

Financial analysis and valuation

Business



Investment Styles: Intuitive Investing * Investor who relies on intuition and hunches – there is no analysis involved Problems: * Self-deception, ignores ability to check intuition Passive Investing * Investor who accepts the market price as value – there is no analysis involved – this is the “ efficient market approach” * It is risky that you may be paying too much for an investment which is overpriced Fundamental Investing: Challenge Market Prices Active Investing * An opportunity to find misperceived investments * Requires proper analysis

Defensive Investing * A defense against paying for/ selling for the wrong price * Prudence requires analysis Users of Accounting Information: * Equity Investors * Debt Investors * Managements * Employees * Litigants * Customers * Governments * Competitors * Fundamental analysts believe that the markets may misprice securities in the short run although the correct price will be reached over a long period of time * Profits can be made by buying/selling undervalued/overvalued securities * Once the markets realizes its mistakes and re-prices securities accordingly, the trading strategy will earn sizable gains.

Example – Newsiest Mining * On February 8, goldmines Newsiest Mining reported a 48 per cent fall in first-half net profit after tax * Interim net profit after tax for the six months to the end of December was \$320 m, down from \$645 m at the same time last year * Sales revenue was down 23 per cent to \$1. 805 b BUT * Newsiest Mining’s shares rose 5. 01 per cent to \$24.

52 WHY? The market interpreted this half year report as good news * Analysts and management both forecast a more dire outcome for the 6

months period. * Since that information had affected the share price for the past 6 months, the stock price had dropped accordingly. * The positive news readjusted the share price according to the official half year report. Example -JOB Hi Fi * On February 10, JOB Hi Fi posted first-half net profit after tax of \$mm, up from \$79. M at the same time last year * Total sales grew 2.3 per cent * Opening of new stores * On a store-by-store basis sales down 3.

5 per cent from the previous corresponding period BUT * JOB Hi Fi's shares rose \$1.71 (15.53 per cent) to \$12.72 * The increase is surprising because revenue had only increased by virtue of the increased number of stores. In terms of store by store, there was actually a decrease. Even so, the market and its analysts had expected worse results.

They were happy that there was some improvement in revenue * This was reflected in the sharp increase in stock price

Complex Issues in Financial Accounting * Noise in accounting information * Earnings quality * Transaction structuring * Techniques to manipulate earnings * Information asymmetry * Cost of capital (debt and equity) * Undervaluation/overvaluation

(misprinting) Case Study: Assai * Independent Liquor engaged in channel stuffing and understating expenses so that the value of the company would be increased when selling to Assai Channel Stuffing Independent Liquor overstated earnings by forward selling stock on extended terms to retailers to bring forward the 'revenue recognition' so that the financial statements would look better. * Understating Expenses * Independent Liquor reversed audit fees, sick leave payments and bonus payments to make the EBITDA higher and therefore have an increased value of the company.

Lecture 2 – Capital Market Analysis (10 Marks Theory, 5 Marks Calculations)

Listing on stock exchange (PIP) Benefits: * Creating a market for the company's shares * Funding opportunities * Public awareness of company/product * Expand operations No longer family run' Costs: * Relinquishing control * Increased accountability * Demands to meet shareholder's expectations * Costly compliance with listing rules and financial reporting requirements Agency Theory: Agency theory explains the separation of ownership and control between shareholders and management. Agency Problems: * Misalignment of interests * Shirking * Managers avoid working to the best of their ability and shirk responsibilities * Consumption of perquisites * Managers take advantage of perks (I. Private Jets) at shareholder costs * Differential time horizon * Managers are more interested in the short term version * Managers are more risk averse than shareholders.

If company takes high risk and is unsuccessful, then business will be in trouble. * Shareholders can diversify their portfolio with a range of different investments – therefore less risk averse because if company fails, they have not lost everything. Agency Costs: * Monitoring costs * Bonding costs * Agent (manager) commits for working for a company for a certain amount of years. This is costly because it means that manager cannot move to different firm Residual loss * Loss in value of company due to interest misalignment * Residual Loss ?

Value of company without interest misalignment – value of company with interest misalignment * Information Asymmetry * Different knowledge between investor and managements Information Asymmetry This is a <https://assignbuster.com/financial-analysis-and-valuation/>

condition in which some valuable information is known to some but not all parties involved. Information asymmetry exists among differentially informed capital market participants: * Insiders * Analysts * Mum and Dad investors

Information Asymmetry Measurement – Bid/Ask Spread: * Bid/Ask Spread can be used as a proxy for information asymmetry $SPREAD = \frac{ASK - BID}{(ASK + BID)}$ * The larger the spread, the more asymmetric information The spread will show a divergence of opinion between what buyers and sellers think the stock is worth

Information Asymmetry: Determinants * Firm specific information asymmetry influenced by: 1.

Stock liquidity * Stock liquidity refers to how easy it is to buy and sell shares without seeing a change in price * Large bid-ask spreads imply low trading volume * Small bid-ask spreads imply high trading volume * Buyers and sellers have come to an ‘agreed price’ on what the share price is worth 2.

Ownership structure * Is ownership evenly spread across a variety of investors or is it concentrated? ownership). There is a positive association between managerial ownership and the content of earnings * There will be smaller information asymmetry when company is mainly owned by management – the information environment becomes more transparent. * However, once management ownership reaches a certain level (tipping point), the information asymmetry will become less transparency (inverted U shape). We are unsure what that level is * There is also a positive relationship between institutional ownership and the information content of earnings * They act as an informed trader and can demand better quality information because they are powerful external corporate governance mechanism 3. Analyst coverage * There is an * This refers to the number of

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analysts actively following and publishing information on a company and its stock

Benefits of Analyst Coverage: * Improves firms' information environment * More informed trading * Improved stock visibility * Improved corporate governance * Analysts' dissemination should eliminate stock mispricing

Analysts are considered to be one of the most important groups influencing a firm's stock price 4.

Information precision * Analysts may have different expectations which leads to information * The imprecision may be a result of the variation recession/imprecision. Twine the levels of private information that different levels of analysts are privy to.

Approaches to Security Analysis * Quantitative v Traditional Fundamental Analysis * Technical Analysis * Attempts to predict stock price movements based on market indicators such as 52 week price range: * 52 Week Price Range provides an indication of volatility in share price and the risk associated with investing in that stock. * Fundamental Analysis * Attempts to evaluate current market prices relative to future projections of earnings or cash flows * Formal v Informal Valuation * Formal Valuation Model * Prospective analysis Informal * Comparing analyst opinions or consensus forecasts. 5.

Disclosure Practices * An increasing level of firm disclosure reduces their information asymmetry * Managers will release information to reduce information asymmetry * This will decrease cost of capital because investors will not need to price protect Managers will not release information that have potential proprietary costs E.

G. Information that will give their competitors an advantage Disclosures can be: * Mandatory * Disclosure regulations * Voluntary * Voluntary disclosure reduces information asymmetry Bad News: * Poor performing firms delay bad news. This means the firm is not as transparent as possible disclose bad news: * Reputation effects * Litigation risk Lecture 3 – Business Analysis (4 marks theory) Macroeconomic Analysis * Interest rates * Is the firm highly levered? * Is it susceptible to interest rate movements? * Good News v * Should * What are projections of interest rates in future and what is the firm doing to protect from this? Exchange rates * Predominantly involved in exporting/importing? * Where does it export? * Europe – debt crisis * Commodity prices * What type of business is this? * Is the company exposed to commodity price fluctuations? * Demographic changes * Aging population * Is the company looking to diversify into areas to take account of demographic changes? * General economic changes * Carbon tax * European debt crisis Industry Analysis * A firm's profit potential is heavily influenced by the industry in which it competes * What is the nature of the industry? * Who are the firm's competitors? * How great is the potential for profit? * What are the industry risks?

Porter's Five Forces: Degree of Actual and Potential Competition (potential for profit) 1. Rivalry among existing firms a. Aggressive Competition on Price (industry) b. Non-Aggressive Competition on Price t.

Coordinated pricing * Retail industry (petrol stations, cinemas) iii. Non-price dimensions of products/services important * Innovation * Brand name

Determinants of the intensity of competition among existing firms: * Industry growth rate * Concentration and balance of competitors * Degree of

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differentiation in products/services * Excess capacity and exit barriers 2.

Threat of new entrants c. Profitable industries likely attract new entrants d.

The ease with which a new firm can enter the industry will affect the profitability of other firms within the industry Factors affecting the barriers to entry are: Economies of scale * Extent of investment required by new entrants * First mover advantage * Exclusive arrangements * Access to distribution channels * Strength of existing relationships * Legal or political barriers * Patents/copyrights * Licensing regulations 3. Threat of substitute services/products e.

Substitutes are those of the same function f. The threat of substitutes depends on customers' willingness to accept substitutes: ' v. Relative price and performance of competing products/services v. Technology v'.

Community awareness Bargaining Power in Input and Output Markets (where this profit is achievable) 4. Bargaining power of buyers g.

Buyer bargaining power can exert downward pressure on prices Factors that can affect this bargaining power are: * Buyer price sensitivity (how much they care to bargain) differentiation * Switching costs * If switching costs are low, prices become relevant * Product * Important of product * If product is large proportion of cost structure, then they will be price sensitive * Relative bargaining power of buyers (how successful their bargaining might be) * # of buyers vs. # of sellers * If there are lots of buyers in relation to sellers, their bargaining power will be low. * Volume of purchaser by buyer If sellers output is consumed by one buyer, then they will have a lot of bargaining

power. 5. Bargaining power of suppliers h. A mirror image of the bargaining power of buyers i.

Suppliers have bargaining power when there are few substitutes and/or few suppliers relative to the number of customers demanding a product or service vii. If only 1 or 2 suppliers, but many buyers, then they will have the bargaining power.

Business Strategy Analysis * Competitive positioning/strategy: * Cost leadership * Firms implementing cost minimization strategies * For example: * Same cost as competitor but greater profit OR Pass the cost minimization to customers * Differentiation * Must identify what uniqueness customers want, and * Provide them to the customers with the product/service, and * At a competitive price. * Corporate strategy * Do multiple business segments create value at the corporate level? Evidence suggests that value creation through a multi-business corporate strategy is hard Lecture 11 & 12 - Valuation Theory and Implementation (Calculations 11 Marks, Theory 4 Marks) Valuation Methods: 1 . Discounted dividend 2.

Discounted abnormal (residual earnings) 3. Discounted Free Cash Flows 4.

Price Multiples Valuation Look at formulas from slides Price Multiples

Valuation: * Firm value is independent of dividend policy * Dividends are arbitrary (depends on management's discretionary powers) Limitations on Price Multiples Valuation: * Selecting comparable firms: * It may be difficult to identify comparable firms, even within an industry Industry averages may be used instead * Firms with poor performance: * Marginal profitability or earning shocks must be considered * Adjustments for leverage Motivation for <https://assignbuster.com/financial-analysis-and-valuation/>

Mergers and Acquisitions Motivations for M ; A: * Improving target management * Combining complimentary sources * Capturing tax benefits