Study Plan

Chapter 5

Learning Objectives

After studying this chapter you should be able to:

- Describe the differences between preference and ordinary shares;
- Understand how investment bankers help firms issue equity securities in the primary market;
- List the major U.S. secondary markets in which investors trade shares;
- Calculate the estimated value of shares using zero, constant, and variable growth models;
- Value an entire company using the free cash flow approach; and
- List alternative approaches for pricing shares that do not rely on discounted cash flow analysis.

Summary and conclusions

- Preference Shares have both debt-and-equity-like features and does not convey an ownership position in the firm.
- Shares represents a residual claim on a firm’s cash flows, and shareholders have the right to vote on corporate matters.
- Stock markets can be classified as either primary or secondary. Shares are sold for the first time in the primary market, but after that, trading occurs in the secondary market.
- Investment bankers play an important role in helping firms issue new securities.
- Stocks trade both on organized exchanges and in an electronic over-the-counter market.
- The same principles apply to the valuation of preference and ordinary shares. The value of a share depends on the cash flow that the share pays to its owner over time.
- Because preference shares pays a constant dividend with no specific expiration date, it can be valued using the perpetuity formula from Chapter 3.
- The approach used to value shares depends on investors’ expectations of dividend growth. Zero dividend growth, constant dividend growth, and variable dividend growth can all be incorporated into the basic valuation approach.
- Estimating dividend growth is very difficult. A starting point is to multiply the retention rate times the return on equity.
- Analysts use the free cash flow approach to value the entire enterprise. From that they derive a price per share.
- Other approaches to valuation rely on book value, liquidation value, or price/earnings multiples.