SS 14 Equity Analysis and Valuation

Answers

Question #1 of 200

A firm has a return on equity (ROE) of 15% and a dividend payout rate of 80%. If last year's dividend was $0.80 and the required return on equity is 10%, what is the firm's estimated dividend growth rate and what is the current stock price?

	Dividend growth rate	Stock price
✓ **A)**	3.00%	$11.77
✗ **B)**	12.00%	$11.77
✗ **C)**	3.00%	$9.96

Explanation

The expected growth rate of dividends is the retention rate (RR) times the return on the equity portion of new investments (ROE), g = (RR)(ROE). The retention rate is 1 minus the payout rate. RR = (1 - 0.80) = 0.20. g = (0.20)(0.15)= 3.00%.

The value of the stock will be the dividend paid next year divided by the required rate of return minus the growth rate. Next year's dividend is $0.80 × 1.03 = $0.824. So the value is 0.824 / (.10 - 0.03) = 0.824 / 0.07 = $11.77

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #2 of 200

A firm pays an annual dividend of $1.15. The risk-free rate (RF) is 2.5%, and the total risk premium (RP) for the stock is 7%. What is the value of the stock, if the dividend is expected to remain constant?

   ✗ **A)** $25.00.

   ✓ **B)** $12.10.

   ✗ **C)** $16.03.

Explanation

If the dividend remains constant, g = 0.

$P = D_1 / (k-g) = 1.15 / (0.095 - 0) = \$12.10$

References

Related Material:

- Key Concepts by LOS

Question #3 of 200

Question ID: 415423

Enterprise value is *most* accurately described as a firm's:

- ✓ **A)** market value of stock plus market value of debt, minus cash and short-term investments.
- ✗ **B)** market value of stock plus cash and short-term investments, minus market value of debt.
- ✗ **C)** market value of assets minus market value of liabilities, plus cash and short-term investments.

Explanation

Enterprise value = market value of common and preferred stock + market value of debt - cash and short-term investments.

References

Question From: Session 14 > Reading 50 > LOS i

Related Material:

- Key Concepts by LOS

Question #4 of 200

Question ID: 415399

If the expected dividend payout ratio of a firm is expected to rise from 50 percent to 55 percent, the cost of equity is expected to increase from 10 percent to 11 percent, and the firm's growth rate remains at 5 percent, what will happen to the firm's price-to-equity (P/E) ratio? It will:

- ✗ **A)** increase.
- ✓ **B)** decline.
- ✗ **C)** be unchanged.

Explanation

Payout increases from 50% to 55%, cost of equity increases from 10% to 11%, and dividend growth rate stays at 5%, the P/E will change from 10 to 9.16:

$P/E = (D/E) / (k - g)$.

$P/E_0 = 0.50 / (0.10 - 0.05) = 10$.

$P/E_1 = 0.55 / (0.11 - 0.05) = 9.16$.

References

Question #5 of 200

When analyzing an industry characterized by increasing book values of equity, return on equity for a period is *most* appropriately calculated based on:

✓ **A)** average book value.

✗ **B)** ending book value.

✗ **C)** beginning book value.

Explanation

When book values are not stable, analysts should calculate ROE based on the average book value for the period. When book values are more stable, beginning book value is appropriate.

References

Question From: Session 14 > Reading 48 > LOS h

Related Material:

• Key Concepts by LOS

Question #6 of 200

If a stock sells for $50 that has an expected annual dividend of $2 and has a sustainable growth rate of 5%, what is the market discount rate for this stock?

✗ **A)** 7.5%.

✓ **B)** 9.0%.

✗ **C)** 10.0%.

Explanation

$k = [(D_1 / P) + g] = [(2/50) + 0.05] = 0.09$, or 9.00%.

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

• Key Concepts by LOS

Question #7 of 200

Hodges Fund provides mezzanine stage financing to private companies. In which type of private equity investing is Hodges Fund most likely involved?

- ✓ **A)** Venture capital.
- ✗ **B)** Private investment in public equity.
- ✗ **C)** Leveraged buyout.

Explanation

Venture capital providers invest in firms that are early in their life cycles. Stages of venture capital financing include seed stage, early stage, and mezzanine financing. In a leveraged buyout, an investor purchases all of a public firm's equity, taking the firm private. In a private investment in public equity (PIPE), an investor purchases private equity issued by a public firm.

References

Question From: Session 14 > Reading 48 > LOS c

Related Material:

- Key Concepts by LOS

Question #8 of 200

When calculating a sustainable growth rate for a company an analyst *most likely* assumes:

- ✗ **A)** return on equity will grow.
- ✗ **B)** equity is sold at a constant rate.
- ✓ **C)** the dividend payout ratio is constant.

Explanation

The sustainable growth rate is the rate at which equity, earnings, and dividends can continue to grow indefinitely assuming that ROE is constant, the dividend payout ratio is constant, and no new equity is sold.

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #9 of 200

Food, beverage, and utility companies are examples of:

✗ **A)** declining industries.

✗ **B)** cyclical industries.

✓ **C)** defensive industries.

Explanation

Food, beverage, and utility companies provide basic necessities of life and are considered to be defensive industries. In a recession, the demand for their products will not fall as much as for some of the other industry groups.

References

Question From: Session 14 > Reading 49 > LOS b

Related Material:

- Key Concepts by LOS

Question #10 of 200

If a firm's growth rate is 12% and its dividend payout ratio is 30%, its current return on equity (ROE) is *closest* to:

✓ **A)** 17.14%.

✗ **B)** 36.00%.

✗ **C)** 40.00%.

Explanation

g = (RR)(ROE)

g / RR = ROE

0.12 / (1 - 0.30) = 0.12 / 0.70 = 0.1714 or 17.14%

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #11 of 200

An analyst evaluating a stable, mature, electric utility with non-cyclical earnings and a high dividend would *most appropriately* use a:

✓ **A)** constant growth model.

✗ **B)** 2-stage model.

✗ **C)** 3-stage model

Explanation

A constant growth model is most appropriate for mature firms in stable markets that pay dividends which grow at a constant rate.

References

Question From: Session 14 > Reading 50 > LOS f

Related Material:

- Key Concepts by LOS

Question #12 of 200

Question ID: 496424

When classifying companies into peer groups for analysis, an analyst should:

✓ **A)** examine firms' annual reports to see if they identify competitors.

✗ **B)** disregard industry classifications from commercial providers.

✗ **C)** include each company in only one peer group.

Explanation

Annual reports are a good source of information when identifying peer groups because companies may identify their key competitors. It is often appropriate to include a company in more than one peer group. An analyst forming peer groups can use commercially available industry classification systems to identify which companies are in the same industry.

References

Question From: Session 14 > Reading 49 > LOS d

Related Material:

- Key Concepts by LOS

Question #13 of 200

Question ID: 415269

Other things equal, preference shares have the *most* risk for the investor when they are:

✗ **A)** non-callable and non-cumulative.

✓ **B)** callable and non-cumulative.

✗ **C)** putable and cumulative.

Explanation

Callable shares have more risk than otherwise equivalent non-callable shares. Putable shares have less risk than otherwise equivalent non-putable shares. Cumulative preference shares have less risk than otherwise equivalent non-cumulative preference shares.

References

Question From: Session 14 > Reading 48 > LOS e

Related Material:

- Key Concepts by LOS

Question #14 of 200

Which of the following statements about book value of equity is *most accurate*?

   ✗ **A)** Book value of equity reflects the market's perception of the firm's prospects.

   ✓ **B)** The primary goal of firm management is to increase the book value of the firm's equity.

   ✗ **C)** Increases in retained earnings decrease book value.

Explanation

Increasing book value is the primary goal of firm management. Increases in retained earnings increase book value. The market value of equity reflects investor perception of the firm's future value.

References

Question From: Session 14 > Reading 48 > LOS g

Related Material:

- Key Concepts by LOS

Question #15 of 200

A firm has a profit margin of 10%, an asset turnover of 1.2, an equity multiplier of 1.3, and an earnings retention ratio of 0.5. What is the firm's internal growth rate?

   ✓ **A)** 7.8%.

   ✗ **B)** 4.5%.

   ✗ **C)** 6.7%.

Explanation

ROE = (Net Income / Sales)(Sales / Total Assets)(Total Assets / Total Equity)

ROE = (0.1)(1.2)(1.3) = 0.156

g = (retention ratio)(ROE) = 0.5(0.156) = 0.078 or 7.8%

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #16 of 200

Wallace Kidwell is classifying an industry as to its life-cycle stage. Kidwell notes that the industry's growth is stable and largely limited to replacement demand and overall population increases. The companies that comprise the industry have achieved efficient cost structures and strong brand loyalty. This level of brand loyalty has resulted in very few price wars. Kidwell will *most likely* classify the industry life cycle stage as being:

- ✓ **A)** Mature.
- ✗ **B)** Decline.
- ✗ **C)** Shakeout.

Explanation

The mature stage exhibits little or no growth, industry consolidation, and high barriers to entry. Kidwell has noted that the industry is growing, but slowly (replacement demand and population gains). Furthermore, the firms have efficient cost structures and strong brand loyalty; both of which are high barriers to entry.

The decline stage exhibits negative growth, excess capacity, and high competition. Kidwell has observed positive, slow growth and a lack of price wars. Both of these observations are contrary to what would be expected in the decline stage.

The shakeout stage exhibits slowing growth, intense competition, and declining profitability. Kidwell has observed that growth is stable, the firms have achieved efficient cost structures, and price wars are uncommon. Hence, growth is not slowing, competition must not be intense because there are price wars (these occur when competition is intense), and profitability is likely stable given the efficient cost structures.

References

Question From: Session 14 > Reading 49 > LOS h

Related Material:

- Key Concepts by LOS

Question #17 of 200

An analyst gathered the following data:

- An earnings retention rate of 40%.
- An ROE of 12%.
- The stock's beta is 1.2.
- The nominal risk free rate is 6%.

- The expected market return is 11%.

Assuming next year's earnings will be $4 per share, the stock's current value is *closest* to:

    ✗ **A)** $45.45.

    ✓ **B)** $33.32.

    ✗ **C)** $26.67.

Explanation

Dividend payout = 1 − earnings retention rate = 1 − 0.4 = 0.6

$R_S = R_f + \beta(R_M − R_f) = 0.06 + 1.2(0.11 − 0.06) = 0.12$

g = (retention rate)(ROE) = (0.4)(0.12) = 0.048

$D_1 = E_1$ × payout ratio = $4.00 × 0.60 = $2.40

Price = D_1 / (k - g) = $2.40 / (0.12 - 0.048) = $33.32

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #18 of 200

Which of the following industries is *most likely* to operate in a fragmented market?

    ✓ **A)** Oil services.

    ✗ **B)** Confections.

    ✗ **C)** Pharmaceuticals.

Explanation

Most areas of the oil services industry are characterized by many small competitors. The confections and pharmaceutical industries each have a small number of very large firms.

References

Question From: Session 14 > Reading 49 > LOS i

Related Material:

- Key Concepts by LOS

Question #19 of 200

The experience curve, which illustrates the cost per unit relative to output:

  ✓ **A)** slopes downward.

  ✗ **B)** slopes upward.

  ✗ **C)** slopes upward in the early years and downward in the later years.

Explanation

The experience curve, which shows the cost per unit relative to output, slopes downward because of increases in productivity and economies of scale, especially in industries with high fixed costs.

References

Question From: Session 14 > Reading 49 > LOS e

Related Material:

- Key Concepts by LOS

Question #20 of 200

An analyst estimates the intrinsic value of a stock to be equal to ¥1,567 per share. If the current market value of the stock is ¥1,487 per share, the stock is:

  ✗ **A)** fairly valued.

  ✓ **B)** undervalued.

  ✗ **C)** overvalued.

Explanation

If a stock's intrinsic value is greater than its market value, the stock is undervalued.

References

Question From: Session 14 > Reading 50 > LOS a

Related Material:

- Key Concepts by LOS

Question #21 of 200

Which of the following industries is *most likely* to be classified as non-cyclical?

  ✗ **A)** Housing.

  ✓ **B)** Utilities.

  ✗ **C)** Autos.

Non-cyclical industries are those for which demand is not highly sensitive to business cycles, such as utilities, health care, and food and beverages. Housing and autos are examples of cyclical industries.

References

Question From: Session 14 > Reading 49 > LOS c

Related Material:

- Key Concepts by LOS

Question #22 of 200

Commercial index providers typically classify companies by:

- ✗ **A)** sensitivity to business cycles.
- ✗ **B)** statistical grouping.
- ✓ **C)** principal business activity.

Explanation

Commercial providers such as Standard and Poor's and MSCI Barra classify companies according to their principal business activity and the products and services they provide.

References

Question From: Session 14 > Reading 49 > LOS b

Related Material:

- Key Concepts by LOS

Question #23 of 200

Starr Company is an asset management firm. Thomas Company is a manufacturer of apparel. Assuming these firms are representative of their industry groups, how are they *best* classified with regard to their sensitivity to the business cycle?

	Starr	Thomas
✗ **A)**	Cyclical	Non-cyclical
✗ **B)**	Non-cyclical	Non-cyclical
✓ **C)**	Cyclical	Cyclical

Explanation

Asset management firms are classified in the financial services industry group. Apparel manufacturers are classified in the

consumer discretionary industry group. Financial services and consumer discretionary are cyclical industry groups.

References

Question From: Session 14 > Reading 49 > LOS c

Related Material:

- Key Concepts by LOS

Question #24 of 200

One advantage to using the price/book value (P/B) ratio over using the price/earnings (P/E) ratio is that P/B can be used when:

- ✓ **A)** earnings or cash flows are negative.
- ✗ **B)** the firm is in a slow growth phase.
- ✗ **C)** stock markets are volatile.

Explanation

When earnings are negative, P/E ratios cannot be used but P/B ratios can be used. The firm's rate of growth and the volatility of markets do not suggest advantages of using P/B ratios rather than P/E ratios.

References

Question From: Session 14 > Reading 50 > LOS k

Related Material:

- Key Concepts by LOS

Question #25 of 200

The competitive forces identified by Michael Porter include:

- ✓ **A)** rivalry among existing competitors and power of buyers.
- ✗ **B)** power of existing competitors and threat of entry.
- ✗ **C)** threat of substitutes and rivalry among suppliers.

Explanation

Porter's five competitive forces are: (1) rivalry among existing competitors; (2) threat of entry; (3) threat of substitutes; (4) power of buyers; (5) power of suppliers.

References

Question From: Session 14 > Reading 49 > LOS f

Related Material:

Question #26 of 200

An analyst gathered the following data for the Parker Corp. for the year ended December 31, 2005:

- EPS_{2005} = $1.75
- $Dividends_{2005}$ = $1.40
- $Beta_{Parker}$ = 1.17
- Long-term bond rate = 6.75%
- Rate of return $S\&P_{500}$ = 12.00%

The firm has changed its dividend policy and now plans to pay out 60% of its earnings as dividends in the future. If the long-term growth rate in earnings and dividends is expected to be 5%, the appropriate price to earnings (P/E) ratio for Parker will be:

- ✓ **A)** 7.60.
- ✗ **B)** 9.14.
- ✗ **C)** 7.98.

Explanation

Required rate of return on equity will be 12.89% = 6.75% + 1.17(12.00% - 6.75).

P/E Ratio = 0.60 / (0.1289 - 0.0500) = 7.60.

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #27 of 200

An analyst has gathered the following data for Webco, Inc:

- Retention = 40%
- ROE = 25%
- k = 14%

Using the infinite period, or constant growth, dividend discount model, calculate the price of Webco's stock assuming that next years earnings will be $4.25.

✗ **A)** $125.00.

✓ **B)** $63.75.

✗ **C)** $55.00.

Explanation

g = (ROE)(RR) = (0.25)(0.4) = 10%

$V = D_1 / (k - g)$

$D_1 = 4.25 (1 - 0.4) = 2.55$

G = 0.10

K - g = 0.14 − 0.10 = 0.04

V = 2.55 / 0.04 = **63.75**

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #28 of 200

The required rate of return on equity used as an input to the dividend discount model is influenced by each of the following factors EXCEPT:

✓ **A)** the stock's dividend payout ratio.

✗ **B)** the stock's appropriate risk premium.

✗ **C)** the expected inflation rate.

Explanation

A stock's required rate of return is equal to the nominal risk-free rate plus a risk premium. The nominal risk-free rate is approximately equal the real risk-free rate plus expected inflation.

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #29 of 200

A firm has an expected dividend payout ratio of 50%, a required rate of return of 12% and a constant growth rate of 6%. If earnings for the next year are expected to be $4.50, the value of the stock today is *closest to*:

- ✗ **A)** $39.75.
- ✓ **B)** $37.50.
- ✗ **C)** $33.50.

Explanation

Expected dividend = $4.50 × 0.50 = $2.25

Value today = $2.25 / (0.12 − 0.06) = $37.50

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #30 of 200

What is the value of a preferred stock that is expected to pay a $5.00 annual dividend per year forever if similar risk securities are now yielding 8%?

- ✗ **A)** $60.00.
- ✗ **B)** $40.00.
- ✓ **C)** $62.50.

Explanation

$5.00/0.08 = $62.50.

References

Question From: Session 14 > Reading 50 > LOS d

Related Material:

- Key Concepts by LOS

Question #31 of 200

Global depository receipts are *most likely* issued:

✗ **A)** outside the issuer's home country and denominated in the exchange's home currency.

✓ **B)** outside the issuer's home country and denominated in U.S. dollars.

✗ **C)** in the United States and denominated in U.S. dollars.

Explanation

Global depository receipts are issued outside the U.S. and the issuer's home country and are most often denominated in U.S. dollars. Depository receipts issued in the United States and denominated in U.S. dollars are called American depository receipts. Global registered shares are denominated in the home currencies of the exchanges on which they trade.

References

Question From: Session 14 > Reading 48 > LOS d

Related Material:

- Key Concepts by LOS

Question #32 of 200

Technological changes are *most likely* to result in which of the following effects? Evolving technology is likely to result in changes in:

✓ **A)** educational curriculum and the relative demand for various products.

✗ **B)** educational curriculum only.

✗ **C)** the relative demand for various products only.

Explanation

If technological changes result in changes in the set of skills required of workers, this is likely to lead to changes in educational curriculum (and possibly delivery). Such changes often result in the production and demand for new or different products.

References

Question From: Session 14 > Reading 49 > LOS j

Related Material:

- Key Concepts by LOS

Question #33 of 200

A firm's cost of equity capital is *least* accurately described as the:

✗ **A)** minimum rate of return investors require to invest in the firm's equity securities.

✓ **B)** ratio of the firm's net income to its average book value.

✗ **C)** expected total return on the firm's equity shares in equilibrium.

Explanation

The ratio of the firm's net income to its average book value is the firm's return on equity, which can be greater than, equal to, or less than the firm's cost of equity. Cost of equity for a firm can be defined as the expected equilibrium total return in the market on its equity shares, or as minimum rate of return that investors require as compensation for the risk of the firm's equity securities.

References

Question From: Session 14 > Reading 48 > LOS h

Related Material:

- Key Concepts by LOS

Question #34 of 200

Which of the following is NOT an assumption of the constant growth dividend discount model (DDM)?

    ✗ **A)** Dividend payout is constant.

    ✗ **B)** ROE is constant.

    ✓ **C)** The growth rate of the firm is higher than the overall growth rate of the economy.

Explanation

Other assumptions of the DDM are: dividends grow at a constant rate and the growth rate continues for an infinite period.

References

Question From: Session 14 > Reading 50 > LOS f

Related Material:

- Key Concepts by LOS

Question #35 of 200

Economic profits are *most likely* to be earned by firms in an industry that is characterized by:

    ✓ **A)** high barriers to entry and low power of buyers.

    ✗ **B)** high power of suppliers and low threat of entry.

    ✗ **C)** low threat of substitutes and high rivalry among existing competitors.

Explanation

High barriers to entry (low threat of entry) and low power of suppliers both increase the potential for economic profits within an industry. The five forces that shape industry competition are rivalry among existing competitors, threat of entry, threat of substitutes, power of buyers, and power of suppliers. The stronger any of these forces are within an industry, the less potential that industry has to generate (or continue to earn) economic profits.

Question From: Session 14 > Reading 49 > LOS f

Related Material:

- Key Concepts by LOS

Question #36 of 200

All else equal, an increase in a company's growth rate will most likely cause its P/E ratio to:

   ✗ **A)** either increase or decrease.

   ✓ **B)** increase.

   ✗ **C)** decrease.

Explanation

Increase in g: As g increases, the spread between k_e and g, or the P/E denominator, will decrease, and the P/E ratio will increase.

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #37 of 200

Equity securities are *least likely* issued to finance:

   ✗ **A)** research and development.

   ✗ **B)** equipment.

   ✓ **C)** inventories.

Explanation

Equity securities are typically issued to finance a firm's long-lived assets, such as equipment, and long-term projects such as research and development.

References

Question From: Session 14 > Reading 48 > LOS f

Related Material:

- Key Concepts by LOS

The capital asset pricing model can be used to estimate which of the following inputs to the dividend discount model?

    ✓ **A)** The required return on equity.

    ✗ **B)** The expected inflation rate.

    ✗ **C)** The expected growth rate in dividends.

<u>Explanation</u>

The capital asset pricing model is a rate of return model that can be used to estimate a stock's required rate of return, given the nominal risk-free rate, the market risk premium, and the stock's beta:

$k = R_{nominal\ risk\ free\ rate} + (beta)(R_{market} - R_{nominal\ risk\ free\ rate})$.

<u>References</u>

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Calculate the value of a common stock that last paid a $2.00 dividend if the required rate of return on the stock is 14 percent and the expected growth rate of dividends and earnings is 6 percent. What growth model is an example of this calculation?

	Value of stock	Growth model
✗ **A)**	$26.50	Supernormal growth
✗ **B)**	$25.00	Gordon growth
✓ **C)**	$26.50	Gordon growth

<u>Explanation</u>

$2(1.06)/0.14 - 0.06 = $26.50.

This calculation is an example of the Gordon Growth Model also known as the constant growth model.

<u>References</u>

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

An argument against using the price-to-sales (P/S) valuation approach is that:

✓ **A)** P/S ratios do not express differences in cost structures across companies.

✗ **B)** sales figures are not as easy to manipulate or distort as earnings per share (EPS) and book value.

✗ **C)** P/S ratios are not as volatile as price-to-earnings (P/E) multiples.

Explanation

P/S ratios do not express differences in cost structures across companies. Both remaining responses are advantages of the P/S ratios, not disadvantages.

References

Question From: Session 14 > Reading 50 > LOS k

Related Material:

- Key Concepts by LOS

A company has 8 percent preferred stock outstanding with a par value of $100. The required return on the preferred is 5 percent. What is the value of the preferred stock?

✓ **A)** $160.00.

✗ **B)** $100.00.

✗ **C)** $152.81.

Explanation

The annual dividend on the preferred is $100(.08) = $8.00. The value of the preferred is $8.00/0.05 = $160.00.

References

Question From: Session 14 > Reading 50 > LOS d

Related Material:

- Key Concepts by LOS

Which of the following is *least likely* an advantage of using price/sales (P/S) multiple?

✓ **A)** P/S multiples are more reliable because sales data cannot be distorted by management.

✗ **B)** P/S multiples are not as volatile as P/E multiples and hence may be more reliable in valuation analysis.

✗ **C)** P/S multiples provide a meaningful framework for evaluating distressed firms.

Explanation

Accounting data on sales is used to calculate the P/S multiple. The P/S multiple is thought to be more reliable because sales figures are not as easy to manipulate as the earnings and book value, both of which are significantly affected by accounting conventions. However, it is not true that "sales data cannot be distorted by management" because aggressive revenue recognition practices can influence reported sales.

References

Question From: Session 14 > Reading 50 > LOS k

Related Material:

- Key Concepts by LOS

Question #43 of 200

A company's required return on equity is 15% and its dividend payout ratio is 55%. If its return on equity (ROE) is 17% and its beta is 1.40, then its sustainable growth rate is *closest* to:

✗ **A)** 6.75%.

✓ **B)** 7.65%.

✗ **C)** 9.35%.

Explanation

Growth rate = (ROE)(Retention Ratio)

= (0.17)(0.45)

= 0.0765 or 7.65%

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #44 of 200

A high growth rate would be consistent with:

✗ **A)** a low retention rate.

✗ **B)** a high dividend payout rate.

✓ **C)** a high ROE.

Explanation

Since g = retention rate * ROE, or (1 - payout ratio) * ROE, the only choice that would result in a higher g is a higher ROE. A low ROE, or a high dividend payout rate (which is the same as a low retention rate) would result in a *low* growth rate.

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #45 of 200

An asset-based valuation model is *most appropriate* for a company that:

✗ **A)** is expected to remain profitable for the foreseeable future.

✓ **B)** is likely to be liquidated.

✗ **C)** has a high proportion of intangible assets among its total assets.

Explanation

For companies that are likely to be liquidated, the asset-based approach may be the most appropriate value as the assets may be worth more to another entity. Asset-based valuation models do not work well for companies that have large amounts of intangible assets. Because asset-based valuation is not forward-looking, an asset-based approach may underestimate the value of companies that are expected to be profitable.

References

Question From: Session 14 > Reading 50 > LOS j

Related Material:

- Key Concepts by LOS

Question #46 of 200

Gwangwa Gold, a South African gold producer, has as its primary asset a mine which is shown on the balance sheet with a value of R100 million. An analyst estimates the market value of this mine to be 90% of book value. The company's balance sheet shows other assets of R20 million and liabilities of R40 million, and the analyst feels that the book value of these items reflects their market values. Using the asset-based valuation approach, what should the analyst estimate the value of the company to be?

✓ **A)** R70 million.

✗ **B)** R110 million.

✗ **C)** R80 million.

Explanation

Market value of assets = 0.9(R100 million) + R20 million = R110 million

Market value of liabilities = R40 million

Estimated net value of company = R110 million − R40 million = R70 million.

References

Question From: Session 14 > Reading 50 > LOS j

Related Material:

- Key Concepts by LOS

Question #47 of 200

Which of the following is a *disadvantage* of using the price-to-book value (PBV) ratio?

✗ **A)** Book value may not mean much for manufacturing firms with significant fixed costs.

✗ **B)** Firms with negative earnings cannot be evaluated with the PBV ratios.

✓ **C)** Book values are affected by accounting standards, which may vary across firms and countries.

Explanation

The disadvantages of using PBV ratios are:

1. Book values are affected by accounting standards, which may vary across firms and countries.
2. Book value may not mean much for service firms without significant fixed costs.
3. Book value of equity can be made negative by a series of negative earnings, which limits the usefulness of the variable.

References

Question From: Session 14 > Reading 50 > LOS k

Related Material:

- Key Concepts by LOS

Question #48 of 200

According to the earnings multiplier model, which of the following factors is the least important in estimating a stock's price-to-earnings ratio? The:

✓ **A)** historical dividend payout ratio.

✗ **B)** estimated required rate of return on the stock.

✗ **C)** expected dividend payout ratio.

Explanation

$P/E = (D_1/E_1)/(k - g)$

where:
D_1/E_1 = the expected dividend payout ratio
k = estimated required rate of return on the stock
g = expected growth rate of dividends for the stock

The P/E is *most* sensitive to movements in the denominator.

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #49 of 200

Stages of an industry life cycle in chronological order are:

    ✗ **A)** embryonic, growth, mature, shakeout, and decline.

    ✗ **B)** growth, shakeout, mature, decline, and embryonic.

    ✓ **C)** embryonic, growth, shakeout, mature, and decline.

Explanation

Embryonic, growth, shakeout, mature, and decline are the life-cycle stages of an industry.

References

Question From: Session 14 > Reading 49 > LOS e

Related Material:

- Key Concepts by LOS

Question #50 of 200

The free cash flow to equity model is *best* described as a(n):

    ✗ **A)** single-factor model.

    ✗ **B)** enterprise value model.

    ✓ **C)** present value model.

The free cash flow to equity model is one type of present value model or discounted cash flow model. It estimates a stock's value as the present value of cash available to common shareholders. The enterprise value model is an example of a multiplier model.

References

Question From: Session 14 > Reading 50 > LOS b

Related Material:

- Key Concepts by LOS

Question #51 of 200

Question ID: 415346

Utilizing the infinite period dividend discount model, all else held equal, if the required rate of return (K_e) decreases, the model yields a price that is:

   ✓ **A)** increased, due to a smaller spread between required return and growth.

   ✗ **B)** reduced, due to increased spread between growth and required return.

   ✗ **C)** reduced, due to the reduction in discount rate.

Explanation

The denominator of the single-stage DDM is the spread between required return K_e, and expected growth rate, g. The smaller the denominator, all else held equal, the larger the computed value.

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #52 of 200

Question ID: 415275

The difference between a firm's balance sheet assets and liabilities is equal to the firm's:

   ✗ **A)** market value of equity.

   ✓ **B)** book value of equity.

   ✗ **C)** intrinsic value of equity.

Explanation

Book value of equity is equal to balance sheet assets minus liabilities.

References

Question From: Session 14 > Reading 48 > LOS g

Question #53 of 200

Which of the following statements regarding price multiples is *most* accurate?

    ✓ **A)** An advantage of the price/sales ratio is that it is meaningful even for distressed firms.

    ✗ **B)** A disadvantage of the price/book value ratio is that it is not an appropriate measure for firms that primarily hold liquid assets.

    ✗ **C)** A rationale for using the price/cash flow ratio is that there is only one clear definition of cash flow.

<u>Explanation</u>

The P/S ratio is meaningful even for distressed firms, since sales revenue is always positive. This is not the case for the P/E and P/BV ratios, which can be negative.

In the P/BV ratio book value is an appropriate measure of net asset value for firms that primarily hold liquid assets.

Analysts use several different definitions of cash flow (CFO, adjusted CFO, FCFE, EBITDA, etc.) to calculate P/CF ratios.

When earnings are negative, the P/E ratio is meaningless.

<u>References</u>

Question From: Session 14 > Reading 50 > LOS g

Related Material:

- Key Concepts by LOS

Question #54 of 200

Assuming the risk-free rate is 5% and the expected return on the market is 12%, what is the value of a stock with a beta of 1.5 that paid a $2 dividend last year if dividends are expected to grow at a 5% rate forever?

    ✗ **A)** $17.50.

    ✓ **B)** $20.00.

    ✗ **C)** $12.50.

<u>Explanation</u>

$P_0 = D_1 / (k - g)$

$R_s = R_f + \beta(R_M - R_f) = 0.05 + 1.5(0.12 - 0.05) = 0.155$

$D_1 = D_0(1 + g) = 2 \times (1.05) = 2.10$

$P_0 = 2.10 / (0.155 - 0.05) = $ **$20.00**

Question #55 of 200

The primary reason for a firm to issue equity securities is to:

- ✗ **A)** increase publicity for the firm's products.
- ✓ **B)** acquire the assets necessary to carry out its operations.
- ✗ **C)** improve its solvency ratios.

Explanation

While issuing equity securities can improve a company's solvency ratios and increase the firm's visibility with the public, the primary reason to issue equity is to raise the capital needed to acquire operating assets.

References

Question From: Session 14 > Reading 48 > LOS f

Related Material:

- Key Concepts by LOS

Question #56 of 200

Which of the following statements about the constant growth dividend discount model (DDM) in its application to investment analysis is *least* accurate? The model:

- ✗ **A)** can't be applied when g > K.
- ✓ **B)** is best applied to young, rapidly growing firms.
- ✗ **C)** is inappropriate for firms with variable dividend growth.

Explanation

The model is most appropriately used when the firm is mature, with a moderate growth rate, paying a constant stream of dividends. In order for the model to produce a finite result, the company's growth rate must not exceed the required rate of return.

References

Question From: Session 14 > Reading 50 > LOS f

Related Material:

- Key Concepts by LOS

The following data pertains to a common stock:

- It will pay no dividends for two years.
- The dividend three years from now is expected to be $1.
- Dividends are expected to grow at a 7% rate from that point onward.

If an investor requires a 17% return on this stock, what will they be willing to pay for this stock now?

✓ **A)** $ 7.30.

✗ **B)** $10.00.

✗ **C)** $ 6.24.

Explanation

time line = $0 now; $0 in yr 1; $0 in yr 2; $1 in yr 3.

$P_2 = D_3/(k - g) = 1/(.17 - .07) = \$10$

Note the math. The price is always one year before the dividend date.

Solve for the PV of $10 to be received in two years.

FV = 10; n = 2; i = 17; compute PV = $7.30

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

A firm that pursues a differentiation strategy is *most likely* to emphasize:

✗ **A)** operating efficiency.

✗ **B)** gains in market share.

✓ **C)** market research.

Explanation

A firm that follows a product or service differentiation strategy needs to emphasize market research to identify needs for which customers are willing to pay a premium. Market share and operating efficiency are more of a focus for firms that pursue a low-cost strategy.

References

Question From: Session 14 > Reading 49 > LOS k

Question #59 of 200

Witronix is a rapidly growing U.S. company that has increased free cash flow to equity and dividends at an average rate of 25% per year for the last four years. The present value model that is *most* appropriate for estimating the value of this company is a:

- ✓ **A)** multistage dividend discount model.
- ✗ **B)** single stage free cash flow to equity model.
- ✗ **C)** Gordon growth model.

Explanation

A multistage model is the most appropriate model because the company is growing dividends at a higher rate than can be sustained in the long run. Though the company may be able to grow dividends at a higher-than-sustainable 25% annual rate for a finite period, at some point dividend growth will have to slow to a lower, more sustainable rate. The Gordon growth model is appropriate to use for mature companies that have a history of increasing their dividend at a steady and sustainable rate. A single stage free cash flow to equity model is similar to the Gordon growth model, but values future free cash flow to equity rather than dividends.

References

Question From: Session 14 > Reading 50 > LOS c

Related Material:

- Key Concepts by LOS

Question #60 of 200

Baker Computer earned $6.00 per share last year, has a retention ratio of 55%, and a return on equity (ROE) of 20%. Assuming their required rate of return is 15%, how much would an investor pay for Baker on the basis of the earnings multiplier model?

- ✗ **A)** $40.00.
- ✗ **B)** $173.90.
- ✓ **C)** $74.93.

Explanation

g = Retention × ROE = $(0.55) \times (0.2) = 0.11$

$P_0/E_1 = 0.45 / (0.15 − 0.11) = 11.25$

Next year's earnings $E_1 = E_0 \times (1 + g) = (6.00) \times (1.11) = \$6.66$

$P_0 = 11.25(\$6.66) = \$74.93$

Question #61 of 200

Use the following information and the dividend discount model to find the value of GoFlower, Inc.'s, common stock.

- Last year's dividend was $3.10 per share.
- The growth rate in dividends is estimated to be 10% forever.
- The return on the market is expected to be 12%.
- The risk-free rate is 4%.
- GoFlower's beta is 1.1.

    ✗ **A)** $26.64.

    ✓ **B)** $121.79.

    ✗ **C)** $34.95.

Explanation

The required return for GoFlower is 0.04 + 1.1(0.12 - 0.04) = 0.128 or 12.8%. The expect dividend is ($3.10)(1.10) = $3.41. GoFlower's common stock is then valued using the infinite period dividend discount model (DDM) as ($3.41) / (0.128 - 0.10) = $121.79.

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #62 of 200

Johnson Company shuts down and is liquidated. Bob Smith owns 100 common shares of Johnson, but has a lower priority of claims than Al Jones, who also owns 100 common shares. Smith *most likely* owns:

    ✗ **A)** non-cumulative shares.

    ✗ **B)** non-participating shares.

    ✓ **C)** Class B shares.

Explanation

Some firms have different classes of common stock (e.g., Class A and Class B shares). These classes may be distinguished by

factors such as voting rights and priority in the event of liquidation. Participating and non-participating, cumulative and non-cumulative refer to characteristics of preferred stock.

References

Question From: Session 14 > Reading 48 > LOS b

Related Material:

- Key Concepts by LOS

Question #63 of 200

An argument against using the price to cash flow (P/CF) valuation approach is that:

  ✓ **A)** non-cash revenue and net changes in working capital are ignored when using earnings per share (EPS) plus non-cash charges as an estimate.

  ✗ **B)** price to cash flow ratios are not as volatile as price-to-earnings (P/E) multiples.

  ✗ **C)** cash flows are not as easy to manipulate or distort as EPS and book value.

Explanation

Items affecting actual cash flow from operations are ignored when the EPS plus non-cash charges estimate is used. For example, non-cash revenue and net changes in working capital are ignored. Both remaining responses are arguments in favor of using the price to cash flow approach.

References

Question From: Session 14 > Reading 50 > LOS k

Related Material:

- Key Concepts by LOS

Question #64 of 200

If a company can convince its suppliers to offer better terms on their products leading to a higher profit margin, the return on equity (ROE) will *most likely*:

  ✗ **A)** increase and the stock price will decline.

  ✓ **B)** increase and the stock price will increase

  ✗ **C)** decrease and the stock price will increase.

Explanation

Better supplier terms lead to increased profitability. Better profit margins lead to an increase in ROE. This leads to an increase in the dividend growth rate. The difference between the cost of equity and the dividend growth rate will decline, causing the stock price to increase.

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #65 of 200

Question ID: 434380

The book value of equity is equal to a firm's assets:

- ✓ **A)** minus its liabilities.
- ✗ **B)** plus its retained earnings.
- ✗ **C)** plus its accumulated other comprehensive income.

Explanation

The book value of equity is the balance sheet value of a firm's assets minus its liabilities.

References

Question From: Session 14 > Reading 48 > LOS g

Related Material:

- Key Concepts by LOS

Question #66 of 200

Question ID: 415254

Dividends on non-participating preference shares are typically:

- ✗ **A)** a contractual obligation of the company.
- ✗ **B)** lower than the dividends on common shares.
- ✓ **C)** a fixed percentage of par value.

Explanation

Similar to the interest payments on a debt security, dividends on non-participating preference shares (preferred stock) are typically fixed. Unlike the interest payments on a debt security, the company is not contractually obligated to pay preferred dividends. Preferred dividends are typically higher than a firm's common dividends.

References

Question From: Session 14 > Reading 48 > LOS a

Related Material:

- Key Concepts by LOS

Question #67 of 200

An analyst gathered the following information about an industry. The industry beta is 0.9. The industry profit margin is 8%, the total asset turnover ratio is 1.5, and the leverage multiplier is 2. The dividend payout ratio of the industry is 50%. The risk-free rate is 7% and the expected market return is 15%. The industry P/E is *closest* to:

   ✓ **A)** 22.73.

   ✗ **B)** 14.20.

   ✗ **C)** 12.00.

Explanation

Using the CAPM: k_i = 7% + 0.9(0.15 − 0.07) = 14.2%.

Using the DuPont equation: ROE = 8% × 1.5 × 2 = 24%.

g = retention ratio × ROE = 0.50 × 24% = 12%.

P/E = 0.5/(0.142 − 0.12) = 22.73.

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #68 of 200

Which of the following is a disadvantage of using price-to-sales (P/S) multiples in stock valuations?

   ✓ **A)** The use of P/S multiples can miss problems associated with cost control.

   ✗ **B)** It is difficult to capture the effects of changes in pricing policies using P/S ratios.

   ✗ **C)** P/S multiples are more volatile than price-to-earnings (P/E) multiples.

Explanation

Due to the stability of using sales relative to earnings in the P/S multiple, an analyst may miss problems of troubled firms concerning its cost control. P/S multiples are actually less volatile than P/E ratios, which is an advantage in using the P/S multiple. Also, P/S ratios provide a useful framework for evaluating effects of pricing changes on firm value.

References

Question From: Session 14 > Reading 50 > LOS g

Related Material:

- Key Concepts by LOS

Use the following information and the multi-period dividend discount model to find the value of Computech's common stock.

- Last year's dividend was $1.62.
- The dividend is expected to grow at 12% for three years.
- The growth rate of dividends after three years is expected to stabilize at 4%.
- The required return for Computech's common stock is 15%.

Which of the following statements about Computech's stock is *least* accurate?

    ✓ **A)** Computech's stock is currently worth $17.46.

    ✗ **B)** At the end of two years, Computech's stock will sell for $20.64.

    ✗ **C)** The dividend at the end of year three is expected to be $2.27.

Explanation

The dividends for years 1, 2, and 3 are expected to be ($1.62)(1.12) = $1.81; ($1.81)(1.12) = $2.03; and ($2.03)(1.12) = $2.27. At the end of year 2, the stock should sell for $2.27 / (0.15 - 0.04) = $20.64. The stock should sell currently for ($20.64 + $2.03) / $(1.15)^2$ + ($1.81) / (1.15) = $18.71.

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

A company last paid a $1.00 dividend, the current market price of the stock is $20 per share and the dividends are expected to grow at 5 percent forever. What is the required rate of return on the stock?

    ✗ **A)** 9.78%.

    ✗ **B)** 10.00%.

    ✓ **C)** 10.25%.

Explanation

$D_0 (1 + g) / P_0 + g = k$

1.00 (1.05) / 20 + 0.05 = 10.25%.

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

Question #71 of 200

Compared to publicly traded firms, privately held firms have which of the following characteristics?

- ✓ **A)** More limited financial disclosure.
- ✗ **B)** Higher reporting costs.
- ✗ **C)** Less ability to focus on long-term prospects.

Explanation

Private firms have fewer financial disclosure requirements, and therefore lower reporting costs, because they are not listed on an exchange. Private firms generally have greater ability to focus on long-term results because they do not experience pressure from public shareholders.

References

Question From: Session 14 > Reading 48 > LOS c

Related Material:

- Key Concepts by LOS

Question #72 of 200

Assume that a stock paid a dividend of $1.50 last year. Next year, an investor believes that the dividend will be 20% higher and that the stock will be selling for $50 at year-end. Assume a beta of 2.0, a risk-free rate of 6%, and an expected market return of 15%. What is the value of the stock?

- ✓ **A)** $41.77.
- ✗ **B)** $40.32.
- ✗ **C)** $45.00.

Explanation

Using the Capital Asset Pricing Model, we can determine the discount rate equal to 0.06 + 2(0.15 - 0.06) = 0.24. The dividends next year are expected to be $1.50 × 1.2 = $1.80. The present value of the future stock price and the future dividend are determined by discounting the expected cash flows at the discount rate of 24%: (50 + 1.8) / 1.24 = $41.77.

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #73 of 200

The rationale for using dividend discount models to value equity is that the:

    ✗ **A)** model works well for the finite period of time over which dividends are paid.

    ✗ **B)** inputs are easily estimated and the model's estimates are robust.

    ✓ **C)** intrinsic value of a stock is the present value of its future dividends.

Explanation

The rationale for dividend discount models is that the fundamental or intrinsic value of a stock is the present value of all its future dividends. Dividend discount models can be applied to either a finite or infinite stream of dividends. There are many ways to calculate the inputs and the estimated stock values may vary significantly with small changes in the inputs.

References

Question From: Session 14 > Reading 50 > LOS c

Related Material:

- Key Concepts by LOS

Question #74 of 200

Compared to a publicly traded firm, a private equity firm is *most likely* to:

    ✗ **A)** exhibit stronger corporate governance.

    ✗ **B)** be more concerned with short-term results.

    ✓ **C)** disclose less information about its financial performance.

Explanation

Private equity firms are not held to the same financial reporting requirements as publicly traded firms. Less public scrutiny and limited financial disclosure may lead to weaker corporate governance. However, with less pressure from public shareholders, a private equity firm is typically more able to focus on long-term performance.

References

Question From: Session 14 > Reading 48 > LOS c

Related Material:

- Key Concepts by LOS

Question #75 of 200

An enterprise value model for equity valuation is *most accurately* described as a(n):

✓ **A)** multiplier model.

✗ **B)** discounted cash flow model.

✗ **C)** asset-based model.

Explanation

An enterprise value model is an example of a multiplier model. Enterprise value is analyzed as a multiple of revenue or earnings and compared among firms in a peer group.

References

Question From: Session 14 > Reading 50 > LOS b

Related Material:

- Key Concepts by LOS

Question #76 of 200

Which of the following statements concerning security valuation is *least* accurate?

✗ **A)** The best way to value a company with high and unsustainable growth that exceeds the required return is to use the temporary supernormal growth (multistage) model.

✓ **B)** A firm with a $1.50 dividend last year, a dividend payout ratio of 40%, a return on equity of 12%, and a 15% required return is worth $18.24.

✗ **C)** The best way to value a company with no current dividend but who is expected to pay dividends in three years is to use the temporary supernormal growth (multistage) model.

Explanation

A firm with a $1.50 dividend last year, a dividend payout ratio of 40%, a return on new investment of 12%, and a 15% required return is worth $20.64. The growth rate is (1 - 0.40) × 0.12 = 7.2%. The expected dividend is then ($1.50)(1.072) = $1.61. The value is then (1.61) / (0.15 - 0.072) = $20.64.

References

Question From: Session 14 > Reading 50 > LOS f

Related Material:

- Key Concepts by LOS

Question #77 of 200

Assume that the expected dividend growth rate (g) for a firm decreased from 5% to zero. Further, assume that the firm's cost of equity (k) and dividend payout ratio will maintain their historic levels. The firm's P/E ratio will *most likely:*

✗ **A)** increase.

✓ **B)** decrease.

✗ **C)** become undefined.

Explanation

The P/E ratio may be defined as: Payout ratio / (k - g), so if k is constant and g goes to zero, the P/E will decrease.

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #78 of 200

If an analyst estimates the intrinsic value for a security that is different from its market value, the analyst should *most likely* take an investment position based on this difference if:

✓ **A)** the model used is not highly sensitive to its input values.

✗ **B)** the security lacks a liquid market and trades infrequently.

✗ **C)** many analysts independently evaluate the security.

Explanation

In general, an analyst can be more confident about an estimate of intrinsic value if the model used is not highly sensitive to changes in its inputs. If a large number of analysts follow a security, its market value is more likely to be a reliable estimate of its intrinsic value. A security that does not trade frequently or in a liquid market may remain mispriced for an extended time, and thus may not result in a profit within the investment horizon even if the analyst's estimate of intrinsic value is correct.

References

Question From: Session 14 > Reading 50 > LOS a

Related Material:

- Key Concepts by LOS

Question #79 of 200

If a preferred stock that pays a $11.50 dividend is trading at $88.46, what is the market's required rate of return for this security?

✗ **A)** 7.69%.

✗ **B)** 11.76%.

✓ **C)** 13.00%.

Explanation

From the formula: Value$_{\text{Preferred Stock}}$ = D / k$_p$, we derive k$_p$ = D / Value$_{\text{Preferred Stock}}$ = 11.50 / 88.46 = 0.1300, or 13.00%.

References

Question From: Session 14 > Reading 50 > LOS d

Related Material:

- Key Concepts by LOS

Question #80 of 200

A basket of listed depository receipts (BLDR) is *best* described as a(n):

   ✓ **A)** exchange traded fund of depository receipts.

   ✗ **B)** index of global depository receipts that trade on a specific exchange.

   ✗ **C)** special purpose vehicle for issuing depository receipts in multiple countries.

Explanation

A basket of listed depository receipts (BLDR) is an exchange traded fund that represents a portfolio of depository receipts.

References

Question From: Session 14 > Reading 48 > LOS d

Related Material:

- Key Concepts by LOS

Question #81 of 200

A firm is *most likely* to have pricing power if it operates in an industry characterized by:

   ✗ **A)** low concentration, overcapacity, and high market share stability.

   ✓ **B)** high concentration, undercapacity, and high market share stability.

   ✗ **C)** high concentration, undercapacity, and low market share stability.

Explanation

Firms in highly concentrated industries are more likely to have pricing power than firms in fragmented industries. Firms in industries with tight capacity constraints are more likely to have pricing power than firms in industries with excess capacity. High market share stability is indicative of pricing power because competition is likely less intensive.

References

Question From: Session 14 > Reading 49 > LOS g

Related Material:

Question #82 of 200

Which of the following statements concerning security valuation is *least* accurate?

    ✗ **A)** A stock to be held for two years with a year-end dividend of $2.20 per share, an estimated value of $20.00 at the end of two years, and a required return of 15% is estimated to be worth $18.70 currently.

    ✓ **B)** A stock with a dividend last year of $3.25 per share, an expected dividend growth rate of 3.5%, and a required return of 12.5% is estimated to be worth $36.11.

    ✗ **C)** A stock with an expected dividend payout ratio of 30%, a required return of 8%, an expected dividend growth rate of 4%, and expected earnings of $4.15 per share is estimated to be worth $31.13 currently.

Explanation

A stock with a dividend last year of $3.25 per share, an expected dividend growth rate of 3.5%, and a required return of 12.5% is estimated to be worth $37.33 using the DDM where $P_o = D_1 / (k - g)$. We are given $D_o = \$3.25$, g = 3.5%, and k = 12.5%. What we need to find is D_1 which equals $D_o \times (1 + g)$ therefore $D_1 = \$3.25 \times 1.035 = \$3.36$ thus $P_o = 3.36 / (0.125 - 0.035) = \$37.33$.

In the answer choice where the stock value is $18.70, discounting the future cash flows back to the present gives the present value of the stock. the future cash flows are the dividend in year 1 plus the dividend and value of the stock in year 2 thus the equation becomes: $V_o = 2.2 / 1.15 + (2.2 + 20) / 1.15^2 = \$18.70$

For the answer choice where the stock value is $31.13 use the DDM which is $P_o = D_1 / (k - g)$. We are given k = 0.08, g = 0.04, and what we need to find is next year's dividend or D_1. D_1 = Expected earnings × payout ratio = $4.15 \times 0.3 = \$1.245$ thus $P_o = \$1.245 / (0.08 - 0.04) = \$31.13$

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

Question #83 of 200

Assume that a firm has an expected dividend payout ratio of 20%, a required rate of return of 9%, and an expected dividend growth of 5%. What is the firm's estimated price-to-earnings (P/E) ratio?

    ✗ **A)** 2.22.

    ✓ **B)** 5.00.

    ✗ **C)** 20.00.

Explanation

The price-to-earnings (P/E) ratio is equal to $(D_1/E_1)/(k - g) = 0.2/(.09 - 0.05) = 5.00$.

Question #84 of 200

Use the following data to analyze a stock's price earnings ratio (P/E ratio):

- The stock's beta is 1.2.
- The dividend payout ratio is 60%.
- The stock's expected growth rate is 7%.
- The risk free rate is 6% and the expected rate of return on the market is 13%.

Using the dividend discount model, the expected P/E ratio of the stock is *closest* to:

   ✗ **A)** 5.4.

   ✓ **B)** 8.1.

   ✗ **C)** 10.0.

Explanation

$k = ER = Rf + Beta(RM − Rf) = 0.06 + (1.2)(0.13 − 0.06) = 0.144$

Dividend payout ratio = 0.60

$P/E = \text{div payout} / (k − g) = 0.6 / (0.144 − 0.07) = 8.1$

Question #85 of 200

One advantage of using price-to-book value (PBV) multiples for stock valuation is that:

   ✗ **A)** book value of a firm can never be negative.

   ✓ **B)** it is a stable and simple benchmark for comparison to the market price.

   ✗ **C)** most of the time it is close to the market value.

Book value provides a relatively stable measure of value that can be compared to the market price. For investors who mistrust the discounted cash flow estimates of value, it provides a much simpler benchmark for comparison. Book value may or may not be closer to the market value. A firm may have negative book value if it shows accounting losses consistently.

References

Question From: Session 14 > Reading 50 > LOS g

Related Material:

- Key Concepts by LOS

Question #86 of 200

Question ID: 415288

Which of the following types of industries is typically characterized by stable performance during both expansions and contractions of the business cycle?

    ✗ **A)** Cyclical.

    ✗ **B)** Growth.

    ✓ **C)** Defensive.

Explanation

A defensive industry is typically characterized by stable performance during both expansions and contractions of the business cycle.

References

Question From: Session 14 > Reading 49 > LOS c

Related Material:

- Key Concepts by LOS

Question #87 of 200

Question ID: 415293

The industry experience curve illustrates the relationship between:

    ✗ **A)** productivity and average years of employment.

    ✗ **B)** company age and profitability.

    ✓ **C)** cumulative output and cost per unit.

Explanation

The industry experience curve shows cost per unit relative to cumulative output. Cost per unit typically decreases over time due to higher utilization rates for fixed capital, improvements in the efficiency of labor, and better product design and manufacturing methods.

References

Question From: Session 14 > Reading 49 > LOS e

Related Material:

- Key Concepts by LOS

Question #88 of 200

Commercial industry classification systems such as the Global Industry Classification Standard (GICS) typically classify firms according to their:

    ✗ **A)** sensitivity to business cycles.

    ✓ **B)** principal business activities.

    ✗ **C)** correlations of historical returns.

Explanation

Commercial providers of industry classification systems such as the GICS classify firms according to principal business activity, such as Consumer Staples, Financial Services, or Health Care.

References

Question From: Session 14 > Reading 49 > LOS b

Related Material:

- Key Concepts by LOS

Question #89 of 200

Company B paid a $1.00 dividend per share last year and is expected to continue to pay out 40% of its earnings as dividends for the foreseeable future. If the firm is expected to earn a 10% return on equity in the future, and if an investor requires a 12% return on the stock, the stock's value is *closest* to:

    ✗ **A)** $16.67.

    ✓ **B)** $17.67.

    ✗ **C)** $12.50.

Explanation

P_0 = Value of the stock = $D_1 / (k - g)$

$g = (RR)(ROE)$

RR = 1 − dividend payout = 1 − 0.4 = 0.6

ROE = 0.1

g = (0.6)(0.1) = 0.06

D_1 = (D_0)(1 + g) = (1)(1 + 0.06) = $1.06

P_0 = 1.06 / (0.12 − 0.06) = 1.06 / 0.06 = $17.67

<u>References</u>

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #90 of 200

Asset-based valuation models are *most appropriate* for a firm that:

  ✗ **A)** has significant intangible assets.

  ✗ **B)** has cyclical earnings.

  ✓ **C)** is being liquidated.

<u>Explanation</u>

Asset-based valuation models are appropriate for a firm that is being liquidated because when a firm ceases to operate as a going concern, its value to equity owners depends on the difference between the fair value of its assets and liabilities. Asset-based models are unlikely to be reliable for estimating the value of firms that have significant intangible assets because fair values of such assets are often difficult to determine. Such a firm may or may not have cyclical earnings.

<u>References</u>

Question From: Session 14 > Reading 50 > LOS j

Related Material:

- Key Concepts by LOS

Question #91 of 200

All of the following factors affects the firm's P/E ratio EXCEPT:

  ✗ **A)** growth rates of dividends.

  ✓ **B)** the expected interest rate on the bonds of the firm.

  ✗ **C)** the required rate of return.

<u>Explanation</u>

The factors that affect the P/E ratio are the same factors that affect the value of a firm in the infinite growth dividend discount model. The expected interest rate on the bonds is not a significant factor affecting the P/E ratio.

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #92 of 200

Which of the following statements about the role of equities in financing a company's assets is *most accurate*?

   ✓ **A)** Equity capital is typically used for the purchase of long-term assets and expansion into new areas.

   ✗ **B)** Management can directly increase the market value of equity by increasing net income.

   ✗ **C)** The book value and market value of equities is usually the same.

Explanation

Equity capital is used for the purchase of long-term assets, equipment, research and development and expansion into new businesses or geographic areas. Book value and market value of equities are almost always valued differently. Management can only indirectly affect the market value of equity.

References

Question From: Session 14 > Reading 48 > LOS f

Related Material:

- Key Concepts by LOS

Question #93 of 200

According to the earnings multiplier model, a stock's P/E ratio (P_0/E_1) is affected by all of the following EXCEPT the:

   ✗ **A)** required return on equity.

   ✓ **B)** expected stock price in one year.

   ✗ **C)** expected dividend payout ratio.

Explanation

According to the earnings multiplier model, the P/E ratio is equal to $P_0/E_1 = (D_1/E_1)/(k_e - g)$.

Thus, the P/E ratio is determined by:

- The expected dividend payout ratio (D_1/E_1).

- The required rate of return on the stock (k_e).

- The expected growth rate of dividends (g).

Question #94 of 200

Given the following information, compute the implied dividend growth rate.

- Profit margin = 10.0%
- Total asset turnover = 2.0 times
- Financial leverage = 1.5 times
- Dividend payout ratio = 40.0%

   ✗ **A)** 12.0%.

   ✓ **B)** 18.0%.

   ✗ **C)** 4.5%.

Explanation

Retention ratio equals 1 - 0.40, or 0.60.
Return on equity equals (10.0%)(2.0)(1.5) = 30.0%.
Dividend growth rate equals (0.60)(30.0%) = 18.0%.

References

Question #95 of 200

Use the following information to determine the value of River Gardens' common stock:

- Expected dividend payout ratio is 45%.
- Expected dividend growth rate is 6.5%.
- River Gardens' required return is 12.4%.
- Expected earnings per share next year are $3.25.

✗ **A)** $30.12.

✓ **B)** $24.80.

✗ **C)** $27.25.

Explanation

First, estimate the price to earnings (P/E) ratio as: (0.45) / (0.124 - 0.065) = 7.63. Then, multiply the expected earnings by the estimated P/E ratio: ($3.25)(7.63) = $24.80.

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #96 of 200

If the payout ratio increases, the justified P/E multiple will:

✓ **A)** increase, if we assume that the growth rate remains constant.

✗ **B)** always increase.

✗ **C)** decrease, if we assume that the growth rate remains constant.

Explanation

When payout ratio increases, the justified P/E multiple increases only if we assume that the growth rate will not change as a result.

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #97 of 200

An investor is considering acquiring a common stock that he would like to hold for one year. He expects to receive both $1.50 in dividends and $26 from the sale of the stock at the end of the year. What is the maximum price he should pay for the stock today to earn a 15 percent return?

✓ **A)** $23.91.

✗ **B)** $24.11.

✗ **C)** $27.30.

<u>Explanation</u>

By discounting the cash flows for one period at the required return of 15% we get: x = (26 + 1.50) / (1+.15)[1]

(x)(1.15) = 26 + 1.50

x = 27.50 / 1.15

x = $23.91

<u>References</u>

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #98 of 200

In a period when U.S. equity prices are increasing and the U.S. dollar is depreciating, which of the following investors in U.S. equities is *most likely* to earn the highest return in the investor's local currency?

✗ **A)** Non-U.S. investor who does not reinvest dividends.

✓ **B)** U.S. investor who reinvests dividends.

✗ **C)** Non-U.S. investor who reinvests dividends.

<u>Explanation</u>

Sources of return on equity securities include price appreciation or depreciation, dividend income, and foreign exchange gains or losses for investors outside the country. In an increasing equity market, reinvesting dividends is likely to increase returns compared to not reinvesting dividends. If the currency is depreciating, investors from outside the country will experience foreign exchange losses that decrease their returns.

<u>References</u>

Question From: Session 14 > Reading 48 > LOS e

Related Material:

- Key Concepts by LOS

Question #99 of 200

Which of the following statements about the industry life cycle is *most* accurate?

    ✗ **A)** Industry growth rates are highest in the embryonic stage.

    ✗ **B)** The mature stage is followed by a shakeout stage and a decline stage.

    ✓ **C)** The growth stage is typically characterized by decreasing prices.

Explanation

Prices tend to decrease in the growth stage as firms begin to realize economies of scale in production. The stages of the industry life cycle, in order, are embryonic, growth, shakeout, mature, and decline. Industry growth is slow during the embryonic stage as firms develop products and attempt to gain customer acceptance.

References

Question From: Session 14 > Reading 49 > LOS h

Related Material:

- Key Concepts by LOS

Question #100 of 200

With which of the following types of equity shares does the investor typically have the greatest voting power?

    ✗ **A)** Unsponsored depository receipts.

    ✓ **B)** Common shares.

    ✗ **C)** Participating preference shares.

Explanation

While common shares have voting rights, preference shares typically do not. With unsponsored depository receipts, the depository bank retains the right to vote the shares.

References

Question From: Session 14 > Reading 48 > LOS b

Related Material:

- Key Concepts by LOS

Question #101 of 200

According to the earnings multiplier model, all else equal, as the required rate of return on a stock increases, the:

✓ **A)** P/E ratio will decrease.

✗ **B)** earnings per share will increase.

✗ **C)** P/E ratio will increase.

Explanation

According to the earnings multiplier model, the P/E ratio is equal to $P_0/E_1 = (D_1/E_1)/(k_e - g)$. As k_e increases, P_0/E_1 will decrease, all else equal.

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #102 of 200

All else equal, if there is an increase in the required rate of return, a stock's value as estimated by the constant growth dividend discount model (DDM) will:

✗ **A)** increase or decrease, depending upon the relationship between ke and ROE.

✓ **B)** decrease.

✗ **C)** increase.

Explanation

If k_e increases, the spread between k_e and g widens (increasing the denominator), resulting in a lower valuation.

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #103 of 200

An analyst gathered the following information about a company:

- The stock is currently trading at $31.00 per share.
- Estimated growth rate for the next three years is 25%.
- Beginning in the year 4, the growth rate is expected to decline and stabilize at 8%.
- The required return for this type of company is estimated at 15%.
- The dividend in year 1 is estimated at $2.00.

The stock is undervalued by approximately:

    ✗ **A)** $15.70.

    ✗ **B)** $0.00.

    ✓ **C)** $6.40.

<u>Explanation</u>

The high "supernormal" growth in the first three years and the decrease in growth thereafter signals that we should use a combination of the multi-period and finite dividend growth models (DDM) to value the stock.

Step 1: Determine the dividend stream through year 4

- D_1 = $2.00 (given)
- $D_2 = D_1 \times (1 + g) = 2.00 \times (1.25) = $2.50
- $D_3 = D_2 \times (1 + g) = $2.50 \times (1.25) = $3.13
- $D_4 = D_3 \times (1 + g) = $3.13 \times (1.08) = $3.38

Step 2: Calculate the value of the stock at the end of year 3 (using D_4)

- $P_3 = D_4 / (k_e - g) = $3.38 / (0.15 - 0.08) = $48.29

Step 3: Calculate the PV of each cash flow stream at k_e = 15%, and sum the cash flows. *Note:* We suggest you clear the financial calculator memory registers before calculating the value. The present value of:

- D_1 = **1.74** = 2.00 / $(1.15)^1$, or FV = -2.00, N = 1, I/Y = 15, PV = 1.74
- D_2 = **1.89** = 2.50 / $(1.15)^2$, or FV = -2.50, N = 2, I/Y = 15, PV = 1.89
- D_3 = **2.06** = 3.13 / $(1.15)^3$, or FV = -3.13, N = 3, I/Y = 15, PV = 2.06
- P_3 = **31.75** = 48.29 / $(1.15)^3$, or FV = -48.29, N = 3, I/Y = 15, PV = 31.75
- Sum of cash flows = 37.44.
- Thus, the stock is undervalued by 37.44 - 31.00 = approximately **6.40.**

Note: Future values are entered in a financial calculator as negatives to ensure that the PV result is positive. It does not mean that the cash flows are negative. Also, your calculations may differ slightly due to rounding. Remember that the question asks you to select the *closest* answer.

<u>References</u>

Question From: Session 14 > Reading 50 > LOS a

Related Material:

- Key Concepts by LOS

Question #104 of 200

Common equity share types ranked from least risky to most risky are:

    ✓ **A)** putable, option-free, callable.

    ✗ **B)** option-free, putable, callable.

✗ **C)** callable, putable, option-free.

<u>Explanation</u>

Putable shares are the least risky because the investor can sell the shares back to the issuer at a predetermined price. Callable shares are the most risky because the issuer can buy the securities back at a predetermined price, which limits the upside for the investor.

<u>References</u>

Question From: Session 14 > Reading 48 > LOS e

Related Material:

- Key Concepts by LOS

Question #105 of 200

Given the following information, compute price/book value.

- Book value of assets = $550,000
- Total sales = $200,000
- Net income = $20,000
- Dividend payout ratio = 30%
- Operating cash flow = $40,000
- Price per share = $100
- Shares outstanding = 1000
- Book value of liabilities = $500,000

   ✓ **A)** 2.0X.

   ✗ **B)** 2.5X.

   ✗ **C)** 5.5X.

<u>Explanation</u>

Book value of equity = $550,000 - $500,000 = $50,000

Market value of equity = ($100)(1000) = $100,000

Price/Book = $100,000/$50,000 = 2.0X

<u>References</u>

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Which of the following statements about the constant growth dividend discount model (DDM) is *least* accurate?

    ✗ **A)** In the constant growth DDM dividends are assumed to grow at a constant rate forever.

    ✓ **B)** For the constant growth DDM to work, the growth rate must exceed the required return on equity.

    ✗ **C)** The constant growth DDM is used primarily for stable mature stocks.

Explanation

Dividends grow at constant rate forever.

Constant growth DDM is used for mature firms.

k must be greater than g.

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Two seats on a board of directors are to be elected. A voting system in which the owner of 100 shares may cast 100 votes in each of the board elections is a:

    ✗ **A)** cumulative voting system.

    ✗ **B)** proportional voting system.

    ✓ **C)** statutory voting system.

Explanation

In a statutory voting system, a shareholder can vote in each separate board election based on the number of shares she owns. Under cumulative voting, the shareholder may choose to cast her total number of votes (200 in this example) for a candidate in one of the elections.

References

Question From: Session 14 > Reading 48 > LOS a

Related Material:

- Key Concepts by LOS

Which of the following is NOT an advantage of using price-to-book value (PBV) multiples in stock valuation?

✗ **A)** PBV ratios can be compared across similar firms if accounting standards are consistent.

✗ **B)** Book value is often positive, even when earnings are negative.

✓ **C)** Book values are very meaningful for firms in service industries.

Explanation

Book values are NOT very meaningful for firms in service industries.

References

Question From: Session 14 > Reading 50 > LOS k

Related Material:

- Key Concepts by LOS

Question #109 of 200

Question ID: 415264

A security that represents an equity share in a foreign firm and for which the voting rights are retained by the depository bank, is a(n):

✗ **A)** American depository share.

✓ **B)** unsponsored depository receipt.

✗ **C)** global registered share.

Explanation

In an unsponsored DR, the depository bank retains the voting rights of the equity shares of the foreign firm. In a sponsored DR, the investor in the DR has the voting rights. For an American depository receipt, an American depository share is the underlying security that trades in the issuing firm's domestic market. A global registered share is an equity security that trades in the local currencies on stock exchanges around the world.

References

Question From: Session 14 > Reading 48 > LOS d

Related Material:

- Key Concepts by LOS

A stock has the following elements: last year's dividend = $1, next year's dividend is 10% higher, the price will be $25 at year-end, the risk-free rate is 5%, the market risk premium is 5%, and the stock's beta is 1.5. The stock's price is *closest to*:

    ✗ **A)** $23.50.

    ✗ **B)** $20.20.

    ✓ **C)** $23.20.

<u>Explanation</u>

Cost of equity capital = 5% + 1.5(5%) = 12.5%
P_0 = (1.1 / 1.125) + (25 / 1.125) = $23.20.

<u>References</u>

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Day and Associates is experiencing a period of abnormal growth. The last dividend paid by Day was $0.75. Next year, they anticipate growth in dividends and earnings of 25% followed by negative 5% growth in the second year. The company will level off to a normal growth rate of 8% in year three and is expected to maintain an 8% growth rate for the foreseeable future. Investors require a 12% rate of return on Day. The value of Day stock today is *closest* to:

    ✗ **A)** $18.65.

    ✗ **B)** $24.05.

    ✓ **C)** $20.70.

<u>Explanation</u>

First find the abnormal dividends:
D_1 = $0.75 × 1.25 = $0.9375
D_2 = $0.9375 × 0.95 = $0.89

D_2 is the first dividend that will grow at a constant rate. We can use this dividend in the constant growth DDM to get a value for the stock in period 1:

$0.89 / (0.12 - 0.08) = $22.25

Value of the stock today = ($22.25 + $0.9375) / 1.12 = $20.70.

<u>References</u>

Question From: Session 14 > Reading 50 > LOS e

Question #112 of 200

A company's payout ratio is 0.45 and its expected return on equity (ROE) is 23%. What is the company's implied growth rate in dividends?

   ✗ **A)** 4.16%.

   ✗ **B)** 10.35%.

   ✓ **C)** 12.65%.

Explanation

Growth Rate = (ROE)(1 - Payout Ratio) = (0.23)(0.55) = 12.65%

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

• Key Concepts by LOS

Question #113 of 200

One advantage of price/sales (P/S) multiples over price to earnings (P/E) and price-to-book value (PBV) multiples is that:

   ✗ **A)** P/S is easier to calculate.

   ✗ **B)** Regression shows a strong relationship between stock prices and sales.

   ✓ **C)** P/S can be used for distressed firms.

Explanation

Unlike the PBV and P/E multiples, which can become negative and not meaningful, the price/sales multiple is meaningful even for distressed firms (that may have negative earnings or book value).

References

Question From: Session 14 > Reading 50 > LOS k

Related Material:

• Key Concepts by LOS

Question #114 of 200

The current price of XYZ, Inc., is $40 per share with 1,000 shares of equity outstanding. Sales are $4,000 and the book value of the firm is $10,000. What is the price/sales ratio of XYZ, Inc.?

✗ **A)** 0.010.

✓ **B)** 10.000.

✗ **C)** 4.000.

Explanation

The price/sales ratio is (price per share)/(sales per share) = (40)/(4,000/1,000) = 10.0. Alternatively, the price/sales ratio may be thought of as the market value of the company divided by its sales, or (40 × 1,000)/4,000, or 10.0 again.

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #115 of 200

A firm has an expected dividend payout ratio of 48 percent and an expected future growth rate of 8 percent. What should the firm's price to earnings ratio (P/E) be if the required rate of return on stocks of this type is 14 percent and what is the retention ratio of the firm?

	P/E ratio	Retention ratio
✗ **A)**	6.5	48%
✓ **B)**	8.0	52%
✗ **C)**	6.5	52%

Explanation

P/E = (dividend payout ratio)/(k - g)

P/E = 0.48/(0.14 - 0.08) = 8

The retention ratio = (1 - dividend payout) = (1 - 0.48) = 52%

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

An analyst gathered the following data for the Parker Corp. for the year ended December 31, 2005:

- EPS$_{2005}$ = $1.75
- Dividends$_{2005}$ = $1.40
- Beta $_{Parker}$ = 1.17
- Long-term bond rate = 6.75%
- Rate of return S&P 500 = 12.00%

The firm is expected to continue their dividend policy in future. If the long-term growth rate in earnings and dividends is expected to be 6%, the forward P/E ratio for Parker Corp. will be:

   ✓ **A)** 11.61.

   ✗ **B)** 12.31.

   ✗ **C)** 21.54.

Explanation

The required rate of return on equity for Parker will be 12.89% = 6.75% + 1.17(12.00% − 6.75%) and the firm pays 80% (1.40 / 1.75) of its earnings as dividends.

Forward P/E ratio = 0.80 / (0.1289 - 0.0600) = 11.61

Where r = required rate of return on equity, g_n = growth rate in dividends (forever).

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Regarding the estimates required in the constant growth dividend discount model, which of the following statements is *most* accurate?

   ✗ **A)** The variables "k" and "g" are easy to forecast.

   ✓ **B)** The model is most influenced by the estimates of "k" and "g."

   ✗ **C)** Dividend forecasts are less reliable than estimates of other inputs.

Explanation

The relationship between "k" and "g" is critical - small changes in the difference between these two variables results in large value fluctuations.

References

Question From: Session 14 > Reading 50 > LOS k

Question #118 of 200

A company currently has a required return on equity of 14% and an ROE of 12%. All else equal, if there is an increase in a firm's dividend payout ratio, the stock's value will *most likely*:

   ✗ **A)** either increase or decrease.

   ✓ **B)** increase.

   ✗ **C)** decrease.

Explanation

Increase in dividend payout/reduction in earnings retention. In this case, an increase in the dividend payout will likely *increase* the P/E ratio because a decrease in earnings retention will likely increase the P/E ratio. The logic is as follows: Because earnings retention impacts both the numerator (dividend payout) and denominator (g) of the P/E ratio, the impact of a change in earnings retention depends upon the relationship of k_e and ROE. If the company is earning a lower rate on new projects than the rate required by the market (ROE < k_e), investors will likely prefer that the company pay out earnings rather than investing in lower-yield projects. Since an increase in the dividend payout would decrease earnings retention, the P/E ratio would rise, as investors will value the company higher if it retains a lower percentage of earnings.

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

• Key Concepts by LOS

Question #119 of 200

Assuming a discount rate of 15%, a preferred stock with a perpetual dividend of $10 is valued at approximately:

   ✗ **A)** $8.70.

   ✓ **B)** $66.67.

   ✗ **C)** $1.50.

Explanation

The formula for the value of preferred stock with a perpetual dividend is: D / kp, or 10.0 / 0.15 = $66.67.

References

Question From: Session 14 > Reading 50 > LOS d

Related Material:

Question #120 of 200

Question ID: 415307

Changes in population size and average age that affect industry growth and profitability are *best* described as:

- ✓ **A)** demographic influences.
- ✗ **B)** macroeconomic influences.
- ✗ **C)** social influences.

Explanation

Among the external influences that affect industries, "demographic factors" refers to those that are related to the size and composition of the population.

References

Question From: Session 14 > Reading 49 > LOS j

Related Material:

- Key Concepts by LOS

Question #121 of 200

Question ID: 434388

Which of the following statements about switching costs is *most accurate*?

- ✗ **A)** Switching costs tend to be lower for specialized products.
- ✗ **B)** Low switching costs contribute to market share stability.
- ✓ **C)** Switching costs include the time needed to learn to use a competitor's product.

Explanation

Switching costs include the time and expense of learning to use a competitor's product and tend to be higher for specialized or differentiated products. High switching costs contribute to market share stability and pricing power.

References

Question From: Session 14 > Reading 49 > LOS g

Related Material:

- Key Concepts by LOS

Question #122 of 200

Question ID: 415401

Which of the following is NOT a determinant of the expected price/earnings (P/E) ratio?

✗ **A)** Expected growth rate in dividends (g).

✓ **B)** Average debt to capital ratio (D/C).

✗ **C)** Expected dividend payout ratio (D/E).

Explanation

The P/E ratio is determined by payout ratio D/E, required return K_e, and expected growth g.

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #123 of 200

Declining prices that result from the development of substitute products are *most likely* to characterize an industry in the:

✓ **A)** decline stage.

✗ **B)** mature stage.

✗ **C)** shakeout stage.

Explanation

The decline stage of the industry life cycle is often characterized by declining prices as substitute products or global competition emerge, or as a result of decreasing demand due to societal changes.

References

Question From: Session 14 > Reading 49 > LOS h

Related Material:

- Key Concepts by LOS

Question #124 of 200

Factors affecting industry growth that are related to the composition and age distribution of the population are *best* described as:

✗ **A)** social influences.

✓ **B)** demographic factors.

✗ **C)** macroeconomic factors.

Explanation

Demographic factors include age distribution and population size, as well as other changes in the composition of the population.

References

Question From: Session 14 > Reading 49 > LOS j

Related Material:

- Key Concepts by LOS

Question #125 of 200

Pricing power for the firms in an industry is *most likely* to result from low:

    ✗ **A)** barriers to entry.

    ✗ **B)** industry concentration.

    ✓ **C)** levels of capacity.

Explanation

Low capacity is associated with pricing power because it increases the likelihood that supply in the short run will be less than demand at current prices. Low barriers to entry and low industry concentration (a fragmented market) typically suggest firms have little pricing power.

References

Question From: Session 14 > Reading 49 > LOS g

Related Material:

- Key Concepts by LOS

Question #126 of 200

After completing a thorough industry analysis, which of the following is *most likely* an additional element an analyst should examine when analyzing a specific company within the industry?

    ✗ **A)** Threat of entry.

    ✗ **B)** Power of buyers.

    ✓ **C)** Competitive strategy.

Explanation

Company analysis involves examining a specific firm's financial condition, products and services, and competitive strategy (cost leadership or differentiation). Industry analysis should include examining competitive forces such as the threat of entry and the power of buyers.

References

Question From: Session 14 > Reading 49 > LOS k

Question #127 of 200

If the return on equity for a firm is 15% and the retention rate is 40%, the firm's sustainable growth rate is *closest* to:

- ✓ **A)** 6%.
- ✗ **B)** 9%.
- ✗ **C)** 15%.

Explanation

g = (RR)(ROE)

= (0.15)(0.40)

= 0.06 or 6%

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #128 of 200

When a company's return on equity (ROE) is 12% and the dividend payout ratio is 60%, what is the implied sustainable growth rate of earnings and dividends?

- ✗ **A)** 4.0%.
- ✓ **B)** 4.8%.
- ✗ **C)** 7.8%.

Explanation

g = ROE × retention ratio = ROE × (1 - payout ratio) = 12 (0.4) = 4.8%

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

A company has just paid a $2.00 dividend per share and dividends are expected to grow at a rate of 6% indefinitely. If the required return is 13%, what is the value of the stock today?

    ✗ **A)** $34.16.

    ✗ **B)** $32.25.

    ✓ **C)** $30.29.

Explanation

$P_0 = D_1 / (k - g) = 2.12 / (0.13 - 0.06) = \$30.29$

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Use the following information on Brown Partners, Inc. to compute the current stock price.

- Dividend just paid = $6.10

- Expected dividend growth rate = 4%

- Expected stock price in one year = $60

- Risk-free rate = 3%

- Equity risk premium = 12%

    ✗ **A)** $59.55.

    ✗ **B)** $57.48.

    ✓ **C)** $57.70.

Explanation

The current stock price is equal to $(D_1 + P_1) / (1 + k_e)$. D_1 equals $6.10(1.04) = $6.34. The equity discount rate is 3% + 12% = 15%. Therefore the current stock price is ($6.34 + $60)/(1.15) = $57.70

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

A preferred stock's dividend is $5 and the firm's bonds currently yield 6.25%. The preferred shares are priced to yield 75 basis points below the bond yield. The price of the preferred is *closest* to:

 ✓ **A)** $90.91.

 ✗ **B)** $80.00.

 ✗ **C)** $5.00.

Explanation

Preferred stock yield (K_p) = bond yield - 0.75% = 6.25% − 0.75% = 5.5%

Value = dividend / K_p = $5 / 0.055 = $90.91.

References

Question From: Session 14 > Reading 50 > LOS d

Related Material:

- Key Concepts by LOS

Which of the following industries is likely to be most sensitive to the business cycle?

 ✗ **A)** Confectionery.

 ✓ **B)** Automobile.

 ✗ **C)** Pharmaceutical.

Explanation

The automobile industry is cyclical because demand for new autos fluctuates with the business cycle. The confectionery industry tends to be non-cyclical and defensive because demand for candy tends to be stable through the business cycle. The pharmaceutical industry is non-cyclical because demand for medicines is independent of the business cycle.

References

Question From: Session 14 > Reading 49 > LOS i

Related Material:

- Key Concepts by LOS

Which of the following changes would *most likely* cause a firm's return on equity to increase?

   ✗ **A)** Net income increases by 5% and average book value of equity increases by 10%.

   ✓ **B)** Net income decreases by 5% and average book value of equity decreases by 10%.

   ✗ **C)** Net income increases by 5% and average book value of equity increases by 5%.

Explanation

Return on equity is net income divided by average book value of equity. If the book value of equity decreases relatively more than net income decreases, return on equity will increase. This illustrates that an increase in ROE is not necessarily positive for the firm. An analyst must examine the reasons for changes in ROE.

References

Question From: Session 14 > Reading 48 > LOS h

Related Material:

- Key Concepts by LOS

Question #134 of 200

Assume that at the end of the next year, Company A will pay a $2.00 dividend per share, an increase from the current dividend of $1.50 per share. After that, the dividend is expected to increase at a constant rate of 5%. If an investor requires a 12% return on the stock, what is the value of the stock?

   ✓ **A)** $28.57.

   ✗ **B)** $31.78.

   ✗ **C)** $30.00.

Explanation

$P_0 = D_1 / k - g$
$D_1 = \$2$
$g = 0.05$
$k = 0.12$
$P_0 = 2 / 0.12 - 0.05 = 2 / 0.07 = \$28.57$

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #135 of 200

The price to book value ratio (P/BV) is a helpful valuation technique when examining firms:

- ✗ **A)** with the same stock prices.
- ✗ **B)** with older assets compared to those with newer assets.
- ✓ **C)** that hold primarily liquid assets.

Explanation

P/BV analysis works best for firms that hold primarily liquid assets.

References

Question From: Session 14 > Reading 50 > LOS g

Related Material:

- Key Concepts by LOS

Question #136 of 200

Question ID: 415290

When constructing a peer group of firms, an analyst should *least* appropriately consider the firms':

- ✗ **A)** cost structures.
- ✗ **B)** industry classification.
- ✓ **C)** business cycle sensitivity.

Explanation

A peer group should consist of firms that are alike in their principal lines of business, along with other similarities such as cost structures and access to capital. Firms can be similar in business cycle sensitivity but dissimilar in terms of their business activities (e.g., a firm in the home building industry and a firm in the heavy equipment manufacturing industry).

References

Question From: Session 14 > Reading 49 > LOS d

Related Material:

- Key Concepts by LOS

Question #137 of 200

Question ID: 415348

Assume a company has earnings per share of $5 and pays out 40% in dividends. The earnings growth rate for the next 3 years will be 20%. At the end of the third year the company will start paying out 100% of earnings in dividends and earnings will increase at an annual rate of 5% thereafter. If a 12% rate of return is required, the value of the company is approximately:

- ✓ **A)** $102.80.
- ✗ **B)** $92.92.

✗ **C)** $55.69.

<u>Explanation</u>

First, calculate the dividends in years 0 through 4: (We need D_4 to calculate the value in Year 3)

$D_0 = (0.4)(5) = 2$
$D_1 = (2)(1.2) = 2.40$
$D_2 = (2.4)(1.2) = 2.88$
$D_3 = E_3 = 5(1.2)^3 = 8.64$

g after year 3 will be 5%, so

$D_4 = 8.64 \times 1.05 = 9.07$

Then, solve for the terminal value at the end of period 3 = $D_4 / (k - g) = 9.07 / (0.12 - 0.05) = \$129.57$

Present value of the cash flows = value of stock = $2.4 / (1.12)^1 + 2.88 / (1.12)^2 + 8.64 / (1.12)^3 + 129.57 / (1.12)^3 = 2.14 + 2.29 + 6.15 + 92.22 = 102.80$

<u>References</u>

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #138 of 200

Two investors, Craig Tower and Erin Gray, own 100 shares each of the same company. Tower receives a quarterly dividend while Gray does not. This is *most likely* because Tower:

- $\checkmark$ **A)** owns a different class of stock than Gray.
- ✗ **B)** purchased his shares after Gray purchased her shares.
- ✗ **C)** owns common shares while Gray owns preferred shares.

<u>Explanation</u>

Different classes of common stocks can have different features with respect to dividends, stock splits, voting power and seniority if the firm's assets are liquidated. If Gray owns preferred shares, she would be more likely to receive a dividend than Tower's common shares. If Gray had purchased shares before an ex-dividend date and Tower purchased the same class of shares after that ex-dividend date, Gray would receive a dividend that Tower did not.

<u>References</u>

Question From: Session 14 > Reading 48 > LOS b

Related Material:

- Key Concepts by LOS

During the contraction phase of the business cycle, how will an active portfolio manager using an industry rotation strategy treat stocks of companies in a cyclical industry?

✗ **A)** Overweight the industry.

✓ **B)** Underweight the industry.

✗ **C)** Maintain the target weight of the industry.

Explanation

A cyclical industry is one that is expected to outperform during an expansion and underperform in a contraction. The industry rotation strategy for a cyclical industry is to overweight during an expansion and underweight during a contraction.

References

Question From: Session 14 > Reading 49 > LOS a

Related Material:

- Key Concepts by LOS

Question #140 of 200

Compared to preferred stock, common stock is *most likely* to:

✗ **A)** pay more frequent dividends.

✗ **B)** exhibit a lower standard deviation of returns.

✓ **C)** provide a higher average return.

Explanation

Common stock is more risky than preferred stock and is expected to provide higher average returns. Preferred stock promises fixed periodic dividends. Common stock can be dividend-paying or non-dividend paying and the dividends are at management's discretion.

References

Question From: Session 14 > Reading 48 > LOS e

Related Material:

- Key Concepts by LOS

Question #141 of 200

A company has 6% preferred stock outstanding with a par value of $100. The required return on the preferred is 8%. What is the value of the preferred stock?

    ✗ **A)** $100.00.

    ✗ **B)** $92.59.

    ✓ **C)** $75.00.

Explanation

The annual dividend on the preferred is $100(.06) = $6.00. The value of the preferred is $6.00/0.08 = $75.00.

References

Question From: Session 14 > Reading 50 > LOS d

Related Material:

- Key Concepts by LOS

Question #142 of 200

A valuation model based on the cash flows that a firm will have available to pay dividends in the future is *best* characterized as a(n):

    ✓ **A)** free cash flow to equity model.

    ✗ **B)** infinite period dividend discount model.

    ✗ **C)** free cash flow to the firm model.

Explanation

Free cash flow to equity represents a firm's capacity to pay future dividends. A free cash flow to equity model estimates the firm's FCFE for future periods and values the stock as the present value of the firm's future FCFE per share.

References

Question From: Session 14 > Reading 50 > LOS c

Related Material:

- Key Concepts by LOS

Question #143 of 200

The Sustainable Growth Rate is equal to:

✗ **A)** (ROE) x (1-RR).

  ✓ **B)** (ROE) x (RR).

  ✗ **C)** (ROE) x (1+RR).

Explanation

The Sustainable Growth Rate is equal to the return on the equity portion of new investments (ROE) multiplied by the firm's retention rate (RR).

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #144 of 200

Market share stability within an industry is *least likely* to result from a high level of:

  ✗ **A)** switching costs.

  ✗ **B)** barriers to entry.

  ✓ **C)** product innovation.

Explanation

Frequent introductions of new products and innovations tend to make firms' market shares within an industry less stable. High barriers to entry into the industry and high switching costs for customers to change to a competing product both contribute to market share stability.

References

Question From: Session 14 > Reading 49 > LOS g

Related Material:

- Key Concepts by LOS

Question #145 of 200

Pearl River Heavy Industries shows the following information in its financial statements:

Total Assets	HK$146,000,000
Total Liabilities	HK$87,000,000
Net Income	HK$27,000,000
Price per Share	HK$312
Shares Outstanding	200,000

The equity securities of Pearl River have a:

    ✗ **A)** book value of HK$62,400,000.

    ✗ **B)** market value of HK$146,000,000.

    ✓ **C)** book value of HK$59,000,000.

Explanation

Book value = Total assets − total liabilities = 146,000,000 − 87,000,000 = HK$59,000,000
Market value of equity = Market price per share × shares outstanding = HK$312 × 200,000 = HK$62,400,000

References

Question From: Session 14 > Reading 48 > LOS g

Related Material:

- Key Concepts by LOS

Question #146 of 200

Assuming all other factors remain unchanged, which of the following would *most likely* lead to a decrease in the market P/E ratio?

    ✗ **A)** An increase in the dividend payout ratio.

    ✗ **B)** A decline in the risk-free rate.

    ✓ **C)** A rise in the stock risk premium.

Explanation

P/E = (1 - RR)/(k - g)

To lower P/E: RR increases, g decreases and or k increases. Both a decline in the RF rate and a decline in the rate of inflation will reduce k. An increase in the stock's risk premium will increase k.

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #147 of 200

A stock is expected to pay a dividend of $1.50 at the end of each of the next three years. At the end of three years the stock price is expected to be $25. The equity discount rate is 16 percent. What is the current stock price?

✗ **A)** $17.18.

✓ **B)** $19.39.

✗ **C)** $24.92.

Explanation

The value of the stock today is the present value of the dividends and the expected stock price, discounted at the equity discount rate:

$1.50/1.16 + $1.50/1.16² + $1.50/1.16³ + $25.00/1.16³ = $19.39

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #148 of 200

Private equity securities *most likely*:

✓ **A)** are illiquid and do not have quoted prices.

✗ **B)** are issued to individual investors.

✗ **C)** trade in over-the-counter dealer markets.

Explanation

Private equity securities are illiquid and do not trade in public securities markets. Holders of private equity must negotiate with other investors to sell the securities. Private equity securities are typically issued to qualified institutional investors.

References

Question From: Session 14 > Reading 48 > LOS c

Related Material:

- Key Concepts by LOS

Question #149 of 200

Industry analysis is *most likely* to provide an analyst with insight about a company's:

✓ **A)** pricing power.

✗ **B)** competitive strategy.

✗ **C)** financial performance.

Industry analysis provides a framework for an analyst to understand a firm in relation to its competitive environment, which determines how much pricing power a firm has. Competitive strategy and financial performance are aspects of company analysis.

References

Question From: Session 14 > Reading 49 > LOS a

Related Material:

- Key Concepts by LOS

Question #150 of 200

General, Inc., has net income of $650,000 and one million shares outstanding. The profit margin is 6 percent and General, Inc., is selling for $30.00. The price/sales ratio is equal to:

  ✗ **A)** 10.83.

  ✓ **B)** 2.77.

  ✗ **C)** 0.65.

Explanation

6% profit margin = $650,000/x; x (sales) = $10,833,333.
Sales per share = $10.83 M/1,000,000 = $10.83 per share.
P/Sales = $30.00/$10.83 = 2.77.

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #151 of 200

Securities that can be sold back to the issuing firm at a specific price are *best* described as:

  ✓ **A)** putable.

  ✗ **B)** convertible.

  ✗ **C)** callable.

Explanation

Putable securities give the investor the right to sell the securities back to the firm at a predetermined price. Callable securities give the issuer the right to buy the securities back at a predetermined price. Convertible securities give the investor the right to

exchange the securities for a predetermined number of the firm's common shares.

Question From: Session 14 > Reading 48 > LOS a

Related Material:

- Key Concepts by LOS

Question #152 of 200

Factors that increase competition in an industry *most likely* include:

- ✓ **A)** low barriers to entry, low concentration, and high unused capacity.
- ✗ **B)** high barriers to entry, low concentration, and low unused capacity.
- ✗ **C)** low barriers to entry, high concentration, and high unused capacity.

<u>Explanation</u>

Low barriers to entry increase competition as more firms can enter the business. Industries that are fragmented and have unused capacity tend to be highly competitive as they fight for market share and attempt to utilize excess manufacturing resources.

Question From: Session 14 > Reading 49 > LOS e

Related Material:

- Key Concepts by LOS

Question #153 of 200

For a non-dividend paying firm, an increase in net income must increase:

- ✗ **A)** market value of equity.
- ✗ **B)** both book value and market value of equity.
- ✓ **C)** book value of equity.

<u>Explanation</u>

Book value of equity is the company's assets minus its liabilities. For a non-dividend paying firm, positive net income will increase the book value of equity. An increase in book value of equity may or may not increase the market value of equity. An increase in net income that does not meet investors' prior expectations may decrease the market value of equity.

Question From: Session 14 > Reading 48 > LOS g

Question #154 of 200

The preferred stock of the Delco Investments Company has a par value of $150 and a dividend of $11.50. A shareholder's required return on this stock is 14%. What is the maximum price he would pay?

- ✓ **A)** $82.14.
- ✗ **B)** $54.76.
- ✗ **C)** $150.00.

Explanation

Value of preferred = D / kp = $11.50 / 0.14 = $82.14

References

Question From: Session 14 > Reading 50 > LOS d

Related Material:

- Key Concepts by LOS

Question #155 of 200

A stock has a required return of 14% percent, a constant growth rate of 5% and a retention rate of 60%. The firm's P/E ratio should be:

- ✗ **A)** 6.66.
- ✗ **B)** 5.55.
- ✓ **C)** 4.44.

Explanation

P/E = (1 - RR) / (k - g) = 0.4 / (0.14 - 0.05) = 4.44

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #156 of 200

What is the value of a stock that paid a $0.25 dividend last year, if dividends are expected to grow at a rate of 6% forever? Assume that the risk-free rate is 5%, the expected return on the market is 10%, and the stock's beta is 0.5.

   ✗ **A)** $3.53.

   ✓ **B)** $17.67.

   ✗ **C)** $16.67.

Explanation

The discount rate is $k_e = 0.05 + 0.5(0.10 − 0.05) = 0.075$. Use the infinite period dividend discount model to value the stock. The stock value = $D_1 / (k_e - g) = (0.25 × 1.06) / (0.075 - 0.06) = \$17.67$.

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #157 of 200

An argument against using the price-to-earnings (P/E) valuation approach is that:

   ✓ **A)** earnings can be negative.

   ✗ **B)** earnings power is the primary determinant of investment value.

   ✗ **C)** research shows that P/E differences are significantly related to long-run average stock returns.

Explanation

Negative earnings render the P/E ratio useless. Both remaining factors increase the usefulness of the P/E approach.

References

Question From: Session 14 > Reading 50 > LOS k

Related Material:

- Key Concepts by LOS

Question #158 of 200

A firm is *most likely* to have pricing power if:

   ✗ **A)** its market share is high.

   ✓ **B)** its product is differentiated.

   ✗ **C)** costs to exit the industry are high.

Explanation

Firms offering products that are differentiated in terms of quality and features are more likely to have pricing power than firms that produce undifferentiated (commodity-like) products. High market share does not necessarily imply pricing power; for example, if four firms each have 25% market share, none of them are likely to have significant pricing power. High exit costs can create overcapacity in an industry and result in a high degree of price competition as firms try to maintain production volume during a period of reduced demand.

References

Question From: Session 14 > Reading 49 > LOS g

Related Material:

- Key Concepts by LOS

Question #159 of 200

An aggressive price reduction to gain market share is *most likely* to be associated with a:

   ✗ **A)** product differentiation strategy.

   ✓ **B)** cost leadership strategy.

   ✗ **C)** service differentiation strategy.

Explanation

Michael Porter identified two competitive strategies: cost leadership and product or service differentiation. A firm that uses a cost leadership or low-cost strategy seeks to have low production costs that will enable it to offer lower prices than its competitors to protect or gain market share. A product or service differentiation strategy seeks to gain a price premium for its products by making them distinctive to the consumer.

References

Question From: Session 14 > Reading 49 > LOS k

Related Material:

- Key Concepts by LOS

Question #160 of 200

Given the following information, compute price/sales.

- Book value of assets = $550,000.
- Total sales = $200,000.
- Net income = $20,000.
- Dividend payout ratio = 30%.
- Operating cash flow = $40,000.
- Price per share = $100.

- Shares outstanding = 1,000.
- Book value of liabilities = $500,000.

     ✗ **A)** 2.00X.

     ✓ **B)** 0.50X.

     ✗ **C)** 2.50X.

Explanation

Market value of equity = ($100)(1000) = $100,000

Price / Sales = $100,000 / $200,000 = 0.5X

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #161 of 200

An analyst projects the following pro forma financial results for Magic Holdings, Inc., in the next year:

- Sales of $1,000,000
- Earnings of $200,000
- Total assets of $750,000
- Equity of $500,000
- Dividend payout ratio of 62.5%
- Shares outstanding of 50,000
- Risk free interest rate of 7.5%
- Expected market return of 13.0%
- Stock Beta at 1.8

If the analyst assumes Magic Holdings, Inc. will produce a constant rate of dividend growth, the value of the stock is *closest to:*

     ✗ **A)** $44

     ✗ **B)** $19

     ✓ **C)** $104

Explanation

Infinite period DDM: $P_0 = D_1 / (k_e - g)$

     D_1   = (Earnings × Payout ratio) / average number of shares outstanding

                 = ($200,000 × 0.625) / 50,000 = $2.50.

$$k_e = \text{risk free rate} + [\text{beta} \times (\text{expected market return} - \text{risk free rate})]$$

$$k_e = 7.5\% + [1.8 \times (13.0\% - 7.5\%)] = 17.4\%.$$

$$g = (\text{retention rate} \times \text{ROE})$$

$$\text{Retention} = (1 - \text{Payout}) = 1 - 0.625 = 0.375.$$

$$\text{ROE} = \text{net income/equity}$$

$$= 200{,}000/500{,}000 = 0.4$$

$$g = 0.375 \times 0.4 = 0.15.$$

$$P_0 = D_1 / (k_e - g) = \$2.50 / (0.174 - 0.15) = 104.17.$$

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #162 of 200

A company's growth rate in dividends and earnings can be estimated as the:

- ✗ **A)** difference between the retention ratio and the return on equity.
- ✗ **B)** product of the return on equity and the dividend payout ratio.
- ✓ **C)** product of the retention ratio and the return on equity.

Explanation

Assuming past investments are stable and earnings are calculated to allow for maintenance of past earnings power, then the firm's expected dividend growth rate (g) can be defined as the firm's earnings plowback or retention rate (RR) times the return on the equity (ROE) portion of new investments. This growth rate is also called the sustainable growth rate.

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #163 of 200

The yield on a company's 7.5%, $50 par preferred stock is 6%. The value of the preferred stock is *closest* to:

    ✗ **A)** $12.50.

    ✓ **B)** $62.50.

    ✗ **C)** $50.00.

Explanation

The preferred dividend is 0.075($50) = $3.75. The value of the preferred = $3.75 / 0.06 = $62.50.

References

Question From: Session 14 > Reading 50 > LOS d

Related Material:

- Key Concepts by LOS

Question #164 of 200

If a company has a "0" earnings retention rate, the firm's P/E ratio will equal:

    ✓ **A)** 1 / k

    ✗ **B)** k + g

    ✗ **C)** D/P + g

Explanation

P/E = div payout ratio / (k − g)

where g = (retention rate)(ROE) = (0)(ROE) = 0

Dividend payout = 1 − retention ratio = 1 − 0 = 1

P/E = 1 / (k − 0) = 1 / k

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #165 of 200

An enterprise value multiple is typically calculated as the ratio of enterprise value to:

✓ **A)** EBITDA.

✗ **B)** net income.

✗ **C)** sales.

Explanation

An enterprise value multiple is typically calculated as the ratio of enterprise value to EBITDA or some other measure of operating income. Net income is not typically used because it reflects a firm's current capital structure and non-cash charges, and because the ratio becomes meaningless when net income is negative.

References

Question From: Session 14 > Reading 50 > LOS i

Related Material:

- Key Concepts by LOS

Question #166 of 200

Assume the following information for a stock:

Beta coefficient	= 1.50
Risk-free rate	= 6%
Expected rate of return on market	= 14%
Dividend payout ratio	= 30%
Expected dividend growth rate	= 11%

The estimated earnings multiplier (P/E ratio) is *closest* to:

✗ **A)** 3.33.

✓ **B)** 4.29.

✗ **C)** 10.00.

Explanation

P/E = D/E1 / (k − g)

D/E1 = Dividend payout ratio = 0.3

g = 0.11

k = 6 + (1.5)(14 − 6) = 18%

P/E = 0.3 / (0.18 − 0.11) = 0.3 / 0.07 = 4.29

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

Question #167 of 200

Question ID: 598996

The threat of substitutes is *most likely* to be low for a firm that:

   ✗ **A)** produces a commodity product in an industry with significant unused capacity.

   ✗ **B)** operates in a fragmented market with little unused capacity.

   ✓ **C)** produces a differentiated product with high switching costs.

Explanation

The threat of competition from substitute products is likely to be low for a firm that produces a differentiated product with high switching costs. Unused capacity and low industry concentration (a fragmented market) tend to intensify rivalry among industry competitors but are not directly related to the threat of substitutes.

References

Question From: Session 14 > Reading 49 > LOS f

Related Material:

• Key Concepts by LOS

Question #168 of 200

Question ID: 434391

Preferred stock *most likely* has a:

   ✗ **A)** variable dividend and no maturity.

   ✗ **B)** fixed dividend and maturity.

   ✓ **C)** fixed dividend and no maturity.

Explanation

Preferred stock typically pays a fixed dividend and does not mature.

References

Question From: Session 14 > Reading 50 > LOS d

Related Material:

• Key Concepts by LOS

Question #169 of 200

Question ID: 415347

What value would be placed on a stock that currently pays no dividend but is expected to start paying a $1 dividend five years from now?

Once the stock starts paying dividends, the dividend is expected to grow at a 5 percent annual rate. The appropriate discount rate is 12 percent.

    ✗ **A)** $14.29.

    ✓ **B)** $9.08.

    ✗ **C)** $8.11.

Explanation

P_4 = D5/(k-g) = 1/(.12-.05) = 14.29

P_0 = [FV = 14.29; n = 4; i = 12] = $9.08.

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #170 of 200

Of the following types of firm, which is *most suitable* for P/B ratio analysis?

    ✗ **A)** A service industry firm without significant fixed assets.

    ✓ **B)** A firm with accounting standards consistent to other firms.

    ✗ **C)** A firm with accounting standards different from other firms.

Explanation

Assuming consistent accounting standards across firms, P/B ratios can reveal signs of misvaluation across firms.

References

Question From: Session 14 > Reading 50 > LOS g

Related Material:

- Key Concepts by LOS

Question #171 of 200

An analyst estimates that a stock's value is 22.50. If the market price of this stock is 25.00 the analyst believes the stock is:

✗ **A)** fairly valued.

✓ **B)** overvalued.

✗ **C)** undervalued.

Explanation

If a stock's intrinsic value is less than its market value, the stock is overvalued.

References

Question From: Session 14 > Reading 50 > LOS a

Related Material:

- Key Concepts by LOS

Question #172 of 200

A firm's earnings are *most likely* to be cyclical if:

✗ **A)** most of the firm's costs depend on its level of output.

✓ **B)** the firm produces luxury items.

✗ **C)** the firm operates in a growth industry.

Explanation

Producers of luxury items tend to have cyclical earnings because consumers typically decrease their purchases of these items during economic recessions. The earnings of firms with high percentages of variable costs are not as likely to be cyclical as those of firms with high percentages of fixed costs (i.e., high operating leverage). A growth industry has demand that is strong enough that earnings remain relatively unaffected by the business cycle.

References

Question From: Session 14 > Reading 49 > LOS c

Related Material:

- Key Concepts by LOS

Question #173 of 200

In which of the following industries are technological factors *least likely* a significant influence?

✓ **A)** Confections.

✗ **B)** Pharmaceuticals.

✗ **C)** Oil services.

Explanation

Technological influences are relatively important in the pharmaceuticals and oil services industries, but they are generally not a significant influence in the confections industry.

<u>References</u>

Question From: Session 14 > Reading 49 > LOS i

Related Material:

- Key Concepts by LOS

Question #174 of 200

A firm has an expected dividend payout ratio of 50 percent, a required rate of return of 18 percent, and an expected dividend growth rate of 3 percent. The firm's price to earnings ratio (P/E) is:

    ✗ **A)** 6.66.

    ✗ **B)** 2.78.

    ✓ **C)** 3.33.

<u>Explanation</u>

P/E = .5 / (18%-3%) = 3.33.

<u>References</u>

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #175 of 200

The constant-growth dividend discount model would typically be most appropriate in valuing a stock of a:

    ✗ **A)** new venture expected to retain all earnings for several years.

    ✓ **B)** moderate growth, "mature" company.

    ✗ **C)** rapidly growing company.

<u>Explanation</u>

Remember, the infinite period DDM has the following assumptions:

- The stock pays dividends and they grow at a constant rate.
- The constant growth rate, g, continues for an infinite period.
- k must be greater than g. If not, the math will not work.

If any one of these assumptions is not met, the model breaks down. The infinite period DDM doesn't work with growth

companies. Growth companies are firms that currently have the ability to earn rates of return on investments that are currently above their required rates of return. The infinite period DDM assumes the dividend stream grows at a constant rate forever while growth companies have high growth rates in the early years that level out at some future time. The high early or supernormal growth rates will also generally exceed the required rate of return. Since the assumptions (constant g and k > g) don't hold, the infinite period DDM cannot be used to value growth companies.

References

Question From: Session 14 > Reading 50 > LOS f

Related Material:

- Key Concepts by LOS

Question #176 of 200

Question ID: 415268

Other things equal, which of the following types of stock has the *most* risk from the investor's perspective?

  ✗ **A)** Putable common share.

  ✓ **B)** Callable common share.

  ✗ **C)** Callable preferred share.

Explanation

Callable shares have more risk than putable shares because the issuer can exercise the call option (which limits the investor's potential gains) while the investor can exercise the put option (which limits the investor's potential losses, assuming the firm is able to meet its obligation). Preferred shares have less risk for the investor than common shares because preferred shares have a higher priority claim on the firm's assets in the event of liquidation, and because preferred dividends typically must be paid before common dividends may be paid.

References

Question From: Session 14 > Reading 48 > LOS e

Related Material:

- Key Concepts by LOS

Question #177 of 200

Question ID: 415392

The earnings multiplier model, derived from the dividend discount model, expresses a stock's P/E ratio (P_0/E_1) as the :

✗ **A)** expected dividend in one year divided by the difference between the required return on equity and the expected dividend growth rate.

✗ **B)** expected dividend payout ratio divided by the sum of the expected dividend growth rate and the required return on equity.

✓ **C)** expected dividend payout ratio divided by the difference between the required return on equity and the expected dividend growth rate.

Explanation

Starting with the dividend discount model $P_0 = D_1/(k_e - g)$, and dividing both sides by E_1 yields: $P_0/E_1 = (D_1/E_1)/(k_e - g)$

Thus, the P/E ratio is determined by:

- The expected dividend payout ratio (D_1/E_1).
- The required rate of return on the stock (k_e).
- The expected growth rate of dividends (g).

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #178 of 200

Which valuation method is *most appropriate* to estimate a floor value for a firm being liquidated?

✓ **A)** Asset-based.

✗ **B)** Price/earnings ratio.

✗ **C)** Discounted cash flow.

Explanation

An asset-based model would likely be most appropriate to estimate a floor value for a firm entering liquidation. Prior or future years' earnings and cash flow are not relevant measures for a firm that is not a going concern.

References

Question From: Session 14 > Reading 50 > LOS k

Related Material:

- Key Concepts by LOS

Question #179 of 200

Participating preference shares *most likely*:

   ✗ **A)** can be exchanged for common stock at a ratio determined at issuance.

   ✓ **B)** receive extra dividends if firm profits exceed a predetermined threshold.

   ✗ **C)** give the shareholder the right to sell the shares back to the firm at a specific price.

Explanation

Participating preference shares receive extra dividends if firm profits exceed a predetermined threshold. Convertible preference shares can be exchanged for common stock at a conversion ratio determined at issuance. Putable common shares give the shareholder the right to sell the shares back to the firm at a specific price.

References

Question From: Session 14 > Reading 48 > LOS a

Related Material:

- Key Concepts by LOS

Question #180 of 200

Cheryl Brower and Todd Sutter each own 100 shares of Hills Company stock. In a recent proxy vote, Brower had 100 votes but Sutter had 10 votes. The *most likely* reason for this difference in voting rights is that:

   ✗ **A)** Hills Company uses a statutory voting method.

   ✓ **B)** Brower and Sutter own different classes of stock.

   ✗ **C)** Brower is a director of Hills Company.

Explanation

Companies may issue classes of stock (e.g., Class A and Class B shares) that differ in aspects such as voting rights, dividends, or priority of claims in liquidation.

References

Question From: Session 14 > Reading 48 > LOS b

Related Material:

- Key Concepts by LOS

Question #181 of 200

A stock has a required rate of return of 15%, a constant growth rate of 10%, and a dividend payout ratio of 45%. The stock's price-earnings ratio should be:

   ✓ **A)** 9.0 times.

✗ **B)** 3.0 times.

✗ **C)** 4.5 times.

Explanation

P/E = D/E$_1$/ (k - g)

D/E$_1$ = Dividend Payout Ratio = 0.45

k = 0.15

g = 0.10

P/E = 0.45 / (0.15 - 0.10)

= 0.45 / 0.05 = 9

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #182 of 200

Given the following information, compute the price/cash flow ratio for EAV Technology, a U.S. GAAP reporting firm.

- Net income per share = $6
- Price per share = $100
- Depreciation per share = $2
- Interest expense per share = $4
- Marginal tax rate = 25%

   ✗ **A)** 9.1X.

   ✗ **B)** 8.3X.

   ✓ **C)** 12.5X.

Explanation

Operating cash flow = Net income per share + Depreciation per share = $6 + $2 = $8

Price/cash flow = $100 / $8.0X = 12.5X

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #183 of 200

Which of the following conditions is *most likely* to indicate that barriers to entry into an industry are low?

  ✗ **A)** Market shares have been stable over the last two business cycles.

  ✓ **B)** Investment capital is available at low cost.

  ✗ **C)** The industry has significant economies of scale.

Explanation

Readily available capital tends to make entry into an industry easier. If an industry is composed of the same firms over a long period of time, barriers to entry are likely high. Economies of scale are a barrier to entry because existing firms are likely to be producing at a lower cost per unit than a new competitor can achieve.

References

Question From: Session 14 > Reading 49 > LOS g

Related Material:

- Key Concepts by LOS

Question #184 of 200

REM Corp.'s return on equity (ROE) is 19.5% and its dividend payout rate is 45%. What is the company's implied dividend growth rate?

  ✗ **A)** 19.5%.

  ✗ **B)** 8.78%.

  ✓ **C)** 10.73%.

Explanation

g = (ROE)(RR)

g = (19.5)(1 − 0.45)

g = (0.195)(0.55)

= 0.1073 or 10.73%

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #185 of 200

Because of dividend displacement of earnings, the net effect on firm value of increasing the dividend payout ratio is:

> ✓ **A)** indeterminate.

> ✗ **B)** to increase firm value.

> ✗ **C)** to decrease firm value.

Explanation

The net effect on firm value of increasing the dividend payout ratio is ambiguous because the positive effect of larger dividends may be offset by a negative effect on the firm's sustainable growth rate. If increasing the payout ratio always increased firm value, all firms would have 100% payout ratios.

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #186 of 200

In its latest annual report, a company reported the following:

Net income	= $1,000,000
Total equity	= $5,000,000
Total assets	= $10,000,000
Dividend payout ratio	= 40%

Based on the sustainable growth model, the *most likely* forecast of the company's future earnings growth rate is:

> ✗ **A)** 6%.

> ✗ **B)** 8%.

> ✓ **C)** 12%.

Explanation

g = (RR)(ROE)

RR = 1 − dividend payout ratio = 1 − 0.4 = 0.6

ROE = NI / Total Equity = 1,000,000 / 5,000,000 = 1 / 5 = 0.2
Note: This is the "simple" calculation of ROE. Since we are only given these inputs, these are what you should use. Also, if given beginning and ending equity balances, use the average in the denominator.

g = (0.6)(0.2) = 0.12 or 12%

References

Question From: Session 14 > Reading 50 > LOS e

Question #187 of 200

Auto manufacturers and home builders would *most likely* be grouped together in an industry classification system based on:

   ✗ **A)** type of business activity.

   ✗ **B)** dividend yields.

   ✓ **C)** sensitivity to business cycles.

Explanation

Auto manufacturing and home building are both cyclical industries. An industry classification system based on business cycle sensitivity would be the most likely to group firms from these industries together.

References

Question From: Session 14 > Reading 49 > LOS b

Related Material:

- Key Concepts by LOS

Question #188 of 200

Holding all else equal, if the beta of a stock increases, the stock's price will:

   ✗ **A)** increase.

   ✓ **B)** decrease.

   ✗ **C)** be unaffected.

Explanation

When the beta of a stock increases, its required return will increase. This increases the discount rate investors use to estimate the present value of the stock's future cash flows, which decreases the value of the stock.

References

Question From: Session 14 > Reading 50 > LOS c

Related Material:

- Key Concepts by LOS

All else equal, if a firm's return on equity (ROE) increases, the stock's value as estimated by the constant growth dividend discount model (DDM) will *most likely*:

- ✓ **A)** increase.
- ✗ **B)** decrease.
- ✗ **C)** not change.

Explanation

Increase in ROE: ROE is a component of g. As g increases, the spread between k_e and g, or the P/E denominator, will decrease, and the P/E ratio will increase.

References

Question From: Session 14 > Reading 50 > LOS h

Related Material:

- Key Concepts by LOS

Question #190 of 200

Question ID: 415367

A company with a return on equity (ROE) of 27%, required return on equity (k_e) of 20%, and a dividend payout ratio of 40% has an implied sustainable growth rate *closest* to:

- ✗ **A)** 10.80%.
- ✓ **B)** 16.20%.
- ✗ **C)** 12.00%.

Explanation

g = (RR)(ROE)

= (.60)(.27)

= 0.162 or 16.2%

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #191 of 200

Question ID: 415253

An equity security that requires the firm to pay any scheduled dividends that have been missed, before paying any dividends to

common equity holders, is a:

✗ **A)** participating preference share.

✓ **B)** cumulative preference share.

✗ **C)** convertible preference share.

Explanation

Cumulative preference shares (cumulative preferred stock) must receive any dividends in arrears before the firm may pay any dividends to common shareholders.

References

Question From: Session 14 > Reading 48 > LOS a

Related Material:

- Key Concepts by LOS

Question #192 of 200

Bybee is expected to have a temporary supernormal growth period and then level off to a "normal," sustainable growth rate forever. The supernormal growth is expected to be 25 percent for 2 years, 20 percent for one year and then level off to a normal growth rate of 8 percent forever. The market requires a 14 percent return on the company and the company last paid a $2.00 dividend. What would the market be willing to pay for the stock today?

✓ **A)** $52.68.

✗ **B)** $47.09.

✗ **C)** $67.50.

Explanation

First, find the future dividends at the supernormal growth rate(s). Next, use the infinite period dividend discount model to find the expected price after the supernormal growth period ends. Third, find the present value of the cash flow stream.

D_1 = 2.00 (1.25) = 2.50 (1.25) = D_2 = 3.125 (1.20) = D_3 = 3.75

P_2 = 3.75/(0.14 - 0.08) = 62.50

N = 1; I/Y = 14; FV = 2.50; compute PV = 2.19.

N = 2; I/Y = 14; FV = 3.125; compute PV = 2.40.

N = 2; I/Y = 14; FV = 62.50; compute PV = 48.09.

Now sum the PV's: 2.19 + 2.40 + 48.09 = $52.68.

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

Question #193 of 200

Which of the following is *least likely* a reason the price to cash flow (P/CF) model has grown in popularity?

- ✓ **A)** CFs are more easily estimated than future dividends.
- ✗ **B)** CFs are generally more difficult to manipulate than earnings.
- ✗ **C)** CFs are used extensively in valuation models.

Explanation

CFs are not easier to estimate than dividends.

References

Question From: Session 14 > Reading 50 > LOS g

Related Material:

- Key Concepts by LOS

Question #194 of 200

A firm will not pay dividends until four years from now. Starting in year four dividends will be $2.20 per share, the retention ratio will be 40%, and ROE will be 15%. If k = 10%, what should be the value of the stock?

- ✗ **A)** $58.89.
- ✓ **B)** $41.32.
- ✗ **C)** $55.25.

Explanation

g = ROE × retention ratio = ROE × b = 15 × 0.4 = 6%

Based on the growth rate we can calculate the expected price in year 3:

$P_3 = D_4 / (k - g) = 2.2 / (0.10 - 0.06) = \$55$

The stock value today is: $P_0 = PV (55)$ at 10% for 3 periods = $41.32

References

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

An analyst studying Albion Industries determines that the average EV/EBITDA ratio for Albion's industry is 10. The analyst obtains the following information from Albion's financial statements:

> EBITDA = £11,000,000
> Market value of debt = £30,000,000
> Cash = £1,000,000

Based on the industry's average enterprise value multiple, what is the equity value of Albion Industries?

✓ **A)** £81,000,000.

✗ **B)** £110,000,000.

✗ **C)** £80,000,000.

Explanation

Enterprise value = Average EV/EBITDA × company EBITDA = 10 × £11,000,000 = £110,000,000

Enterprise value = Equity value + debt − cash

Equity value = Enterprise value − debt + cash = £110,000,000 − £30,000,000 + £1,000,000 = £81,000,000

References

Question From: Session 14 > Reading 50 > LOS i

Related Material:

- Key Concepts by LOS

A firm is expected to have four years of growth with a retention ratio of 100%. Afterwards the firm's dividends are expected to grow 4% annually, and the dividend payout ratio will be set at 50%. If earnings per share (EPS) = $2.4 in year 5 and the required return on equity is 10%, what is the stock's value today?

✗ **A)** $20.00.

✗ **B)** $30.00.

✓ **C)** $13.66.

Explanation

Dividend in year 5 = (EPS)(payout ratio) = 2.4 × 0.5 = 1.2

$P_4 = 1.2 / (0.1 − 0.04) = 1.2 / 0.06 = \$20$

$P_0 = PV\ (P_4) = \$20 / (1.10)^4 = \$13.66$

References

Related Material:

- Key Concepts by LOS

Question #197 of 200

Given the following estimated financial results for the next period, value the stock of FishnChips, Inc., using the infinite period dividend discount model (DDM).

- Sales of $1,000,000.
- Earnings of $150,000.
- Total assets of $800,000.
- Equity of $400,000.
- Dividend payout ratio of 60.0%.
- Average shares outstanding of 75,000.
- Real risk free interest rate of 4.0%.
- Expected inflation rate of 3.0%.
- Expected market return of 13.0%.
- Stock Beta at 2.1.

The per share value of FishnChips stock is approximately: *(Note: Carry calculations out to at least 3 decimal places.)*

   ✗ **A)** $30.89.

   ✗ **B)** $17.91.

   ✓ **C)** $26.86.

Explanation

Here, we are given all the inputs we need. Use the following steps to calculate the value of the stock:

First, expand the infinite period DDM:

DDM formula: $P_0 = D_1 / (k_e - g)$

D_1 = (Earnings × Payout ratio) / average number of shares outstanding

       = ($150,000 × 0.60) / 75,000 = $1.20

k_e = nominal risk free rate + [beta × (expected market return - nominal risk free rate)]

       Note: Nominal risk-free rate   = (1 + real risk free rate) × (1 + expected inflation) - 1

                                     = (1.04)× (1.03) - 1 = 0.0712, or 7.12%.

k_e = 7.12% + [2.1 × (13.0% − 7.12%)] = 0.19468

g   = (retention rate × ROE)

        Retention   = (1 - Payout) = 1 - 0.60 = 0.40.

$$\text{ROE} = (\text{net income / sales})(\text{sales / total assets})(\text{total assets / equity})$$

$$= (150,000 / 1,000,000)(1,000,000 / 800,000)(800,000 / 400,000)$$

$$= 0.375$$

g $= 0.375 \times 0.40 = 0.15$

Then, calculate: $P_0 = D_1 / (k_e - g) = \$1.20 / (0.19468 - 0.15) = \textbf{26.86.}$

<u>References</u>

Question From: Session 14 > Reading 50 > LOS e

Related Material:

- Key Concepts by LOS

Question #198 of 200

An equity valuation model that values a firm based on the market value of its outstanding debt and equity securities, relative to a firm fundamental, is a(n):

- ✓ **A)** enterprise value model.
- ✗ **B)** market multiple model.
- ✗ **C)** asset-based model.

<u>Explanation</u>

An enterprise value model relates a firm's enterprise value (the market value of its outstanding equity and debt securities minus its cash and marketable securities holdings) to its EBITDA, operating earnings, or revenue.

<u>References</u>

Question From: Session 14 > Reading 50 > LOS b

Related Material:

- Key Concepts by LOS

Question #199 of 200

For relative valuation, a peer group is *best* described as companies:

- ✓ **A)** with similar business activities and competitive factors.
- ✗ **B)** in a similar sector or industry classification.
- ✗ **C)** at a similar stage of the industry life cycle.

<u>Explanation</u>

An analyst should form peer groups of companies that have similar business activities, drivers of demand and costs, and access to capital. Companies in the same industry or sector and companies at the same stage of the industry life cycle are not necessarily comparable for equity valuation purposes.

References

Question From: Session 14 > Reading 49 > LOS d

Related Material:

- Key Concepts by LOS

Question #200 of 200

Calculate the value of a preferred stock that pays an annual dividend of $5.50 if the current market yield on AAA rated preferred stock is 75 basis points above the current T-Bond rate of 7%.

   ✗ **A)** $78.57.

   ✓ **B)** $70.97.

   ✗ **C)** $42.63.

Explanation

$k_{preferred}$ = base yield + risk premium = 0.07 + 0.0075 = 0.0775

$Value_{Preferred}$ = Dividend / $k_{preferred}$

Value = 5.50 / 0.0775 = $70.97

References

Question From: Session 14 > Reading 50 > LOS d

Related Material:

- Key Concepts by LOS