

# The gordon model essay sample



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The Gordon Model is particularly useful since it includes the ability to price in the growth rate of dividends over the long term. It is important to remember that the price result of the Constant Dividend Growth Model assumes that the growth rate of the dividends over time will remain constant. This is a difficult assumption to accept in real life conditions, but knowing that the result is dependent on the growth rate allows us to conduct sensitivity analysis to test the potential error should the growth rate be different than anticipated.

Where is the price, at time zero, of a share.

is the dividend expected at the end of a period

is the return expected by investors during the period

is the growth rate of dividends, estimated for the period. The cost of equity share capital of Latrike plc. is estimated to be 11% per annum at this time.

From the above table, we can know:(Arnold, G. 2007)

So the present value of shares in Latrike plc is 19. 74

2. estimated share price change if the return expected by investors were to increase to 12%

If the return expected by investors were to increase to 12%, then share price change=  $1974p - 1563p = 411p$

Why might investors require an increased return from shares in Latrike plc?

The reason why investors are willing to invest is because the requirement of return expected by investors is high enough. And it can cover the perceptible

risk of investment. If a person buys a stock, that person may desire a high required rate of return. Required rate of return is an important index for investors to evaluate the company dividend. It reflects the investors from the dividend yield of the stock investment. It is one of important index that the investors Judging investment risk and measure the investment income. High required rate of return illustrate the company has a good return on investment. And investors usually tend to buy high dividend rate of return of stock exactly. That's why might investors require an increased return from shares in Latrike plc.(Jing xin, Wang huacheng, Liu yunyan2009)

Consider the problem of estimating dividend growth in the above equation and any alternative methods of setting a number for other than the one you chose in answering part 1.

The parameters in the model prediction and estimation with high subjectivity and uncertainty. The hypothesis is very sensitive. Take the case of computational formula above. If we change the growth assumption to 8 per cent and reduce the required rate of return to 15 per cent, the value of the share jumps to 1072p.(Arnold, G. 2007)

As the growth rate converges on the required rate of return the value goes to infinity. Different analysis researchers used model although consistent, but in k or g hypothesis has slight difference, , it will let the share price from calculation at opposite poles.

We can choose another alternative method. Change other formula like

r : Return on Capital Employed

b: proportion of earnings retained

5. After making your calculation you find that the price of shares in Latrike plc on the London Stock Exchange is £11.25. Consider possible reasons for the difference between this price and the one you have estimated using the dividend growth model.

Calculated from the stock prices using the dividend growth model is a theoretical price. The stock price calculated using the dividend growth model is a theoretical price, it can not reflect the intrinsic value of the stock. The market price fluctuates around the intrinsic value, and this pricing model includes prediction of  $g$  and  $r$ . It may deviate from the market price. And this model also neglected the stock market for stock price influence, just make investors can determine whether a from the current market conditions affect the company's absolute value.

Valuation model have not considered the existence of non-tradable shares. The dividend discount model valuation is the discounted value of the dividend per share to all stocks equally.

Valuation model is effective need an effective market. Valuation model of clear operation is conditional: one is the information fully, timely, truly get public; The second is the information can be investors to get, and investors can make reasonable judgment from information; Thirdly it is investors according to the judgment to make accurate, timely action. It means valuation model requires an effective market.

Accounting data reflect the deviation of information. Discounted cash flow model valuation do not need accounting earnings but actually produced from the company's cash flow. However, numerous use a discounted cash

flow model plus the cost of non-cash outflow for the “cash flow” data on the basis of the accounting surplus.

Limited the scope of the dividend growth model. Dividend growth model application of the hypothesis is a project or enterprise management continual and stable, the future cash flow can be expected. Dividend growth model is suitable for more than share out bonus and stable company and non-cyclical industry. Does not apply to dividends little or unstable companies, cyclical industries.

What advice, would you give, to those using the dividend growth method as the way of valuing shares?

The usefulness dividend growth model is very small in actual life. As we can see from the formula, the underlying condition is  $k > g$ . Otherwise, it will calculate the price for negative. So, notice if dividend growth exceeded earnings growth eventually dividends will exceed earnings, and it is not sustainable. But in fact, net profit or dividend growth rate more than 10% over us everywhere. There are also many more than 30% of high-growth stocks. In fact, the model is only a basic model, only for enterprise that mature, sustainable growth rate is lower than the capital rate of return. Because the model simplistically assumes a constant rate of growth, it generally is used only for mature companies (or broad market indices) with low to moderate growth rates.

Can the model be used for private as well as public limited companies?

There are three assumptions of dividend growth model. Firstly dividend payment on time is permanent. Secondly dividend growth rate is a constant. Thirdly the required rate of return is greater than the dividend growth rate in the model. So the model is not used for private as well as public limited companies. Because it need establishment of the company for a long time, and have historical data. Companies can often pay dividends with stable dividend growth rate, and is expected to continue. Obviously private companies do not comply with these conditions. Public limited companies issue of shares in public, but private companies do not.

#### References:

##### 1. Constant Growth (Gordon) Model

[http://www.ultimatecalculators.com/constant\\_growth\\_model\\_calculator.html](http://www.ultimatecalculators.com/constant_growth_model_calculator.html)

Arnold, G. (2007). Essentials of Corporate Financial Management. Harlow: Pearson Education Limited.

3. Jing xin, Wang huacheng, Liu yunyan(2009). science of financial management. Bei jing: China Renmin University Press.