Unit 8 Stock Valuation

QN1 What is Common stock? What are the features of Common stock?

Common stock is a source of long term financing of corporation The owners of a company of a corporation are called stockholders. Common stock shares issued by a corporation are claims to a share of the assets of a corporation as well as to a share of the corporation net income i.e., the corporation's income after subtraction of taxes and other expenses, including the payment of any debt obligations.

Different forms of common stock
Authorized shares: Maximum number of shares that company is permited to issue.
Issued Shares : Shares that have been issued by the company.
Outstanding *Shares*: Shares that have been issued by the company and are held by investors.
Treasury stock : Common stock that has been repurchased and is held by the issuing company.

Features of common stock

Par value/ Face value: Printed value of share on its certificate.

Maturity: The capital obtained from this sources cannot be redeemed in the mid life of the organization.

Priority to assets and earnings: Common stockholders have a residual claim on the earnings and assets of their corporation. This means that if the corporation goes bankrupt, the law says that all bills (such as employee's wages;suplier's bills, and bondholder's interest) must be paid before common stockholders are entitled to divide up whatever assets remain from thre bankrupt opearation.

Voting rights: Typically, common stockholders receive one vote per share to elecy the company's board of directors.

Preemptive right: The preemptive rights gives the current sharesholders the right to purchased any new shares issued in proportion to their current holding.

Limited liability: If the corporation goes bankrupt the common stock holders cannot be forced to participate in the payment of unpaid bills. Stockholders cannot lose more than the cost of their investment.

Different Value:

Book value/Net worth: Book value is an accounting concept, amount of book value the equity records/ includes common stock, shares premium (paid in capital) retained earnings.
Liquidation Value: Liquidation value is the net proceeds that could be realized by selling the firm's assets and paying off its creditors.
Going Concern Value: The value that can be realized if it is sold as an operation business.

Market Value: Market value of an assets or securities is the current price at which the assets or the securities is being sold or bought in the market.
Intrinsic Value: Intrinsic value is equivalent to the present value of all assets' expected future cash flows discounted at the investor's appropriate required rate of return.

QN2 What is Preferred stock? What are the features of Preferred stock?

Preferred stock is the long-term sources of financing under which the stockholders are entitled to get fixed amount of dividend out of the earning of the company after payments of debentures interest and tax.

Features of Preferred stock:

Fixed dividend: The dividend rate is fixed at the rate expressed as percentage of par value.
Cumulative dividends: The unpaid dividends in any single year have to be carried forward and the company must pay the dividends in arrears on its preferred stock before any ordinary shareholders.
Par Value: Preferred stock usually has a par value. E.g. Rs 100
Participative features: This allows preferred stockholders to participate in extraordinary profit or residual earning of the company.
Voting rights: They may be provided with contingent voting rights when company fails to provide for certain specific period; normally two or more consecutive preceding years or for three or more years in preceding six years.
Claims on income and assets: Preferred stock has prior claims on company's income and assets than ordinary shareholders.
Redemption/retirement: Preference shares can be redeemable and irredeemable (perpetual). The perpetual stocks have no maturity period but redeemable stocks mature after specified period.
Sinking fund: Sinking fund is created for the purpose of redemption of preference share.
Call provision: Call feature permits the company to buy back the preferred stock. The call price may be higher than the par value and this difference represent the call premium.
Convertibility: Preference shares may be convertible or non convertible. If it is convertible, the preference shares can be converted into debentures or ordinary shares.

QN3 Explain the valuation method of common stock and preferred stock.

Common stock valuation:

Common stock is valued by finding the present value of the expected future cash flows stream. People typically buy common stock expecting to earn dividends plus a capital gain when they sell their shares at the end of some holding period.
From *Dividend Discount Model*, value of the stock today is calculated as the present value of an infinite stream of dividends as:
Zero growth model

Under this model, current dividend, earnings are expected to remain constant for infinite period. In other words there is no growth on earnings and dividend. The equation of this model is;

$$P_0 = \frac{D_0}{K_s}$$

Where,

Po = Intrinsic value of stock, Do = Current dividend, Ks = Required rate of return

Constant growth model / Gordon's model

Under this model it is assumed that dividend grows at a constant rate "g" and the growth rate is less than required rate of return. Current value of equity is calculated as follows;

$P_0 = \frac{D_1}{K_s - g}$ Where, D_1= expected dividend, g = Growth rate

Supernormal growth model/ multiple growth model/ variable growth model

Supernormal growth model considers such changes in the growth rates. It is assumed that company may realize supernormal growth for finite time period and thereafter the normal growth rate will prevail indefinitely. In such situation investor may realize two components of returns;

- Dividends
- Selling price at the end of supernormal growth period

To find out intrinsic value of such type of equity, we follow three steps;

Step 1: Calculation of PV of dividend stream during supernormal growth period

Step 2: Calculation of PV of price of stock at the end of supernormal growth period

Step 3: Intrinsic value (Po) = Step 1 + Step 2

Symbolically,

$$P_0 = \frac{D_1}{(1+k_s)^1} + \frac{D_2}{(1+k_s)^2} + \frac{D_3}{(1+k_s)^3} + \cdots + \frac{D_n}{(1+k_s)^n} + \frac{P_n}{(1+k_s)^n}$$

Where,

Price of stock at the end of "nth" period (P_n) = $\frac{D_n(1+g_c)}{K_s - g_c}$

Preferred stock valuation:

Valuation of perpetual preferred stock: Perpetual preferred stock has infinite period. It is also called the irredeemable preferred stock and calculated as:

$$V_{ps} = \frac{D_{ps}}{K}$$

D_{ps}= Preferred stock dividend; V_{ps}= Value of preferred stock; K= required rate of return

Valuation of redeemable preferred stock: Redeemable preferred stock has finite maturity period and valued as:

V_{ps}=D_{ps} (PVIFA $_{k\%\ nyr.}$) + M (PVIF $_{k\%\ nyr.}$)

M=Maturity value, k=discount rate, n=maturity period