Chapter Preview : Chapter 9

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Answer the following questions briefly.

1. Explain the purpose of a dividened-discount model

   The purpose of a dividend discount model is to estimate the intrinsic value of a stock by discounting its future dividend payments to their present value. Essentially, it helps investors determine what a company's stock is worth based on the dividends it is expected to pay out in the future.

2. What is the total return?

   Total return refers to the overall gain or loss on an investment over a specified period, typically expressed as a percentage. It includes not only the capital appreciation (or depreciation) of the investment but also any income generated from it, such as dividends, interest, or capital gains distributions.

3. Does repurchase of stock can affect shareholder wealth?

   Yes. Stock repurchases, also known as share buybacks, involve a company using its cash reserves or borrowing funds to buy back its own outstanding shares from the market. It often considered as positive policy for shareholders, so the price of the stock is likely to increase.

4. What is the method of comparables?

   The method of comparables, also known as the comparable companies analysis (CCA) or trading multiples analysis, is a valuation approach used to estimate the value of a company by comparing it to similar publicly traded companies within the same industry. This method relies on the principle of market efficiency, assuming that similar companies should have similar valuation multiples due to comparable risk and growth prospects.

5. How the price-earnings ratio (P/E) can be used to estimate the value of a firm?

   The price-earnings ratio (P/E) can be used to estimate the value of a firm by comparing its stock price to its earnings per share. A higher P/E ratio suggests that investors are willing to pay more for each unit of earnings, indicating a higher valuation for the firm.

6. State the efficient market hypothesis.

   The efficient market hypothesis states that asset prices fully reflect all available information, making it impossible for investors to consistently achieve higher returns through active trading or market timing.

7. Define the following terms:

   a. **Dividend payout ratio**:

      - The dividend payout ratio is a financial metric indicating the proportion of net earnings distributed to shareholders as dividends. It is typically calculated by dividing the dividends paid out by net earnings.

   b. **Weighted average cost of capital (WACC)**:

      - The weighted average cost of capital is the average rate of return a company is expected to pay to all its investors (both debt and equity holders) to finance its assets. It is calculated by weighting the cost of equity and the cost of debt based on their respective proportions in the company's capital structure.

   c. **Sustainable growth rate**:

      - The sustainable growth rate is the maximum rate at which a company can grow its sales, earnings, and dividends over the long term without having to increase its debt or equity financing. It is determined by factors such as profitability, dividend policy, asset turnover, and financial leverage.