

Charta Learning

Equity Valuation

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Equity Valuation

EQ.1.a · Work out a share's intrinsic value with the dividend discount model

What does the dividend discount model say a share is worth?	The present value of the dividends it will pay.
State the Gordon growth formula and name its symbols.	$V_0 = D_1 \div (r - g)$, where D_1 is next year's dividend, r the required return and g the constant dividend growth rate.
What condition must hold for the Gordon growth model to work?	Growth g must be below the required return r .
Why is the model's output so sensitive?	Small changes in the spread between r and g swing the valuation sharply.
For which firms does the model suit, and where does it fit poorly?	It suits stable, dividend-paying firms and fits poorly where dividends are absent or erratic.
One-period dividend discount model	$V_0 = (D_1 + P_1) \div (1 + r)$ where D_1 = the dividend expected at the end of the year; P_1 = the price expected at the end of the year; r = the required return on the equity A holding of one period, where the value is the dividend plus what the share can then be sold for. Every longer model is this one applied again to P_1.

EQ.1.b · Set out what the Gordon growth model takes for granted and how sensitive its output is to inputs

What does the constant growth model assume?	Dividends grow forever at a single rate strictly below the required return, and the required return itself is stable.
Why are the model's assumptions strong?	No company grows faster than the economy in perpetuity.
What happens if growth is set slightly too close to the required return?	The denominator heads toward zero and the value toward infinity.
Why does a sensitivity table matter more than a point estimate for the constant growth model?	Because the value is extremely sensitive to the growth and required-return inputs, and most sensitive precisely where those inputs are least certain, so a range of outcomes is more informative than a single figure.
Gordon growth model	$V_0 = D_1 \div (r - g)$ where D_1 = next year's dividend, not the one just paid; r = the required return on the equity; g = the constant growth rate of the dividend, for ever Dividends growing at one rate for ever, with g below r. As g approaches r the denominator approaches zero and the value explodes, which is why a mature, stable payer is the only company this suits.

Sustainable growth rate	$g = b \times ROE$ where b = the retention rate, the share of earnings not paid out; ROE = return on equity The growth a company can fund from its own earnings without raising new equity or changing its leverage. It is where the g in a growth model comes from when nobody hands you one.
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EQ.1.c · Use a dividend discount model with several growth stages

How does a multi-stage dividend model work?	It discounts an explicit dividend forecast over a growth phase, then applies a terminal value, usually the constant growth formula, once growth has settled.
Why should the terminal growth rate get the most scrutiny?	The terminal value often dominates the answer, in many cases three quarters or more of the total, depending on horizon, growth and discount rate.
Where does most of the modelling effort go, and is that proportionate?	Into the detailed near-term forecast, which deserves less scrutiny than the terminal growth rate.
How does an H-model differ from a two-stage model?	A two-stage model has an abrupt drop in growth, a simplification. An H-model fades growth linearly, often the more plausible shape.
Multi-stage dividend discount model	$V_0 = \sum [D_t \div (1 + r)^t] + \text{terminal value} \div (1 + r)^n$ where D_t = the dividend forecast individually for each year of the first stage; r = the required return; t = the year a dividend falls in, 1 through n ; n = the last year of the first stage; terminal value = the Gordon value of everything after year n , as at year n A company growing fast now and expected to settle later. Two errors to avoid: the terminal value is struck at year n and so is discounted n years, not $n + 1$, and it uses the dividend of year $n + 1$.

EQ.1.d · Explain why free cash flow to equity can serve as the basis of a valuation

What is free cash flow to equity?	What could be paid to shareholders after operating expenses, interest, taxes, working capital, capital expenditure and net borrowing.
When is FCFE usually the better valuation basis than dividends?	When a company pays no dividend, pays one unrelated to its capacity, or is valued from a control perspective where the acquirer would set the payout.
At what rate is FCFE discounted?	The required return on equity.
How does FCFE valuation relate to a dividend model, and what is the key difference?	It gives the same conceptual answer as a dividend model would if payout matched capacity, but does not depend on a board's distribution policy.

Free cash flow to equity

$$\text{FCFE} = \text{CFO} - \text{FCInv} + \text{net borrowing}$$

where CFO = cash flow from operating activities; FCInv = investment in fixed capital, the capital expenditure; net borrowing = debt raised in the period less debt repaid
What could be paid out to shareholders after the business is funded, which is why it values a company that pays no dividend or pays one unrelated to what it earns. Discount it at the required return on equity, not the WACC.

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