and Valuation Applications

Difficulty: medium

Use the following information to answer the next 3 questions:

An investment club, which collectively manages a \$100,000 common stock portfolio, is about to begin its monthly meeting. While waiting for the meeting to begin, two members of the club, Claire Kirkland and Katherine Jones, are engaging in a theoretical discussion. Ms. Kirkland is an avid believer in index funds. She is currently arguing that markets are very efficient, and market prices do accurately represent a security's intrinsic value. Ms. Jones is of a different mind. She enjoys actively picking stocks and thinks she can outperform the market, and has above-market performance in her personal portfolio to support her claim. Ms. Jones believes in what she calls the “rational efficient market formulation”—the belief that investors will only go to the trouble of trying to identify undervalued stocks if there are excess returns to compensate for the investor's efforts. The debate is a friendly one, and concludes as the meeting begins.

The first item for discussion is a stock held in the investment club's portfolio, Family Adventures Inc. (FAI). Family Adventures operates several theme parks, a film studio, and multiple retail stores that sell licensed products from their films. The club's chairperson offers a summary of FAI's current status: “As many of you know, FAI is staggering under a heavy debt load, and two of the last three films it produced were disappointments at the box office. Lastly, the lagging economy has negatively affected theme park ticket sales as well as store sales. There are concerns that the company may be insolvent. However, it must be said that management has outlined a restructuring plan to improve financial results. I think we should consider selling our shares of Family Adventures Inc.”

Ms. Jones comments: “I completely disagree. I have done my own analysis of the value of FAI, and I recommend we purchase more shares given that they currently sell at a depressed market value. The theme park division alone is worth more than the total valuation being afforded FAI's shares. I realize that we have a loss on the shares we purchased earlier, but I believe we should dollar cost average. I expect FAI shares will appreciate significantly once management's turn-around plan has been implemented.”

i.

The excess return (the perceived mispricing) that Ms. Jones expects to earn when she selects a security is *best* described as being the difference between:

- ☐ the true intrinsic value of the security and its market price.
- ☒ her estimate of the security's intrinsic value and its market price.
- ☐ the analyst's estimate of the security's intrinsic value and the true intrinsic value.

Rationale

✔ This Answer is Correct

Perceived mispricings are the difference between the analyst's calculation of intrinsic value and the asset's market price. Mispricings can derive from one of two components. The first is abnormal return, or the difference between the true intrinsic value and the security's market price. The second is the error in the analyst's estimate, or the difference between the analyst's estimated intrinsic value and the true intrinsic value.

Rationale

✔ This Answer is Correct

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Rationale

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ii.

Valuations for Family Adventures Inc. should *most likely* assume a framework of:

- ☒ going-concern.
- ☐ liquidation value.
- ☐ investment value.

Rationale

✘ This Answer is Incorrect

As long as a company is expected to continue operating, the relevant value to apply is a going-concern value. If the company were to be dissolved, the liquidation value would be relevant. In spite of recent poor performance, since FAI's management has outlined a restructuring plan, the company should still be thought of as a going-concern.

Rationale

✖ This Answer is Incorrect

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Rationale

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As long as a company is expected to continue operating, the relevant value to apply is a going-concern value. If the company were to be dissolved, the liquidation value would be relevant. In spite of recent poor performance, since FAI's management has outlined a restructuring plan, the company should still be thought of as a going-concern.

iii.

The type of valuation which Ms. Jones has *most likely* performed on FAI shares is:

- ☒ sum of the parts valuation.
- ☐ top-down analysis.
- ☐ fair market value.

Rationale

✖ This Answer is Incorrect

Given FAI's divergent business segments, it is most likely that Ms. Jones performed a valuation on each of the company's business segments, and then totaled her results to arrive at a share value. This is supported by her comment concerning the theme park division being worth more than the total valuation being afforded FAI's shares.

Rationale

✖ This Answer is Incorrect

Given FAI's divergent business segments, it is most likely that Ms. Jones performed a valuation on each of the company's business segments, and then totaled her results to arrive at a share value. This is supported by her comment concerning the theme park division being worth more than the total valuation being afforded FAI's shares.

Rationale

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Question 28

L2EQ-TB0003-1412

LOS: LOS-7860

Lesson Reference: Lesson 1: Value Definitions and Valuation Applications

Difficulty: medium

Investment value is most useful as a value definition for:

- ☒ The situation where an asset is worth more to a particular buyer due to operational synergies.
- ☐ An analyst valuing public equities.
- ☐ Perishable inventory that has to be immediately sold.

Rationale

This Answer is Correct

The concept of value to a specific buyer taking into account potential synergies and based on the investor's requirements and expectations is called investment value.

Question 29

L2R29TB-AC026-1512

LOS: LOS-7900

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

A company with many different business segments would *most likely* be assessed with a conglomerate discount because:

- ☐ of mistakes made in estimating company fundamentals.
- ☐ of concerns that future acquisitions will diminish the company's earnings.
- ☒ unsuccessful companies may attempt to grow through acquiring unrelated enterprises.

Rationale

 **of mistakes made in estimating company fundamentals.**


A conglomerate discount may be applied for endogenous reasons, such as when underperforming companies make acquisitions in unrelated businesses.

Rationale

 **of concerns that future acquisitions will diminish the company's earnings.**

A conglomerate discount may be applied for endogenous reasons, such as when underperforming companies make acquisitions in unrelated businesses.

Rationale

 **unsuccessful companies may attempt to grow through acquiring unrelated enterprises.**

A conglomerate discount may be applied for endogenous reasons, such as when underperforming companies make acquisitions in unrelated businesses.

Question 30

L2R29TB-AC016-1512

LOS: LOS-7840

Lesson Reference: Lesson 1: Value Definitions and Valuation Applications

Difficulty: medium

For the shares of Acme Inc., an analyst knows the market price and his estimate of the stock's value. To calculate the true mispricing for the stock, he must also know Acme's:

- ☐ going-concern value.
- ☐ estimated alpha.
- ☒ intrinsic value.

Rationale

 **going-concern value.**

The difference between an asset's market price and an analyst's calculation of intrinsic value is called a perceived mispricing and investors hope to profit from such mispricings.

A mispricing, or $VE - P$, is equal to two elements.

$$V_E - P = (V - P) + (V_E - V)$$

Where VE is the estimated value, P is the market price, and V is the intrinsic value.

The first element, $V - P$, is the true mispricing and it is the difference between the accurate but unknowable intrinsic value and the knowable market price. The second element, $VE - V$, is the difference between the analyst's estimated value and the accurate but unknowable intrinsic value.

One would need to know the intrinsic value to calculate the true mispricing.

Rationale

 **estimated alpha.**

The difference between an asset's market price and an analyst's calculation of intrinsic value is called a perceived mispricing and investors hope to profit from such mispricings.

A mispricing, or $VE - P$, is equal to two elements.

$$V_E - P = (V - P) + (V_E - V)$$

Where VE is the estimated value, P is the market price, and V is the intrinsic value.

The first element, $V - P$, is the true mispricing and it is the difference between the accurate but unknowable intrinsic value and the knowable market price. The second element, $VE - V$,

is the difference between the analyst's estimated value and the accurate but unknowable intrinsic value.

One would need to know the intrinsic value to calculate the true mispricing.

Rationale

✔ intrinsic value.

The difference between an asset's market price and an analyst's calculation of intrinsic value is called a perceived mispricing and investors hope to profit from such mispricings.

A mispricing, or $V_E - P$, is equal to two elements.

$$V_E - P = (V - P) + (V_E - V)$$

Where V_E is the estimated value, P is the market price, and V is the intrinsic value.

The first element, $V - P$, is the true mispricing and it is the difference between the accurate but unknowable intrinsic value and the knowable market price. The second element, $V_E - V$, is the difference between the analyst's estimated value and the accurate but unknowable intrinsic value.

One would need to know the intrinsic value to calculate the true mispricing.

Question 31

L2R29TB-AC019-1512

LOS: LOS-7870

Lesson Reference: Lesson 1: Value Definitions and Valuation Applications

Difficulty: medium

Charles Calder, a trust department equity analyst, specializes in “reverse engineering” analysis—he analyzes and quantifies market expectations of future fundamentals inherent in current market prices. He *most likely* does this to:

- ☐ decide whether he should sell the stock short.
- ☐ discover potential catalysts embedded in the fundamentals.
- ☒ use those implied fundamentals for comparisons with other companies.

Rationale

 **decide whether he should sell the stock short.**

Analysts infer market expectations from valuation models in order to assess whether the market expectations are reasonable, or to use the inferred fundamentals as benchmarks or comparisons for other companies.

Rationale

 **discover potential catalysts embedded in the fundamentals.**

Analysts infer market expectations from valuation models in order to assess whether the market expectations are reasonable, or to use the inferred fundamentals as benchmarks or comparisons for other companies.

Rationale

 **use those implied fundamentals for comparisons with other companies.**

Analysts infer market expectations from valuation models in order to assess whether the market expectations are reasonable, or to use the inferred fundamentals as benchmarks or comparisons for other companies.

Question 32

L2EQ-TB0001-1412

LOS: LOS-7840

Lesson Reference: Lesson 1: Value Definitions and Valuation Applications

Difficulty: medium

Which of the following is *least likely* to be a source of perceived mispricing for a valuation estimate of an equity security?

- ☐ True mispricing.
- ☐ Estimation error.
- ☒ Intrinsic value.

Rationale

This Answer is Correct

The difference between a valuation estimate and the prevailing market price, that is, the perceived mispricing of a security, is a combination of the true mispricing of the security (the true intrinsic value minus the prevailing price), plus the error of the estimate (the valuation estimate minus the intrinsic value).

Question 33

L2EQ-TBB202-1412

LOS: LOS-7880

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

When assessing the industry and competitive landscape for a company during the equity valuation process, a company following a cost leadership strategy would be *most likely* to be seen to exhibit:

- ☐ Lowest price.
- ☒ Highest margins.
- ☐ Strong branding.

Rationale

This Answer is Correct

The cost leadership strategy involves being the lowest-cost producer while offering products comparable to those of other companies so that products can be priced at or near the industry average. Due to the low-cost structure, the company would be expected to have high margins should it successfully execute this strategy.

Question 34

L2R29TB-AC025-1512

LOS: LOS-7900

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

Berkshire Hathaway Inc. is a company with numerous holding companies which operate in the following industries: property and casualty insurance, railroads, electric utilities, clothing, and finance. An analyst attempting to assess a value for Berkshire Hathaway would *most likely* use:

- ☒ sum-of-the-parts valuation method.
- ☐ a lack of marketability discount.
- ☐ liquidation value.

Rationale

sum-of-the-parts valuation method.

Sum-of-the-parts valuation is appropriate for Berkshire Hathaway since it has many differentiated businesses. This method estimates a value for a company's various operating segments, and then totals those values. It assumes the company is a going concern, and is also known as a breakup value or a private market value.

Rationale

a lack of marketability discount.

Sum-of-the-parts valuation is appropriate for Berkshire Hathaway since it has many differentiated businesses. This method estimates a value for a company's various operating segments, and then totals those values. It assumes the company is a going concern, and is also known as a breakup value or a private market value.

Rationale

liquidation value.

Sum-of-the-parts valuation is appropriate for Berkshire Hathaway since it has many differentiated businesses. This method estimates a value for a company's various operating segments, and then totals those values. It assumes the company is a going concern, and is also known as a breakup value or a private market value.

Question 35

L2R29TB-AC022-1512

LOS: LOS-7890

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

An analyst selects a residual income model to value the shares of a company. This model is *most likely* an example of:

- ☐ relative valuation.
- ☒ absolute valuation.
- ☐ sensitivity analysis.

Rationale

relative valuation.

Absolute valuation models yield an assessment of intrinsic value, which can then be compared directly to the security's market price. Present value models, also known as discounted cash flow models are useful absolute valuation models, and a residual income model is a present value model.

Rationale

absolute valuation.

Absolute valuation models yield an assessment of intrinsic value, which can then be compared directly to the security's market price. Present value models, also known as discounted cash flow models are useful absolute valuation models, and a residual income model is a present value model.

Rationale

sensitivity analysis.

Absolute valuation models yield an assessment of intrinsic value, which can then be compared directly to the security's market price. Present value models, also known as discounted cash flow models are useful absolute valuation models, and a residual income model is a present value model.

Question 36

L2R29TB-AC011-1512

LOS: LOS-7890

Lesson Reference: Lesson 2: The Valuation Process and Communicating valuation Results

Difficulty: medium

Investor Justin Balch has a long position in Pepsico Inc. and a short position in Coca Cola Company. Mr. Balch is *most likely* using:

- ☒ pairs trading.
- ☐ due diligence.
- ☐ technical analysis.

Rationale

☒ **pairs trading.**

He is using pairs trading, which is a methodology where valuations of closely related companies are analyzed, then trades are executed according to the relative valuations of the two companies. The relatively undervalued stock is purchased, and the relatively overvalued stock is sold short.

Rationale

☐ **due diligence.**

He is using pairs trading, which is a methodology where valuations of closely related companies are analyzed, then trades are executed according to the relative valuations of the two companies. The relatively undervalued stock is purchased, and the relatively overvalued stock is sold short.

Rationale

☐ **technical analysis.**

He is using pairs trading, which is a methodology where valuations of closely related companies are analyzed, then trades are executed according to the relative valuations of the two companies. The relatively undervalued stock is purchased, and the relatively overvalued stock is sold short.