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The Textbook

- The table of contents is shown below. You can also read the introduction and follow our blog
- The 350-page textbook is written in a style designed to integrate theory with practice with an emphasis upon learning by doing
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Residual Income Model: Sample Textbook Extract

In this chapter, we will use the two major accounting statements the *Balance Sheet* and the *Income Statement* to study the ***Residual Income Valuation*** Model. Although this model is analytically equivalent to the dividend model, the notable distinguishing feature of this model is that it formally accounts for the *opportunity cost of capital*. One interpretation of the cost of equity capital (calculated, for example, from the Capital Asset Pricing Model or CAPM) is that it equals the rate of return required by investors from the resources under the control of the firm's management. Consequently, to create shareholder value, management must generate returns at least as great as this opportunity cost of capital. From an accounting perspective, this is the essence of the concept of

"***residual income***." Here, "residual" means in excess of the opportunity costs, and is measured relative to the book value of shareholders' equity. Finally we note that the valuation technique introduced in this chapter applies to any firm irrespective of whether or not it pays a dividend because the opportunity cost associated with not paying a dividend is correctly accounted for.

The specific learning objectives for this chapter are to understand:

- The Relationship between the Residual Income Valuation (RIV) and Dividend Models
- What is Comprehensive Income?
- What is Residual Income?
- How to apply the RIV to real world companies using Valuation Tutor
- How to perform sensitivity analysis on the key drivers to test their reasonableness
- What is the expected return from a stock using the RIV model

Abnormal Earnings Growth Model: Sample Textbook Extract

In Chapter 2, we introduced one of the most popular accounting ratios, the ROE (Return on Equity), and showed you how this ratio is related to growth (and is sometimes called "fundamental growth). In the last chapter, you studied the RIV model, where the focus is on the book value of equity; in fact, we motivated the model in this way. Most analysts, however, focus on earnings. The P/E ratio is used as a valuation tool (the value equals expected earnings times the multiple). The relationship between earnings and intrinsic value is the subject of much research, and some references include Williams (1938), Modigliani and Miller (1958), Ohlson (1995) and Ohlson and Juettner-Nauroth (2005). The more recent works study the relationship between earnings and value under names like the Abnormal Earnings Growth model (AEG) and the "OJ" model. In some ways, we have come full circle; we started with a cash-based model (the dividend model) and extended it to the free-cash flow model. Then we moved to the RIV model and shifted the focus to the book value; we now return to earnings, which lie at the heart of cash flows and growth in shareholder equity.

The Abnormal Earnings Growth model carries along with it the clean surplus relationship and comprehensive earnings. Under clean surplus, there is an implied equivalence relationship between AEG and the change in Residual Income, which is demonstrated in this chapter. So you may ask: what is the contribution of AEG over and above the Residual Income model? If they are analytically equivalent, then why not just apply the Residual Income model? One answer to this question is that implementations of the two models can lead to multiple estimates of intrinsic value because real world imperfections imply that clean surplus will not literally hold. A second is that the AEG model provides different insights into what drives firm value by focusing on earnings rather than book value

Free Cash Flow to Equity Model: Sample Textbook Extract

In the last chapter, we introduced the dividend model and defined the concept of intrinsic value.

The simple dividend model is very sensitive to the firm's dividend policy and this sensitivity limits its practical usefulness. For example, a profitable firm that does not pay any dividends would have a zero value, which is clearly incorrect. In this chapter we extend the dividend model to a model called the Free Cash Flow to Equity (FCFE) Model. Conceptually, this FCFE Model refines the concept of a dividend from an *accounting dividend,* which is dependent upon the firm's dividend policy and legal restrictions, to the concept of an *economic dividend* which does not depend upon a firm's dividend policy. As a result, this model is applicable to *any* stock, including non-dividend paying stocks.

The specific learning objectives for this chapter are to understand:

- Accounting versus Economic Dividends
- The FCFE Model of intrinsic value
- How to use Valuation Tutor to work with the FCFE model
- How to apply the FCFE Model to real world companies
- How to perform sensitivity analysis on the key drivers to test their reasonableness
- How to calculate implied expected return using the FCFE model

Distressed Firm Valuation Model: Sample Textbook Extract

The valuation techniques described in the previous chapters cannot easily answer the following question: why do some stocks with negative shareholder's equity trade with positive stock prices? This is not an uncommon occurrence; in March of 2010, more than 50 companies with a market value of $500m or more had negative equity, i.e. their debts were larger than their assets. But their market value was positive.

If you think about it a second, the reason for the positive value of the stock has to be that the shareholders expect the first to become solvent and profitable in the future. So to value such firms, we cannot do what have been doing, namely projecting current income or free cash flows into the future. The FCFE model is sometimes extended to a three stage model to handle such companies; in such a model, the company has negative earnings in stage 1, moves from negative to positive in stage 2, and is profitable in stage 3. The problem of specifying exactly how these earnings will change over time can be difficult because you will have to say what happens to the firm every year until stage 3 (after which it grows in perpetuity).

A particularly elegant solution to this problem is provided by option pricing theory, and in particular a model presented by Merton (1974) which uses option pricing techniques to value a firm. In Merton's model, a stock, when viewed from the perspective of the fundamental accounting equation (Total Assets equal Total Liabilities plus Owners Equity) can be thought of as call option on the assets of the firm. Think about it this way. The firm currently has some assets and some debt, with the value of the debt being greater than the value of the assets. Suppose the debt matures in 5 years. So even though there is negative equity, what actually matters is whether the firm can pay off the debt when it is due. So we need to project what happens in five years. If at that time, the assets are

greater than the debt, the firm will be solvent, and the shareholders will own the residual claim, which is the difference between the assets and the debt. If not, the shareholders will get nothing (since the firm will be insolvent). But this means that the shareholders have a call option on the assets of the firm, and so the stock can be valued in the same way as we value an option.

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