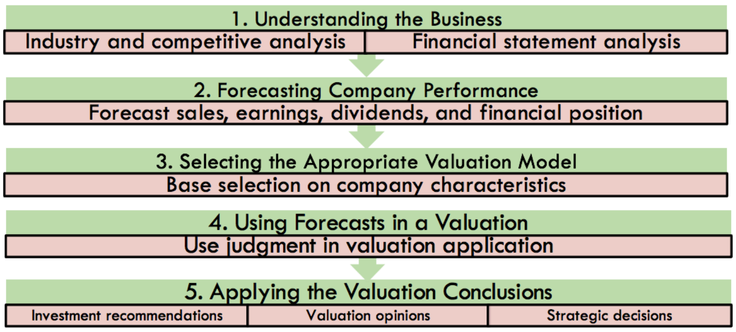
FINC3015: Lecture Notes
Lecture 1/Week 1: Intro

1.1 Introduction to valuation
- Tries to make sense out of uncertainty
  - Uncertainty always present – understanding of past and anticipation of future always will be obscured by uncertainty.
  - Mid-course corrections are needed to take into account new information and development

1.1.1 Applications
- Stock selection
  - To determine what should be bought/sold (is BHP @ $35 cheap?)
  - EMH states financial markets are efficient and trying to outperform averages is futile (matching market is best)
  - Reality – markets has bouts of irrationality – Graham's analogy to take advantage of anomalies as share price can change for number of reasons (beyond prices for affirmation of investment decision)
- Inferring market expectations
  - E.g. Intel (Sept 21 2000): intel announces revenue growth for Q3 below expectations (7-9% short but expectations 8-12%) – stock price falls 30%
  - Was announcement info sufficient to warrant loss of value of that magnitude; What future revenue growth rates were consistent with Intel's stock price of $61.50 just prior to the press release, and $43.41 5 days later?; was investors reaction to press release therefore irrational?
  - Dot-com bubble; magnitude of the loss is an expectation for intel, and current normal expectation is too high, reversion of expectations; price movements always based on expectations
- Evaluate corporate events
  - Cornell (2001): post-announcement valuation matches market prices with following assumptions (Intel)
  - Equity risk premium = 3.9% (normally 6% between risk-free and stock market); growth rate = 20% (unachievable), therefore sales would need to increase from 34 → $162bn; gross margin 62.5% (unrealistic)
- Rendering fairness opinions
- Evaluating business strategies and model's
- Communicating with analysts and shareholders
- Appraising private businesses



1.1.2 Investment formula
- Understanding the business
  - Understand economic and industry context & mgmt. strategic responses
  - Pro-cyclical or counter-cyclical; looking at input drivers that determine the futures position of the firm
  - <u>Have an opinion and justify</u> – how attractive are the industries in which company operates in terms of offering prospects for sustained profitability; what is company's relative competitive position within industry; competitive strategy; how well is company executing with strategy.
  - What is driving value – value driver is performance variable which impacts results of business such as product effectiveness or customer satisfaction – linked to shareholder value creation and measure by financial and operational KPIs (cover LT growth and operating performance)
  - Miller (2004): suggests profitability, growth and capital intensity are considered
  - Operational KPIs can be quantified (originally qualitative) whilst some marginal accounts don't matter
- Forecasting company performance
  - Economic forecasting: top-down or bottom-up (e.g. start with forecasted economic growth, m size, m share, revenue forecasts) – <u>place of firm within economic environment</u> (not other way around)
  - Financial forecasting: dynamic area – integrate analysis of industry prospects and competitive corporates strategy with FS analysis to formulate specific numerical forecasts – pro-forma analysis
  - Look at <u>regulated industry</u> and place higher restrictions
- Select appropriate valuation model
- Use forecasts to value
- Apply valuation conclusions