Topic 4: Stock Valuation: Understanding Equity

*** Stocks represent the third topic that you will be responsible for this summer. The presentation here is a fine introduction.

Intro: The video has too much emphasis on the word “owner”. Bond holders have a claim on the cash flows of a firm. Stock holders also have a claim on the cash flows of a firm. In addition, stock holders have voting rights. It is the voting rights that are behind the video’s repeated use of the word “owner”.

4.1 Bond holders have the first claim(s) on a firm’s cash flows. As stated, stock holders have the second (or residual) claim on the cash flows.

4.2 Video: A bond promises a series of cash flows (the coupon payments and return of face value). If a firm goes into bankruptcy (i.e., the firm might default on the bond), the actual cash flows you receive are likely to be less than the promised cash flows. Keep this in mind when thinking about bonds. The concept of YTM is based on <u>promised cash flows</u>.

Video: Discounting dividends is only one method of valuing a stock. There are other methods that we can discuss in FIN 502.

4.3 Video and Text: Many people (like myself) don’t consider “Preferred Stock” to be equity. Preferred stock holders do not vote. Preferred dividends are paid after bond holders are paid and before common shareholders are paid. Therefore, from the point of view of a common shareholder, preferred stock can be thought of as a fixed obligation (i.e., like a bond).

Don’t worry too much about preferred stock. We won’t deal too much with this security in FIN 502 (unless, of course, if questions come up).

Assessment:
- Please disregard Q.1 “Which of the following securities represents ownership in the firm?”
- Reasoning is given above.

4.4 Nothing to add.

4.5 Assessment:

- Round off error: Answer to Q.4 should be 28.95 not 28.96
- Please disregard Q.5. It is confusing.

4.6 As part of the Entrepreneurial Finance Note, the text contains “EBITDA” and mentions that it was discussed previously in the accounting topic. However, it is not covered in the topics of this course.

To restate what is in the text: EBITDA stands for “Earnings Before Interest Taxes Depreciation and Amortization”. It is a rough estimate for the free cash flow generated in a given year (or period).

One can buy and sell enterprises (firms) based on EBITDA. Here is an example. Suppose it is 2018 and a firm has no debt. The firm’s expected EBITDA for 2019 is $12.7 million. A bid of 5x forward EBITDA means someone is willing to pay 5 x 12.7 = $63.5 million for the enterprise. A bid of 6x forward EBITDA implies a price of $76.2 million.

4.7 Round off error: Answer to Q.22 should be 52.99 not 53.00