

MAFA : CA FINAL

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Disclaimer

Every effort is taken to avoid errors and omissions.

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VALUATION OF SHARES

Objective of Valuation of shares

Decision Making	To buy the shares Not to buy the shares
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Base for Decision Making

Valuation	Shares are Underpriced Buy the shares
	Shares are Over priced Not to buy the shares

Valuation of shares, depends on 2 things

Personal characteristics	Time period of Investment
Market Characteristics	Dividends / Earnings K : Discounting Rate g : Growth rate

Time Period of Investment

Single period

Multi period

Dividend / Earnings

Most probably, it may be given in the problem
So no need to calculate it in this chapter

K : It is known in different names, as mentioned below

Capitalisation Rate
Cost of Capital / Equity
Discounting Rate of Return
Required Rate of Return

g : Growth

It is a very integral part in finding the valuation of shares

FORMULAS

Single period Valuation

Analysis

Investor expects to hold equity share for one year
It is assumed, that cash flow in one year, may be by
Dividend, &
Sale of share, @ the end of one year

$$P_0 = \frac{D_1 + P_1}{1 + K}$$

Where, P_0 = Value of the share calculated.

D_1 = Dividend per share @ the end of year one

P_1 = Market price of share @ the end of year one.

K = Discounting rate / Capitalisation rate / Cost of equity/
Required rate of return

Multi Period Valuation - No Growth

Analysis

Equity shares are perpetual in nature
Investor expects cash flow, for an infinite period, in the form of
Dividend
Annual dividend, remains same year after year

Value of share

$$P_0 = \frac{D}{K}$$

Cost of equity

$$K = \frac{D}{P_0}$$

Multi Period Valuation - Growth

Analysis

Value of share

$$P_0 = \frac{D_1}{K - g}$$

cost of equity

$$K = \frac{D_1}{P_0} + g$$

Where,

P_0 = Current value of the share

Valuation of Shares

D1 = Dividend per share @ the end of year one

K = Discounting rate / Capitalisation rate / Cost of equity/
Required rate of return

g = Fixed annual growth rate

$g = b * r$

b = Retention ratio = $\frac{EPS - DPS}{EPS}$

r = Rate of return on investment of the company

Earning Capitalisation Approach

Analysis

Similar, to Multi period of valuation - No Growth

$$\begin{array}{c} \text{Value of share} \\ P_0 = \frac{E}{K} \end{array}$$

$$\begin{array}{c} \text{cost of equity} \\ K = \frac{E}{P_0} \end{array}$$

Where,

P_0 = Current value of the share

E = EPS

Price Earning Ratio Approach

Analysis

$$\text{PE ratio} = \frac{MPS}{EPS}$$

Therefore,

$$MPS = \text{PE ratio} * EPS$$

Return on share / Investment

$$\frac{\text{Selling price} + \text{Dividend} - \text{Investment}}{\text{Investment}}$$

Other Issues

Division of Dividend / Earnings by : k or 1+k

For infinite Cash Flow k

For non-infinite cash flow 1+k

k

Divide by this, Solution will be one year less

1+k

Divide once, it will be one year less

Divide twice it will be two year less

Valuation of Shares

Rights Issue

Theoretical Post Right Price per Share

$$\frac{(\text{Current Shares} * \text{MPS}) + (\text{Right Shares} * \text{Right Price})}{(\text{current Shares} + \text{Right Shares})}$$

Theoretical Value of Right share alone

$$\text{Theoretical Post right price per share} - \text{Right Price}$$