Learning Objectives

After studying this chapter you should be able to:

✓ Distinguish between various valuation concepts.
✓ Estimate the value of a bond.
✓ Calculate various measures of bond yield.
✓ Read bond and stock quotations.
✓ Value a preference stock.
✓ Calculate the value of a stock using the dividend discount model and the P/E ratio approach.
✓ Show the relationship between E/P ratio, expected return, and growth.

In Chapter 6 we discussed the basic methods used to value future cash flows. In this chapter we will apply those methods for valuing bonds and stocks. In addition, we will introduce some of the terminology used in these areas and describe how the financial press reports the prices of these assets.

We assume that the appropriate discount rate is known. The question of how risk determines the appropriate discount rate is very important and we will discuss this issue in the following chapter. For now, our focus will be on what the relevant cash flows of financial assets are and how to value them, given an appropriate discount rate.

The objective of financial management is to maximise the value of the firm. Hence managers must know how stocks and bonds are valued. Knowing how to value securities (bonds and stocks, in the main) is as important for investors as it is for managers. Current and prospective investors must understand how to value bonds and stocks. Such knowledge is helpful to them in deciding whether they should buy or hold or sell securities at the prices prevailing in the market.

This chapter discusses the basic discounted cash flow valuation model and its application to bonds and stocks.
7.1 VALUATION CONCEPTS

The term value is used in different senses. Hence, let us briefly review the differences that exist among the major concepts of value.

**Liquidation Value versus Going Concern Value**  The liquidation value is the amount that can be realised when an asset, or a group of assets representing a part or even the whole of a firm, is sold separately from the operating organisation to which it belongs. In contrast, the going concern value represents the amount that can be realised if the firm is sold as a continuing operating entity.

In general, security valuation models assume a going concern, an operating business entity that generates cash flows to its security holders. When the going concern assumption is not appropriate as in the case of an impending bankruptcy, liquidation value of assets is more relevant in determining the worth of the firm’s financial securities.

**Book Value versus Market Value**  The book value of an asset is the accounting value of the asset, which is simply the historical cost of the asset less accumulated depreciation or amortisation as the case may be. The book value of a firm’s equity is equal to the book value of its assets minus the book value of its liabilities. Because book value reflects a historical accounting value it may diverge significantly from market value. However, under IFRS accounting, which is expected to be adopted in India, more assets are likely to be reported at “fair values.” So, the traditional divergence between book value and market value may diminish.

The market value of an asset is simply the market price at which the asset trades in the market place. Often the market value is greater than the book value.

**Market Value versus Intrinsic Value**  As the nomenclature suggests, the market value of a security is the price at which the security trades in the financial market.

The intrinsic value of a security is the present value of the cash flow stream expected from the security, discounted at a rate of return appropriate for the risk associated with the security. Put differently, intrinsic value is economic value. If the market is reasonably efficient, the market price of the security should hover around its intrinsic value. The focus of this chapter is on establishing a security’s intrinsic value.

7.2 BOND VALUATION

A bond represents a contract under which a borrower promises to pay interest and principal on specific dates to the holders of the bond.

Bonds are issued by a variety of organisations. The principal issuers of bonds in India are the central government, state governments, public sector undertakings, private sector companies, and municipal bodies.

Bonds issued by the central government are called Treasury bonds. These are bonds which have maturities ranging up to 20 years. These bonds generally pay interest semi-annually. Presently, Treasury bonds dominate the Indian bond market in terms of market capitalisation, liquidity, and turnover.

State government bonds are issued by the state governments. These bonds have maturities that generally range from 3 to 20 years and pay interest semi-annually.
Bonds issued by companies are classified into two types: PSU (public sector undertakings) bonds and private sector bonds. PSU bonds are bonds issued by companies in which the central or state governments have an equity stake in excess of 50 percent. Some of these bonds enjoy a tax-free status whereas others are taxable. Private sector bonds are bonds issued by private sector companies. Bonds issued by companies, PSU bonds as well as private sector bonds, generally have maturity ranging from 1 year to 15 years and pay interest semi-annually.

**Terminology** In order to understand the valuation of bonds, we need familiarity with certain bond related terms.

**Par Value** This is the value stated on the face of the bond. It represents the amount the firm borrows and promises to repay at the time of maturity. Usually the par or face value of bonds issued by business firms is ₹ 100. Sometimes it is ₹ 1,000.

**Coupon Rate and Interest** A bond carries a specific interest rate which is called ‘the coupon rate’. The interest payable to the bond holder is simply: par value of the bond × coupon rate. Most bonds pay interest semi-annually. For example, a government security which has a par value of ₹ 1,000 and a coupon rate of 11 percent pays an interest of ₹ 55 every six months.

**Maturity Period** Typically bonds have a maturity period of 1-15 years; sometimes they have longer maturity. At the time of maturity the par (face) value plus perhaps a nominal premium is payable to the bondholder.

**Valuation Model** The value of a bond - or any asset, real or financial - is equal to the present value of the cash flows expected from it. Hence determining the value of a bond requires:
- An estimate of expected cash flows
- An estimate of the required return

To simplify our analysis of bond valuation we will make the following assumptions:
- The coupon interest rate is fixed for the term of the bond.
- The coupon payments are made annually and the next coupon payment is receivable exactly a year from now.
- The bond will be redeemed at par on maturity.

Given these assumptions, the cash flow for a non-callable bond (a bond that cannot be prematurely retired) comprises of an annuity of a fixed coupon interest and the principal amount payable at maturity. Hence the value of the bond is:

\[
P = \sum_{t=1}^{n} \frac{C}{(1+r)^t} + \frac{M}{(1+r)^n}
\]

where \(P\) is the value (in rupees), \(n\) is the number of years to maturity, \(C\) is the annual coupon payment (in rupees), \(r\) is the periodic required return, \(M\) is the maturity value, and \(t\) is the time when the payment is received.

Since the stream of coupon payments is an ordinary annuity, we can apply the formula for the present value of an ordinary annuity. Hence the bond value is given by the formula:

\[
P = C \times PVIFA_{r,n} + M \times PVIF_{r,n}
\]
To illustrate how to compute the price of a bond, consider a 10-year, 12% coupon bond with a par value of ₹ 1,000. Let us assume that the required yield on this bond is 13%. The cash flows for this bond are as follows:

- 10 annual coupon payments of ₹ 120
- ₹ 1,000 principal repayment 10 years from now

The value of the bond is:

\[
P = 120 \times PVIFA_{13\%,10\text{yrs}} + 1,000 \times PVIF_{13\%,10\text{yrs}}
\]

\[
= 120 \times 5.426 + 1,000 \times 0.295
\]

\[
= 651.1 + 295 = ₹ 946.1
\]

**Bond Values with Semi-annual Interest**  Most of the bonds pay interest semi-annually. To value such bonds, we have to work with a unit period of six months, and not one year. This means that the bond valuation equation has to be modified along the following lines:

- The annual interest payment, \( C \), must be divided by two to obtain the semi-annual interest payment.
- The number of years to maturity must be multiplied by two to get the number of half-yearly periods.
- The discount rate has to be divided by two to get the discount rate applicable to half-yearly periods.

With the above modifications, the basic bond valuation becomes:

\[
P = \frac{C}{2} \times PVIFA_{r/2,2n} + M \times PVIF_{r/2,2n}
\]

where \( P \) is the value of the bond, \( C/2 \) is the semi-annual interest payment, \( r/2 \) is the discount rate applicable to a half-year period, \( M \) is the maturity value, and \( 2n \) is the maturity period expressed in terms of half-yearly periods.

As an illustration, consider an 8 year, 12 percent coupon bond with a par value of ₹ 100 on which interest is payable semi-annually. The required return on this bond is 14 percent.

Applying Eq.(7.2), the value of the bond is:

\[
P = \frac{6}{(1.07)^1} + \frac{100}{(1.07)^{16}}
\]

\[
= 6(PVIFA_{7\%,16}) + 100(PVIF_{7\%,16})
\]

\[
= ₹ 6(9.447) + ₹ 100(0.339) = ₹ 90.6
\]

Let us recalculate the above using the Excel financial function PRICE (settlement, maturity, rate, yield, redemption, frequency, basis), as follows:
<p>| | | | | | | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A</strong></td>
<td><strong>B</strong></td>
<td><strong>C</strong></td>
<td><strong>D</strong></td>
<td><strong>E</strong></td>
<td><strong>F</strong></td>
<td><strong>G</strong></td>
<td><strong>H</strong></td>
<td><strong>I</strong></td>
<td><strong>J</strong></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Settlement</td>
<td>1/1/2015</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Maturity</td>
<td>30/12/2022</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Rate</td>
<td>12%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Yield</td>
<td>14%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Redemption</td>
<td>100</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Frequency</td>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Basis</td>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Price</td>
<td>90.55</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Bond price is obtained per ₹ 100 of the face value of the bond. Here, the redemption value being ₹ 100, the price would be ₹ 90.55 x 100/100 = ₹ 90.55</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Relationship between Coupon Rate, Required Yield, and Price**

A basic property of a bond is that its price varies inversely with yield. The reason is simple. As the required yield decreases, the present value of the cash flow increases; hence the price increases. Conversely, when the required yield increases, the present value of the cash flow decreases.

The price-yield relationship may be illustrated with an example. Consider a bond carrying a coupon rate of 14 percent issued 3 years ago for ₹ 1000 (its par value) by Signal Corporation. The original maturity of the bond was 10 years, so its residual maturity now is 7 years. The interest rate has fallen in the last 3 years and investors now expect a return of 10 percent from this bond. The price of this bond now would be

\[ P_0 = \sum_{t=1}^{7} \frac{140}{(1.10)^t} + \frac{1000}{(1.10)^7} = ₹ 1194.7 \]

The arithmetic of the bond price increase is clear. What is the logic behind it? The fact that the required return on such a bond has fallen to 10 percent means that if you had ₹ 1,000 to invest, you can buy new bonds like Signal’s except that these new bonds would pay ₹ 100, rather than ₹ 140, by way of interest. Naturally, as an investor you would prefer ₹ 140 to ₹ 100, so you would be willing to pay more than ₹ 1,000 for a Signal bond to enjoy its higher coupons. All investors would behave similarly and consequently the bond of Signal would be bid up in price to ₹ 1194.7. At that price it would provide a return of 10 percent, the rate the new bonds offer.

Now let us look at what happens when the interest rate rises after the bond has been issued. Assume that because of a rise in interest rates, investors now expect a return of 18 percent from the Signal bond. The price of the bond would be:
The graph of the price-yield relationship for the bond has a convex shape as shown in Exhibit 7.1.

To sum up, the relationship between the coupon rate, the required yield, and the price is as follows:

- Coupon rate > Required yield → Price > Par (Premium bond)
- Coupon rate = Required yield → Price = Par
- Coupon rate < Required yield → Price < Par (Discount bond)

**Relationship between Bond Price and Time** Since the price of a bond must typically be equal to its par value at maturity (assuming that there is no risk of default), the bond price changes with time. For example, a bond that is redeemable for ₹ 1,000 (which is its par value) after 5 years when it matures, will have a price of ₹ 1,000 at maturity, no matter what the current price is. If its current price is, say, ₹ 1,100, it is said to be a premium bond. If the required yield does change between now and the maturity date, the premium will decline over time as shown by curve A in Exhibit 7.2. On the other hand, if the bond has a current price of say ₹ 900, it is said to be a discount bond. The discount too will disappear over time as shown by curve B in Exhibit 7.2. Only when the current price is equal to par value - in such a case the bond is said to be a par bond - there is no change in price as time passes, assuming that the required yield does not change between now and the maturity date. This is shown by the dashed line in Exhibit 7.2.

### 7.3 BOND YIELDS

In the previous section we learned how to determine the price of a bond and discussed how price and yield were related. We now discuss various yield measures.

The commonly employed yield measures are: current yield, yield to maturity, and yield to call. Let us examine how these yield measures are calculated.
Exhibit 7.2  Price Changes with Time

<table>
<thead>
<tr>
<th>Price of bond</th>
<th>Premium bond: ( r_d = 11% )</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,100</td>
<td>A</td>
</tr>
<tr>
<td>1,000</td>
<td>Par value bond: ( r_d = 13% )</td>
</tr>
<tr>
<td>900</td>
<td>B</td>
</tr>
<tr>
<td></td>
<td>Discount bond: ( r_d = 15% )</td>
</tr>
</tbody>
</table>

### Current Yield
The current yield relates the annual coupon interest to the market price. It is expressed as:

\[
\text{Current yield} = \frac{\text{Annual interest}}{\text{Price}}
\]

For example, the current yield of a 10 year, 12 percent coupon bond with a par value of ₹1000 and selling for ₹950 is 12.63 percent.

\[
\text{Current yield} = \frac{120}{950} = 0.1263 \text{ or } 12.63\%
\]

The current yield calculation reflects only the coupon interest rate. It does not consider the capital gain (or loss) that an investor will realise if the bond is purchased at a discount (or premium) and held till maturity. It also ignores the time value of money. Hence it is an incomplete and simplistic measure of yield.

### Yield to Maturity
The yield to maturity (YTM) of a bond is the interest rate that makes the present value of the cash flows receivable from owning the bond equal to the price of the bond. Mathematically, it is the interest rate \( r \) which satisfies the equation:

\[
P = \frac{C}{(1+r)} + \frac{C}{(1+r)^2} + \ldots + \frac{C}{(1+r)^n} + \frac{M}{(1+r)^n}
\]

(7.3)

where \( P \) is the price of the bond, \( C \) is the annual interest (in rupees), \( M \) is the maturity value (in rupees), and \( n \) is the number of years left to maturity.

The computation of YTM requires a trial and error procedure. To illustrate this, consider a ₹1,000 par value bond, carrying a coupon rate of 9 percent, maturing after 8 years. The bond is currently selling for ₹800. What is the YTM on this bond? The YTM is the value of \( r \) in the following equation:
\[800 = \sum_{t=1}^{n} \frac{90}{(1+r)^t} + \frac{1000}{(1+r)^n}\]

\[= 90 \text{ (PVIFA}_{r,8\text{yrs}}\text{)} + 1,000 \text{ (PVIF}_{r,8\text{yrs}}\text{)}\]

Let us begin with a discount rate of 12 percent. Putting a value of 12 percent for \(r\) we find that the right-hand side of the above expression is:

\[\text{\text{\textcolor{red}{\text{\$}}}} 90 \text{ (PVIFA}_{12\text{\%,8yrs}}\text{)} + \text{\textcolor{red}{\text{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{90(4.968) + 1,000(0.404)}}}}}}}}}} = \text{\textcolor{red}{\text{\text{\textcolor{red}{\text{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{851.0}}}}}}}}}}}}\]

Since this value is greater than \(\text{\textcolor{red}{\text{\textcolor{red}{\text{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{800}}}}}}}}}}\)), we may have to try a higher value for \(r\). Let us try \(r = 14\) percent. This makes the right-hand side equal to:

\[\text{\textcolor{red}{\text{\textcolor{red}{\text{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{90(4.639) + 1,000(0.351)}}}}}}}}}}}} = \text{\textcolor{red}{\text{\text{\textcolor{red}{\text{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{876.1}}}}}}}}}}}}\]

Since this value is less than \(\text{\textcolor{red}{\text{\textcolor{red}{\text{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{800}}}}}}}}}}\)), we try a lower value for \(r\). Let us try \(r = 13\) percent. This makes the right-hand side equal to:

\[\text{\textcolor{red}{\text{\textcolor{red}{\text{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{90(4.800) + 1,000(0.376)}}}}}}}}}}}} = \text{\textcolor{red}{\text{\text{\textcolor{red}{\text{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{\textcolor{red}{808}}}}}}}}}}\]

Thus \(r\) lies between 13 percent and 14 percent. Using a linear interpolation in the range 13 percent to 14 percent, we find that \(r\) is equal to 13.2 percent.

\[13\% + (14\% - 13\%) \frac{808 - 800}{808 - 768.1} = 13.2\%\]

**An Approximation**  If you are not inclined to follow the trial-and-error approach described above, you can employ the following formula to find the approximate YTM on a bond:

\[\text{YTM} = \frac{C + (M - P)/n}{0.4M + 0.6P} \text{ (7.4)}\]

where YTM is the yield to maturity, \(C\) is the annual interest payment, \(M\) is the maturity value of the bond, \(P\) is the present price of the bond, and \(n\) is the years to maturity.

To illustrate the use of this formula, let us consider the bond discussed above. The approximate YTM of the bond works out to:

\[\text{YTM} = \frac{90 + (1000 - 800)/8}{0.4 \times 1000 + 0.6 \times 800} = 13.1\%\]

Thus, we find that this formula gives a value which is very close to the true value (13.2 percent). Hence it is very useful.

The YTM calculation considers the current coupon income as well as the capital gain or loss the investor will realise by holding the bond to maturity. In addition, it takes into account the timing of the cash flows.

**Yield to Call**  Some bonds carry a call feature that entitles the issuer to call (buy back) the bond prior to the stated maturity date in accordance with a call schedule (which specifies a call price for each call date). For such bonds, it is a practice to calculate the yield to call (YTC) as well as the YTM.
The yield to maturity for the above example may also be obtained using an Excel spreadsheet, either using the RATE function or the YIELD function, as shown below.

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Formula used</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Price of the bond at present (PV)</td>
<td>₹ 800</td>
</tr>
<tr>
<td>3</td>
<td>Par value / Maturity value of the bond</td>
<td>₹ 1,000</td>
</tr>
<tr>
<td>4</td>
<td>Coupon rate</td>
<td>9%</td>
</tr>
<tr>
<td>5</td>
<td>Coupon amount payable per period (PMT)</td>
<td>₹ 90</td>
</tr>
<tr>
<td>6</td>
<td>No. of periods (NPER)</td>
<td>8</td>
</tr>
<tr>
<td>7</td>
<td>Yield to Maturity (RATE)</td>
<td>= RATE(C6, C5, -C2, C3, 0)</td>
</tr>
</tbody>
</table>

Yield to maturity of a bond can also be obtained using the Yield formula in Excel, as shown below.

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Formula used</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Settlement</td>
<td>As the date is not given, use any date</td>
</tr>
<tr>
<td>12</td>
<td>Maturity</td>
<td>= C11 + 365 * 8</td>
</tr>
<tr>
<td>13</td>
<td>Rate</td>
<td>9%</td>
</tr>
<tr>
<td>14</td>
<td>Redemption</td>
<td>100</td>
</tr>
<tr>
<td>15</td>
<td>Frequency</td>
<td>1</td>
</tr>
<tr>
<td>16</td>
<td>Basis</td>
<td>3</td>
</tr>
<tr>
<td>17</td>
<td>Price</td>
<td>= 800 / 10</td>
</tr>
<tr>
<td>18</td>
<td>Yield to maturity</td>
<td>= YIELD(C11, C12, C13, C17, C14, C15, C16)</td>
</tr>
</tbody>
</table>

Note: The parameters are the same as those used in the spreadsheet illustration for 'PRICE'.

The procedure for calculating the YTC is the same as that for the YTM. Mathematically, the YTC is the value of r in the following equation:

\[
P = \sum_{i=1}^{n^*} \frac{C}{(1 + r)^i} + \frac{M^*}{(1 + r)^{n^*}}
\]

where \(M^*\) is the call price (in rupees) and \(n^*\) is the number of years until the assumed call date.

### 7.4 BOND MARKET

Bonds are bought and sold in large quantities. The Indian bond market has grown rapidly since the mid 1990s. With a daily turnover of about ₹ 5,000 crore in mid-2003, it is one of the largest in Asia. The growth in the bond market has been stimulated by a host of reforms such as the increased functional autonomy of the RBI, improved institutional infrastructure, technology-related initiatives, and consolidation and creation of benchmark securities.

Most trading in bonds takes place over the counter. This means that the transactions are privately negotiated and they don’t take place through the process of matching of orders on
Financial Management

an organised exchange. This is a characteristic of bond markets all over the world, not just in India. Because the bond market is largely over the counter, it lacks transparency. A financial market is transparent if you can easily observe its prices and volumes.

The National Stock Exchange has a Wholesale Debt Market (WDM) segment. The WDM segment is a market for high value transactions in government securities, PSU bonds, commercial papers, and other debt instruments. The quotations of this segment mostly reflect over the counter transactions that are privately negotiated over the phone or computer and registered with the exchange for reporting purposes.

An illustrative quotation from the WDM segment of NSE pertaining to no-repo (NR) trades on 31/12/2014 in 8.40% government securities (GS) issued by central government (CG) and 9.85% bank bonds (BB) issued by SBI is given below.

<table>
<thead>
<tr>
<th>Date</th>
<th>Security Type</th>
<th>Security Name</th>
<th>Issue Name</th>
<th>Trade Type</th>
<th>No. of Trades</th>
<th>Traded Value</th>
<th>Low Price/Rate</th>
<th>High Price/Rate</th>
<th>Last Price</th>
<th>YTM</th>
</tr>
</thead>
<tbody>
<tr>
<td>31-Dec-14</td>
<td>GS</td>
<td>CG2024</td>
<td>8.40%</td>
<td>NR</td>
<td>2</td>
<td>125</td>
<td>103.57</td>
<td>103.6</td>
<td>103.57</td>
<td>7.86</td>
</tr>
<tr>
<td>31-Jul-14</td>
<td>BB</td>
<td>SBI16</td>
<td>9.85%</td>
<td>NR</td>
<td>1</td>
<td>15</td>
<td>101.446</td>
<td>101.446</td>
<td>101.446</td>
<td>8.96</td>
</tr>
</tbody>
</table>

The retail trade in corporate debt securities is done mostly on the capital market segment of the NSE and the debt segment of the BSE.

7.5 VALUATION OF PREFERENCE STOCK

Preference stock generally pays regular, fixed dividends. Preference dividends are not increased when the profits of the firm rise, nor are they lowered or suspended unless the firm faces financial difficulties. If preference dividends are cut or suspended for some time, the firm is normally required to pay the arrears before paying equity dividends.

Preference stock may be perpetual or redeemable. While the former has no maturity period, the latter is expected to be redeemed after its limited life. Preference stock in India is typically redeemable.

If we assume that the preference stock pays fixed annual dividends during its life and the principal amount on maturity, its value is given as follows.

\[
P_0 = \sum_{i=1}^{n} \frac{D}{(1 + r_p)^i} + \frac{M}{(1 + r_p)^n}
\]

(7.6)

where \(P_0\) is the current price of the preference stock, \(D\) is the annual dividend, \(n\) is the residual life of the preference stock, \(r_p\) is the required rate of return on the preference stock, and \(M\) is the maturity value.

Since the stream of dividends is an ordinary annuity, we can apply the formula for the present value of an ordinary annuity. Hence the value of the preference stock is:

\[
P_0 = D \times PVIFr_{p,n} + M \times PVIFr_{p,n}
\]

To illustrate how to compute the value of a preference stock, consider an 8 year, 10 percent preference stock with a par value of ₹ 1000. The required return on this preference stock is 9 percent.
The value of the preference stock is
\[ P = 100 \times PVIFA_{9\%,8yrs} + 1000 \times PVIF_{9\%,8yrs} \]
\[ = 100 \times 5.535 + 1000 \times 0.502 = ₹1055.5 \]

### 7.6 EQUITY VALUATION: DIVIDEND DISCOUNT MODEL

According to the dividend discount model, the value of an equity share is equal to the present value of dividends expected from its ownership plus the present value of the sale price expected when the equity share is sold. For applying the dividend discount model, we will make the following assumptions: (i) dividends are paid annually; and (ii) the first dividend is received one year after the equity share is bought.

**Single-period Valuation Model**

Let us begin with the case where the investor expects to hold the equity share for one year. The price of the equity share will be:

\[ P_0 = D_1 \frac{1}{(1+r)} + P_1 \frac{1}{(1+r)} \]  

(7.7)

where \( P_0 \) is the current price of the equity share, \( D_1 \) is the dividend expected a year hence, \( P_1 \) is the price of the share expected a year hence, and \( r \) is the rate of return required on the equity share.

**Example**

Prestige’s equity share is expected to provide a dividend of ₹ 2.00 and fetch a price of ₹ 18.00 a year hence. What price would it sell for now if investors’ required rate of return is 12 percent? The current price will be:

\[ P_0 = \frac{2.00}{(1.12)} + \frac{18.00}{(1.12)} = ₹17.86 \]

What happens if the price of the equity share is expected to grow at a rate of \( g \) percent annually? If the current price, \( P_0 \), becomes \( P_0(1+g) \) a year hence, we get:

\[ P_0 = \frac{D_1}{(1+r)} + \frac{P_0(1+g)}{(1+r)} \]  

(7.8)

Simplifying Eq.(7.8) we get:

\[ P_0 = \frac{D_1}{r-g} \]  

(7.9)

---

1 The steps in simplification are:

\[ P_0 = \frac{D_1}{(1+r)} + \frac{P_0(1+g)}{(1+r)} \]  

(1)

\[ P_0 = \frac{D_1 + P_0(1+g)}{(1+r)} \]  

(2)

\[ P_0 (1 + r) = D_1 + P_0 (1 + g) \]  

(3)

\[ P_0 (1 + r) - P_0 (1 + g) = D_1 \]  

(4)

\[ P_0 (r-g) = D_1 \]  

(5)

\[ P_0 = \frac{D_1}{r-g} \]  

(6)
Example  The expected dividend per share on the equity share of Roadking Limited is ₹ 2.00. The dividend per share of Roadking Limited has grown over the past five years at the rate of 5 percent per year. This growth rate will continue in future. Further, the market price of the equity share of Roadking Limited, too, is expected to grow at the same rate. What is a fair estimate of the intrinsic value of the equity share of Roadking Limited if the required rate is 15 percent?

Applying Eq.(7.9) we get the following estimate:

$$P_0 = \frac{2.00}{0.15 - .05} = ₹ 20.00$$

Expected Rate of Return  In the preceding discussion we calculated the intrinsic value of an equity share, given information about (i) the forecast values of dividend and share price, and (ii) the required rate of return. Now we look at a different question: What rate of return can the investor expect, given the current market price and forecast values of dividend and share price? The expected rate of return is equal to:

$$r = \frac{D_1}{P_0 + g}$$  \hspace{1cm} (7.10)

Example  The expected dividend per share of Vaibhav Limited is ₹ 5.00. The dividend is expected to grow at the rate of 6 percent per year. If the price per share now is ₹ 50.00, what is the expected rate of return?

Applying Eq. (7.10), the expected rate of return is:

$$r = \frac{5}{50} + 0.06 = 16 \text{ percent}$$

Multi-period Valuation Model  Having learnt the basics of equity share valuation in a single-period framework, we now discuss the more realistic, and also the more complex, case of multi-period valuation.

Since equity shares have no maturity period, they may be expected to bring a dividend stream of infinite duration. Hence the value of an equity share may be put as:

$$P_0 = \frac{D_1}{(1+r)} + \frac{D_2}{(1+r)^2} + ... + \frac{D_\infty}{(1+r)^\infty} = \sum_{t=1}^{\infty} \frac{D_t}{(1+r)^t}$$ \hspace{1cm} (7.11)

where $P_0$ is the price of the equity share today, $D_1$ is the dividend expected a year hence, $D_2$ is the dividend expected two years hence,..... $D_\infty$ is the dividend expected at the end of infinity, and $r$ is the expected return.

Equation (7.11) represents the valuation model for an infinite horizon. Is it applicable to a finite horizon? Yes. To demonstrate this, consider how an equity share would be valued by an investor who plans to hold it for $n$ years and sell it thereafter for a price of $P_n$. The value of the equity share to him is:

$$P_0 = \frac{D_1}{(1+r)^1} + \frac{D_2}{(1+r)^2} + ... + \frac{D_n}{(1+r)^n} + \frac{P_n}{(1+r)^n}$$
Now, what is the value of \( P_n \) in Eq.(7.12)? Applying the dividend capitalisation principle, the value of \( P_n \) would be the present value of the dividend stream beyond the \( n \)th year, evaluated as at the end of the \( n \)th year. This means:

\[
P_n = \frac{D_{n+1}}{(1+r)^1} + \frac{D_{n+2}}{(1+r)^2} + \ldots + \frac{D_\infty}{(1+r)^\infty}
\]  

(7.13)

Substituting this value of \( P_n \) in Eq. (7.12) we get:

\[
P_0 = \frac{D_1}{(1+r)^1} + \frac{D_2}{(1+r)^2} + \ldots + \frac{D_n}{(1+r)^n} + \frac{1}{(1+r)^n} \left[ \frac{D_{n+1}}{(1+r)^1} + \frac{D_{n+2}}{(1+r)^2} + \ldots + \frac{D_\infty}{(1+r)^\infty} \right]
\]

\[
= \frac{D_1}{(1+r)^1} + \frac{D_2}{(1+r)^2} + \ldots + \frac{D_n}{(1+r)^n} + \frac{D_n}{(1+r)^{n+1}} + \ldots + \frac{D_\infty}{(1+r)^\infty}
\]

\[
= \sum_{t=1}^{\infty} \frac{D_t}{(1+r)^t}
\]  

(7.14)

This is the same as Eq.(7.11) which may be regarded as a generalised multi-period valuation formula. Eq.(7.11) is general enough to permit any dividend pattern — constant, rising, declining, or randomly fluctuating. For practical applications it is helpful to make simplifying assumptions about the pattern of dividend growth. The more commonly used assumptions are as follows:

- The dividend per share remains constant forever, implying that the growth rate is nil (the zero growth model).
- The dividend per share grows at a constant rate per year forever (the constant growth model).
- The dividend per share grows at a constant rate for a finite period, followed by a constant normal rate of growth forever thereafter (the two-stage model).
- The dividend per share, currently growing at an above-normal rate, experiences a gradually declining rate of growth for a while. Thereafter, it grows at a constant normal rate (the \( H \) model).

**Zero Growth Model** If we assume that the dividend per share remains constant year after year at a value of \( D \), Eq.(7.11) becomes :

\[
P_0 = \frac{D}{(1+r)^1} + \frac{D}{(1+r)^2} + \ldots + \frac{D}{(1+r)^n} + \ldots \infty
\]

(7.15)

Equation (7.15), on simplification, becomes:

\[
P_0 = \frac{D}{r}
\]

(7.16)

This is an application of the present value of perpetuity formula.
**Constant Growth Model**  One of the most popular dividend discount models assumes that the dividend per share grows at a constant rate \( g \). The value of a share, under this assumption, is:

\[
P_0 = \frac{D_1}{(1+r)} + \frac{D_1(1+g)}{(1+r)^2} + \cdots + \frac{D_1(1+g)^n}{(1+r)^{n+1}} + \cdots
\]  

(7.17)

Applying the formula for the sum of a geometric progression, the above expression simplifies to:

\[
P_0 = \frac{D_1}{r - g}
\]  

(7.18)

**Example**  Ramesh Engineering Limited is expected to grow at the rate of 6 percent per annum. The dividend expected on Ramesh’s equity share a year hence is ₹ 2.00. What price will you put on it if your required rate of return for this share is 14 percent?

The price of Ramesh’s equity share would be:

\[
P_0 = \frac{2.00}{0.14 - 0.06} = ₹ 25.00
\]

**What Drives Growth**  Most stock valuation models are based on the assumption that dividends grow over time. What drives this growth? The two major drivers of growth are: (a) ploughback ratio and (b) return on equity (ROE). To see why this is so let us consider an example. Omega Limited has an equity (net worth) base of 100 at the beginning of year 1. It earns a return on equity of 20 percent. It pays out 40 percent of its equity earnings and ploughs back 60 percent of its equity earnings. Its financials for a 3 year period are shown in Exhibit 7.3, from which we find that dividends grow at a rate of 12 percent. The growth figure is a product of: Ploughback ratio \( \times \) Return on equity \( = 0.6 \times 20\% = 12\% \)

\[2\]  

Start with

\[
P_0 = \frac{D_1}{(1+r)} + \frac{D_2}{(1+r)^2} + \cdots + \frac{D_n}{(1+r)^n} = \frac{D_1}{(1+r)} + \frac{D_1(1+g)}{(1+r)^2} + \cdots
\]

(1)

Multiplying both the sides of (1) by \([(1 + g)/(1 + r)]\) gives:

\[
P_0 \left[\frac{1+g}{1+r}\right] = \frac{D_1(1+g)}{(1+r)^2} + \frac{D_1(1+g)^2}{(1+r)^3} + \cdots + \frac{D_1(1+g)^{n+1}}{(1+r)^{n+2}} \quad (n \rightarrow \infty)
\]

(2)

Subtracting (2) from (1) yields:

\[
\frac{P_0(r-g)}{1+r} = D_1 \left[ \frac{1}{(1+r)} - \frac{(1+g)^{n+1}}{(1+r)^{n+2}} \right] \quad (n \rightarrow \infty)
\]

(3)

As \( n \rightarrow \infty \), \( \frac{(1+g)^{n+1}}{(1+r)^{n+2}} \rightarrow 0 \) because \( g < r \)

Hence (2) becomes:

\[
\frac{P_0(r-g)}{1+r} = D_1
\]

(4)

This means:

\[
P_0 = \frac{D_1}{r - g}
\]

(5)
**Exhibit 7.3 Financials of Omega Limited**

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning equity</td>
<td>100</td>
<td>112</td>
<td>125.44</td>
</tr>
<tr>
<td>Return on equity</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Equity earnings</td>
<td>20</td>
<td>22.4</td>
<td>25.1</td>
</tr>
<tr>
<td>Dividend payout ratio</td>
<td>0.4</td>
<td>0.4</td>
<td>0.4</td>
</tr>
<tr>
<td>Dividends</td>
<td>8</td>
<td>8.96</td>
<td>10.04</td>
</tr>
<tr>
<td>Ploughback ratio</td>
<td>0.6</td>
<td>0.6</td>
<td>0.6</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>12</td>
<td>13.44</td>
<td>15.06</td>
</tr>
</tbody>
</table>

**Two Stage Growth Model**  The simplest extension of the constant growth model assumes that the extraordinary growth (good or bad) will continue for a finite number of years and thereafter the normal growth rate will prevail indefinitely.

Assuming that the dividends move in line with the growth rate, the price of the equity share will be:

\[
P_0 = D_1 \left( 1 + g_1 \right) \left( \frac{1}{1 + r} \right) + \frac{D_1 (1 + g_1)^2}{(1 + r)^2} + \frac{D_1 (1 + g_1)^3}{(1 + r)^3} + \cdots + \frac{D_1 (1 + g_1)^{n-1}}{(1 + r)^n} + \frac{P_n}{(1 + r)^n} \tag{7.19}\]

where \( P_0 \) is the current price of the equity share, \( D_1 \) is the dividend expected a year hence, \( g_1 \) is the extraordinary growth rate applicable for \( n \) years, and \( P_n \) is the price of the equity share at the end of year \( n \).

The first term on the right hand side of Eq.(7.19) is the present value of a growing annuity. Its value is equal to:

\[
D_1 \left( 1 - \frac{(1 + g_1)^n}{1 + r} \right) \left( \frac{1}{r - g_1} \right) \tag{7.20}\]

Remember that this is a straightforward application of Eq.(6.7) developed in the previous chapter.

Hence

\[
P_0 = D_1 \left( 1 - \frac{(1 + g_1)^n}{1 + r} \right) \left( \frac{1}{r - g_1} \right) + \frac{P_n}{(1 + r)^n} \tag{7.21}\]

Since the two-stage growth model assumes that the growth rate after \( n \) years remains constant, \( P_n \) will be equal to:

\[
\frac{D_{n+1}}{r - g_2} \tag{7.22}\]

where \( D_{n+1} \) is the dividend for year \( n+1 \) and \( g_2 \) is the growth rate in the second period.
$D_{n+1}$, the dividend for year $n+1$, may be expressed in terms of the dividend at the end of the first stage and growth rate in the second stage:

$$D_{n+1} = D_1 (1+g_1)^{n-1} (1+g_2)$$  \hspace{1cm} (7.23)

Substituting the above expression, we have:

$$P_0 = D_1 \left( 1 - \frac{\left(1+\frac{1}{1+r}\right)^n}{r-g_1} \right) + \left[ D_1 (1+g_1)^{n-1} (1+g_2) \right] \left[ \frac{1}{(1+r)^n} \right]$$  \hspace{1cm} (7.24)

**Example**  The current dividend on an equity share of Vertigo Limited is ₹ 2.00. Vertigo is expected to enjoy an above-normal growth rate of 20 percent for a period of 6 years. Thereafter the growth rate will fall and stabilise at 10 percent. Equity investors require a return of 15 percent. What is the intrinsic value of the equity share of Vertigo?

The inputs required for applying the two-stage model are:

- $g_1 = 20$ percent
- $g_2 = 10$ percent
- $n = 6$ years
- $r = 15$ years
- $D_1 = D_0 (1+g_1) = ₹ 2(1.20) = 2.40$

Plugging these inputs in the two-stage model, we get the intrinsic value estimate as follows:

$$P_0 = 2.40 \left[ 1 - \frac{1.20^{6}}{1.15 - 0.20} \right] + \left[ 2.40 (1.20)^5 (1.10) \right] \left[ \frac{1}{(1.15)^6} \right]$$

$$= 2.40 \left[ 1 - 1.291 \right] + \left[ 2.40 (2.488)(1.10) \right] [0.432]$$

$$= 13.96 + 56.80$$

$$= ₹ 70.76$$

The Excel spreadsheet for the two stage growth model is as under:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>g₁</td>
<td>g₂</td>
<td>n(years)</td>
<td>r</td>
<td>$D₀(₹)$</td>
</tr>
<tr>
<td>2</td>
<td>20%</td>
<td>10%</td>
<td>6</td>
<td>15%</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>$P₀(₹)$</td>
<td>Formula used = $E₂²(1 + A₂)(1-(1 + A₂)/(1 + D₂)^*C₂)/(D₂ - A₂) + E₂²(1 + A₂)(1 + A₂)^*C₂²(1 + B₂)/(D₂ - B₂)/(1 + D₂)^*C₂²$</td>
<td>70.76</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**H Model**  The $H$ model of equity valuation is based on the following assumptions:

- While the current dividend growth rate, $g_{a'}$, is greater than $g_{n'}$, the normal long-run growth rate, the growth rate declines linearly for 2$H$ years.
After 2H years the growth rate becomes $$g_n$$.

The graphical representation of the dividend growth rate pattern for the H-model is shown in Exhibit 7.4.

**Exhibit 7.4** Dividend Growth Rate Pattern for the H model

While the derivation of the H model is rather complex, the valuation equation for the H model is quite simple:

$$P_0 = \frac{D_0\left([1+g_n]+H(g_a - g_n)\right)}{r-g_n}$$  \hspace{1cm} (7.25)

where $$P_0$$ is the intrinsic value of the share, $$D_0$$ is the current dividend per share, $$r$$ is the rate of return expected by investors, $$g_n$$ is the normal long-run growth rate, $$g_a$$ is the current growth rate, and $$H$$ is one-half of the period during which $$g_a$$ will level off to $$g_n$$.

Equation (7.25) may be re-written as:

$$P_0 = \frac{D_0(1+g_n)}{r-g_n} + \frac{D_0H(g_a - g_n)}{r-g_n}$$  \hspace{1cm} (7.26)

Expressed this way, the H model may be interpreted in a simple, intuitive manner. The first term on the right hand side of Eq. (7.26)

$$\frac{D_0(1+g_n)}{r-g_n}$$

represents the value based on the normal growth rate, whereas the second term

$$\frac{D_0H(g_a - g_n)}{r-g_n}$$

reflects the premium due to abnormal growth rate.

**Example** The current dividend on an equity share of International Computers Limited is ₹ 3.00. The present growth rate is 50 percent. However, this will decline linearly over a period of 10 years and then stabilise at 12 percent. What is the intrinsic value per share of International Computers Limited, if investors require a return of 16 percent?
The inputs required for applying the \( H \)-model are:

\[
D_0 = \text{\textrsf{\textcurrency} \ 3.00} \\
g_a = 50 \text{ percent} \\
H = 5 \text{ years} \\
g_n = 12 \text{ percent} \\
r = 16 \text{ percent}
\]

Plugging these inputs in the \( H \)-model we get the intrinsic value estimate as follows:

\[
P_0 = \frac{300 \left[ (1.12) + 5(0.50 - 0.12) \right]}{0.16 - 0.12} = \text{\textrsf{\textcurrency} \ 226.5}
\]

The Excel illustration of the \( H \)-model is under:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>ga</td>
<td>gn</td>
<td>H(years)</td>
<td>r</td>
<td>( D_0(\text{\textcurrency}) )</td>
</tr>
<tr>
<td>2</td>
<td>50%</td>
<td>12%</td>
<td>5</td>
<td>16%</td>
<td>3</td>
</tr>
<tr>
<td>3</td>
<td>( P_0(\text{\textcurrency}) )</td>
<td>Formula used = ( E2* \left( (1+B2) + C2*(A2–B2) \right)/(D2-B2) )</td>
<td></td>
<td>226.5</td>
<td></td>
</tr>
</tbody>
</table>

**Impact of Growth on Price, Returns, and P/E Ratio**  
The expected growth rates of companies differ widely. Some companies are expected to remain virtually stagnant or grow slowly; other companies are expected to show normal growth; still others are expected to achieve supernormal growth rate.

Assuming a constant total required return, differing expected growth rates mean differing stock prices, dividend yields, capital gains yields, and price-earnings ratios. To illustrate this, consider three cases:

- **Low growth firm**
  - Growth rate (%): 5
- **Normal growth firm**
  - Growth rate (%): 10
- **Supernormal growth firm**
  - Growth rate (%): 15

The expected earnings per share and dividend per share of each of the three firms for the following year are \( \text{\textrsf{\textcurrency} \ 3.00} \) and \( \text{\textrsf{\textcurrency} \ 2.00} \) respectively. Investors’ required total return from equity investment is 20 percent.

Given the above information, we may calculate the stock price, dividend yield, capital gains yield, and price-earnings ratio for the three cases as shown in Exhibit 7.5.

The results in Exhibit 7.5 suggest the following points:

1. As the expected growth in dividend increases, other things being equal, the expected return\(^3\) depends more on the capital gains yield and less on the dividend yield.
2. As the expected growth rate in dividend increases, other things being equal, the price-earnings ratio increases.

\(^3\) Note that total return is the sum of the dividend yield and capital gain yield:

\[
\frac{D_t + P_t - P_{t-1}}{P_{t-1}} = \frac{D_t}{P_{t-1}} + \frac{P_t - P_{t-1}}{P_{t-1}}
\]

Total return = Dividend yield + Capital gains yield
3. High dividend yield and low price-earnings ratio imply limited growth prospects.
4. Low dividend yield and high price-earnings ratio imply considerable growth prospects.

**Exhibit 7.5** Price, Dividend Yield, Capital Gains Yield, and Price-Earnings Ratio under Differing Growth Assumptions

<table>
<thead>
<tr>
<th></th>
<th>Price</th>
<th>Dividend yield</th>
<th>Capital gains yield</th>
<th>Price earnings ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$p_0 = \frac{D_1}{r - g}$</td>
<td>$(D_1/p_0)$</td>
<td>$(P_1 - P_0)/P_0$</td>
<td>$(P/E)$</td>
</tr>
<tr>
<td>Low growth firm</td>
<td>$p_0 = \frac{\text{\textrupee } 2.00}{0.20 - 0.05} = \text{\textrupee } 13.33$</td>
<td>5.0%</td>
<td>4.44</td>
<td></td>
</tr>
<tr>
<td>Normal growth firm</td>
<td>$p_0 = \frac{\text{\textrupee } 2.00}{0.20 - 0.10} = \text{\textrupee } 20.00$</td>
<td>10.0%</td>
<td>6.67</td>
<td></td>
</tr>
<tr>
<td>Supernormal growth firm</td>
<td>$p_0 = \frac{\text{\textrupee } 2.00}{0.20 - 0.15} = \text{\textrupee } 40.00$</td>
<td>5.0%</td>
<td>13.33</td>
<td></td>
</tr>
</tbody>
</table>

**Is the Stock Market Shortsighted?** Many managers believe that the stock market is myopic and obsessed with short-term performance. Let’s test this assertion with the help of the constant growth model. Sun Pharma was quoting at $\text{\textrupee } 591.80$ on May 26, 2014. Sun Pharma’s most recent dividend was $\text{\textrupee } 10$ per share and the dividend growth rate in the previous five years was 19 percent per year. If we assume that the dividend per share continues to grow at the same rate for the next five years and apply a discount rate of 13 percent, the present value of the projected dividends for the following five years would be:

\[
PV = \frac{\text{\textrupee } 10(1.19)}{(1.13)} + \frac{\text{\textrupee } 10(1.19)^2}{(1.13)^2} + \frac{\text{\textrupee } 10(1.19)^3}{(1.13)^3} + \frac{\text{\textrupee } 10(1.19)^4}{(1.13)^4} + \frac{\text{\textrupee } 10(1.19)^5}{(1.13)^5}
\]

\[
= 10.53 + 11.09 + 11.68 + 12.30 + 12.95 = \text{\textrupee } 58.55
\]

Recall that Sun Pharma’s stock price was $\text{\textrupee } 591.80$. Therefore, less than 10 percent of the current stock price is attributable to the projected cash flows (by way of dividends) for the following five years. This means that Sun Pharma managers should focus on increasing long-term cash flows. This is true for most companies. Indeed, many researchers and consultants have found that for a typical company more than 80 percent of current stock price is accounted for by cash flows beyond five years.

If long-term cash flows account for the bulk of a stock’s value, why are managers and analysts obsessed with quarterly earnings? The primary reason seems to be the informational content of short-term earnings. While the quarterly earnings by themselves may not be important, the information they convey about long-term prospects may be very significant. If the quarterly earnings are lower than expected because the new products launched by the company have failed, the long-term cash flows of the company would be negatively impacted. On the other hand, if the reason is that the company has significantly increased its
R&D outlay on promising projects, the market may greet it positively rather than negatively. Another reason for managerial focus on short-term earnings may be that the bonus of managers is linked to reported earnings.

7.7 EQUITY VALUATION: THE P/E RATIO APPROACH

An approach to valuation, practised widely by investment analysts, is the P/E ratio or earnings multiplier approach. The value of a stock, under this approach, is estimated as follows:

\[ P_0 = \frac{E_1 \times P_0}{E_1} \]  

\[ \text{(7.27)} \]

where \( P_0 \) is the estimated price, \( E_1 \) is the estimated earnings per share, \( P_0/E_1 \) is the justified price-earnings ratio.

**Determinants of the P/E Ratio**  The determinants of the P/E ratio can be derived from the dividend discount model, which is the foundation for valuing equity stocks.

Let us start with the constant growth dividend discount model:

\[ P_0 = \frac{D_1}{r - g} \]  

\[ \text{(7.28)} \]

In this model \( D_1 = E_1 (1 - b) \). \( b \) stands for the ploughback ratio and \( g = \text{ROE} \times b \). Note that ROE is return on equity. Making these substitutions we find that:

\[ P_0 = \frac{E_1 (1 - b)}{r - \text{ROE} \times b} \]  

\[ \text{(7.29)} \]

Dividing both the sides by \( E_1 \), we get:

\[ \frac{P_0}{E_1} = \frac{(1 - b)}{r - \text{ROE} \times b} \]  

\[ \text{(7.30)} \]

Equation (7.30) indicates that the factors that determine the P/E ratio are:

- The dividend payout ratio, \((1 - b)\)
- The required rate of return, \(r\)
- The expected growth rate, \(\text{ROE} \times b\)

**P/E Ratio and Ploughback Ratio**  Note that \( b \), the ploughback ratio, appears in the numerator as well as the denominator of the ratio on the right hand side of Eq. (7.30). What is the effect of a change in \( b \) on the P/E ratio? It depends on how ROE compares with \( r \). If ROE is greater than \( r \), an increase in \( b \) leads to an increase in \( P/E \); if ROE is equal to \( r \) an increase in \( b \) has no effect on \( P/E \); if ROE is less than \( r \) an increase in \( b \) leads to decrease in \( P/E \).

**P/E Ratio and Interest Rate**  The required rate of return on equity stocks reflects interest rate and risk. When interest rates increase, required rates of return on all securities, including equity stocks, increase, pushing security prices downward. When interest rates fall security prices rise. Hence there is an inverse relationship between P/E ratios and interest rates.

**P/E Ratio and Risk**  Other things being equal, riskier stocks have lower P/E multiples. This can be seen easily by examining the formula for the P/E ratio of the constant growth model:

\[ P/E = \frac{1 - b}{r - g} \]  

\[ \text{(7.31)} \]
Riskier stocks have higher required rates of return \( (r) \) and hence lower P/E multiples. This is true in all cases, not just the constant growth model. For any expected earnings and dividend stream, the present value will be lower when the stream is considered to be riskier. Hence the P/E multiple will be lower.

**P/E Ratio and Liquidity** Other things being equal, stocks which are highly liquid command higher P/E multiples and stocks which are highly illiquid command lower P/E multiples. The reason for this is not far to seek. Investors value liquidity just the way they value safety and hence are willing to give higher P/E multiples to liquid stocks.

### 7.8 THE RELATIONSHIP BETWEEN EARNINGS-PRICE RATIO, EXPECTED RETURN, AND GROWTH

We often hear about growth stocks and income stocks. Growth stocks are supposed to provide returns primarily in the form of capital appreciation whereas income stocks are expected to provide returns mainly in the form of cash dividends. Does such a distinction make sense? Let us examine.

Consider the case of Maturity Limited, a firm that does not grow at all. It pays all its earnings as dividends and does not plough back anything. Put differently, it pays a constant stream of dividends and hence its stock is like a perpetual bond. Hence the expected return on its stock is its dividend per share divided by the share price (i.e. the dividend yield) which is also the same as its earnings per share divided by the share price (i.e. the E/P ratio). If the earnings per share as well as the dividend per share is ₹15 and the stock price is ₹100, we have:

\[
\text{Expected return} = \frac{D_1}{P_0} = \frac{E_1}{P_0} = \frac{15}{100} \text{ or } 15\% 
\]

The price is equal to:

\[
P_0 = \frac{D_1}{r} = \frac{E_1}{r} \quad (7.32)
\]

where \( r \) is the expected return.

Even for a growing firm, the expected return can equal the E/P ratio, if retained earnings earn a return equal to the market capitalisation ratio. Suppose Maturity Limited identifies a proposal to invest ₹15 a share next year which is expected to earn a return of 15 percent, just equal to the opportunity cost of capital. To undertake this investment, Maturity Limited decides to skip the dividend for year 1. The investment of ₹15 a share will generate an additional earnings of ₹2.25 (₹15 times 15 percent) per share in future thereby raising the dividend per share to ₹17.25 per share from year 2 onwards.

The net present value (NPV) per share for this proposal will be:

\[
-15 + \frac{2.25}{0.15} = 0
\]

Since the prospective return on this investment is equal to the opportunity cost of capital, it makes no contribution to the value of the firm and has no effect on the share price. The reduc-
tion in value caused by a zero dividend in year 1 is offset by an increase in value due to higher dividends in subsequent years. Hence, the market capitalisation rate equals the E/P ratio:

\[ r = \frac{E_1}{P_0} = \frac{15}{100} = 0.15 \]

Exhibit 7.6 presents our example for varying assumptions about the profitability of the proposed investment. Note that the earnings-price ratio \( \frac{E_1}{P_0} \) is equal to the market capitalisation rate \( r \) only when the proposed investment has a zero NPV. This is a very important point because managers often confuse E/P ratio with the market capitalisation rate and tend to make poor financial decisions.

**Exhibit 7.6** Impact of Project Rate of Return on E/P Ratio

<table>
<thead>
<tr>
<th>Rate of Return</th>
<th>Incremental Cash Flow</th>
<th>Project’s Impact on Share Price in Year 0, P₀</th>
<th>Share Price in Year 0, P₀</th>
<th>( \frac{E_1}{P_0} )</th>
<th>( r )</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.05</td>
<td>0.75</td>
<td>-10</td>
<td>91.30</td>
<td>0.164</td>
<td>0.15</td>
</tr>
<tr>
<td>0.10</td>
<td>1.50</td>
<td>-5</td>
<td>95.65</td>
<td>0.157</td>
<td>0.15</td>
</tr>
<tr>
<td>0.15</td>
<td>2.25</td>
<td>0</td>
<td>0</td>
<td>0.15</td>
<td>0.15</td>
</tr>
<tr>
<td>0.20</td>
<td>3.00</td>
<td>5</td>
<td>104.35</td>
<td>0.144</td>
<td>0.15</td>
</tr>
<tr>
<td>0.25</td>
<td>3.75</td>
<td>10</td>
<td>108.70</td>
<td>0.138</td>
<td>0.15</td>
</tr>
</tbody>
</table>

In general, we can think of the stock price as the capitalised value of the earnings under the assumption of no growth plus the present value of growth opportunities (PVGO).

\[ P_0 = \frac{E_1}{r} + \text{PVGO} \]  

(7.33)

Manipulating this a bit, we get

\[ \frac{E_1}{P_0} = r \left[ 1 - \frac{\text{PVGO}}{P_0} \right] \]  

(7.34)

From this equation, it is clear that:

- Earnings-price ratio is equal to \( r \) when PVGO is zero.
- Earnings-price ratio is less than \( r \) when PVGO is positive.
- Earnings-price ratio is more than \( r \) when PVGO is negative.

### 7.9 STOCK MARKET

The stock market consists of a primary segment and a secondary segment. New securities are issued in the primary market and outstanding securities are traded in the secondary market.

The process of issuing securities in the primary market will be discussed in Chapter 18. Here our focus is mainly on the secondary market.

The secondary market in India comprises of about twenty three stock exchanges recognised by the government under the Securities Contracts (Regulation) Act. Of course, the principal bourses are the National Stock Exchange and the Bombay Stock Exchange, accounting for virtually all the trading on the Indian stock market.
Veritable Transformation

The secondary market in India has undergone a metamorphosis after 1994. The following changes have virtually transformed the character of the secondary market.

Screen-based Trading  
Till 1994, trading on the stock market in India was based on the open outcry system. With the establishment of the National Stock Exchange in 1994, India entered the era of screen-based trading. Within a short span of time, screen-based trading has supplanted the open outcry system on all the stock exchanges in the country, thanks to SEBI’s initiative and the inherent superiority of screen-based trading.

Electronic Delivery  
Traditionally, trades in India required physical delivery. This led to high paperwork cost and created bad paper risk.

To mitigate the costs and risks associated with physical delivery, security transactions are now settled mainly through electronic delivery facilitated by depositories. A depository is an institution which dematerialises physical certificates and effects transfer of ownership by electronic book entries.

Rolling Settlement  
Till recently security transactions in India were settled on the basis of a weekly account period. From 2002 onwards, SEBI has gradually introduced the rolling settlement system under which each day constitutes an account period and its trades are settled after a few days. For example, under the T + 2 rolling system which is currently in vogue in India, the trades are settled after 2 days.

Thanks to screen-based trading, electronic delivery, and rolling settlement, the transaction costs in India’s stock market have decreased dramatically.

Principal Exchanges

The National Stock Exchange has in a short period of time emerged as the largest exchange; the Bombay Stock Exchange, traditionally the leading exchange, is now the second largest exchange in the country. Hence it is instructive to understand the distinctive features of these principal exchanges.

The National Stock Exchange  
The distinctive features of the National Stock Exchange (NSE), as it functions currently, are as follows:

- The NSE is a ringless, national, computerised exchange.
- The NSE has two segments: the Capital Market segment and the Wholesale Debt Market segment. The Capital Market segment covers equities, convertible debentures, and retail trade in non-convertible debentures. The Wholesale Debt Market segment is a market for high value transactions in government securities, PSU bonds, commercial papers, and other debt instruments.
- The trading members in the Capital Market segment are connected to the central computer in Mumbai through a satellite link-up, using VSATs (Very Small Aperture Terminals). The trading members in the Wholesale Debt Market segment are linked through dedicated high speed lines to the central computer at Mumbai.
- The NSE has opted for an order-driven system.
When a trade takes place, a trade confirmation slip is printed at the trading member’s workplace. It gives details like quantity, price, code number of counterparty, and so on.

The identity of a trading member is not revealed to others.

All trades on NSE are guaranteed by the National Securities Clearing Corporation (NSCC).

**The Bombay Stock Exchange**

Established in 1875, the Bombay Stock Exchange (BSE) is one of the oldest organised exchanges in the world with a long, colourful, and chequered history. Its distinctive features are as follows:

- The BSE switched from the open outcry system to the screen-based system in 1995. It accelerated its computerisation programme in response to the threat from NSE.
- Jobbers traditionally played an important role on the BSE. A jobber is a broker who trades on his own account and hence offers a two-way quote or a bid-ask quote. The bid price reflects the price at which the jobber is willing to buy and the ask price represents the price at which the jobber is willing to sell.
- Investors have to transact via a jobber/broker. The jobber/broker feeds his buy/sell quotes in his computer terminal, which is linked to the main server at the BSE. Since both jobbers and brokers feed their orders, the BSE initially adopted a ‘quote-driven’ system and an ‘order-driven’ system, but subsequently shifted to the latter system.

**Stock Market Quotations and Stock Market Indices**

Information on stock market activity is reported in various media. It is covered by on-line services, newspapers, business periodicals, other publications, radio, and television.

Investors are interested in knowing what is happening to individual stocks and what is happening to the market as a whole. Let us see how the information about these aspects is reported.

**Individual Stock Quotations**

Investors can get to know what is happening to individual stocks and what is happening to the market as a whole by referring to the websites of BSE and NSE. For instance, you may go to [http://www.nseindia.com/products/content/equities/equities/archieve_eq.htm](http://www.nseindia.com/products/content/equities/equities/archieve_eq.htm) and select a report named Bhavcopy dated 02-01-2015 to see the following traded details of Bajaj Auto Limited stock on NSE on that day.

<table>
<thead>
<tr>
<th>Symbol</th>
<th>Series</th>
<th>Open</th>
<th>High</th>
<th>Low</th>
<th>Close</th>
<th>Last</th>
<th>Prev close</th>
<th>Total Trdqty</th>
<th>Total Trdval</th>
<th>Time Stamp</th>
<th>Total Trade</th>
<th>ISIN</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bajaj-Auto</td>
<td>EQ</td>
<td>2457</td>
<td>2476.4</td>
<td>2432</td>
<td>2451.8</td>
<td>2446</td>
<td>2452.15</td>
<td>164726</td>
<td>403919700</td>
<td>2-Jan-15</td>
<td>10233</td>
<td>INE91711010</td>
</tr>
</tbody>
</table>

Some of the important abbreviations used in stock quotations are:

- con - convertible
- xd - ex (excluding) dividend
- cd - cum (with) dividend
- xr - ex (excluding) right
- sl - small lot
Stock Market Indices  Investors often ask the question: How is the market doing? This interest in the broad market movement stems from the general observation that prices of most of the stocks tend to move together, a fact that has a fairly strong empirical underpinning. The general movement of the market is measured by indices representing the entire market or important segments thereof.

The two most popular stock market indices in India are Sensex and Nifty. A brief discussion of them follows:

- **Bombay Stock Exchange Sensitive Index**  Perhaps the most widely followed stock market index in India, the Bombay Stock Exchange Sensitive Index, popularly called the Sensex reflects the movement of 30 sensitive shares. The index of any trading day reflects the aggregate market value of the floating stock of the sample of 30 shares on that day in relation to the average aggregate market value of the floating stock of these shares in the base year, 1978-79. The base value of this index is 100.

- **S&P CNX Nifty**  Perhaps the most rigorously constructed stock market index in India, the Nifty reflects the price movement of 50 shares selected on the basis of market capitalisation and liquidity (impact cost). The index of any trading day reflects the aggregate market value of the floating stock of a sample of 50 shares on that day in relation to the aggregate market value of the floating stock of those shares on November 3, 1995. The base value of this index is 1000.

**SUMMARY**

- The term value is used in different senses. Liquidation value, going concern value, book value, market value, and intrinsic value are the most commonly used concepts of value.

- The *intrinsic value* of any asset, real or financial, is equal to the present value of the cash flows expected from it. Hence, determining the value of an asset requires an estimate of expected cash flows and an estimate of the required return.

- The value of a bond is:

\[
P = \sum_{i=1}^{n} \frac{C}{(1+r)^t} + \frac{M}{(1+r)^n}
\]

- A basic property of a bond is that its price varies inversely with yield.

- The relationship between coupon rate, required yield, and bond price is as follows:

  - Coupon rate < Required yield \(\rightarrow\) Price < Par (Discount bond)
  - Coupon rate = Required yield \(\rightarrow\) Price = Par
  - Coupon rate > Required yield \(\rightarrow\) Price > Par (Premium bond)

- The *current yield* on a bond is defined as: Annual interest / Price

- The *yield to maturity* (YTM) on a bond is the rate of return the investor earns when he buys the bond and holds it till maturity. It is the value of \(r\) in the bond valuation model. For estimating YTM readily, the following approximation may be used:

\[
YTM = \frac{C + (M - P)/n}{0.4M + 0.6P}
\]

- According to the *dividend discount model*, the value of an equity share is equal to the present value of dividends expected from its ownership.
If the dividend per share remains constant the value of the share is:

\[ P_0 = \frac{D}{r} \]

If the dividend per share grows at a constant rate, the value of the share is:

\[ P_0 = \frac{D_1}{(r - g)} \]

The two key drivers of dividend growth are (a) ploughback ratio and (b) return on equity.

The value per share, according to the \( H \) model is:

\[ P_0 = \frac{D_0(1+g_n)}{r-g_n} + \frac{D_0H(g_n^* - g_n)}{r-g_n} \]

An approach to valuation, practised widely by investment analysts, is the P/E ratio approach. The value of an equity share, under this approach, is estimated as follows:

\[ P_0 = E_1 \times \frac{P_0}{E_1} \]

The stock price may be considered as the capitalised value of the earnings under the assumption of no growth plus the present value of growth opportunities.

The stock market consists of a primary segment and a secondary segment. The principal bourses are the National Stock Exchange and the Bombay Stock Exchange, accounting for the bulk of the trading on the Indian stock market.

**QUESTIONS**

1. Describe briefly the various concepts of value.
2. Discuss the basic bond valuation.
3. State the formula for a bond which pays interest semi-annually.
4. What is the relationship between coupon rate, required yield, and price?
5. Explain and illustrate the following yield measures: current yield, yield to maturity, and yield to call.
6. State and illustrate the formula to find the approximate YTM on a bond.
7. Discuss the constant growth dividend discount model.
8. Explain the two stage dividend discount model.
9. Discuss the \( H \) model.
10. What is the impact of growth on price, dividend yield, capital gains yield, and price-earnings ratio?
11. Discuss the P/E ratio approach to stock valuation.
12. How is the E/P linked to the required return and the present value of growth opportunities?
13. Explain how the price-earnings ratio is related to growth, dividend payout ratio, and the required return.
14. Discuss the transformation of the Indian stock market from mid 1990s.
15. Discuss the salient features of the National Stock Exchange.
16. Discuss the salient features of the Bombay Stock Exchange.
17. How is stock price reported?

**SOLVED PROBLEMS**

7.1 A ₹ 100 par value bond bearing a coupon rate of 12 percent will mature after 5 years. What is the value of the bond, if the discount rate is 15 percent?
Solution Since the annual interest payment will be ₹ 12 for 5 years and the principal repayment will be ₹ 100 after 5 years, the value of the bond, at a discount rate of 15 percent, will be

\[ V = ₹ 12 \times (PVIFA_{15\%, \ 5 \ yrs}) + ₹ 100 \times (PVIF_{15\%, \ 5 \ yrs}) \]

\[ = ₹ 12 \times (3.352) + ₹ 100 \times (0.497) \]

\[ = 40.22 + 49.70 = ₹ 89.92 \]

7.2 The market price of a ₹ 1,000 par value bond carrying a coupon rate of 14 percent and maturing after 5 years is ₹ 1050. What is the yield to maturity (YTM) on this bond? What is the approximate YTM?

Solution The YTM is the value of \( r \) in the following equation:

\[ 1,050 = \sum_{t=1}^{5} \frac{140}{(1+r)^t} + \frac{1,000}{(1+r)^5} \]

Let us try a value of 13 percent for \( r \). The right hand side of the above expression becomes:

\[ 140 \times (PVIFA_{13\%, \ 5 \ yrs}) + 1,000 \times (PVIF_{13\%, \ 5 \ yrs}) \]

\[ = 140 \times (3.517) + 1,000 \times (0.543) \]

\[ = 492.4 + 543.0 = ₹ 1,035.4 \]

Since this is less than ₹ 1,050, we try a lower value for \( r \). Let us try \( r = 12 \) percent. This makes the right-hand side equal to:

\[ 140 \times (PVIFA_{12\%, \ 5 \ yrs}) + 1,000 \times (PVIF_{12\%, \ 5 \ yrs}) \]

\[ = 140 \times (3.605) + 1,000 \times (0.567) \]

\[ = 504.7 + 567.0 = ₹ 1,071.7 \]

Thus, \( r \) lies between 12 percent and 13 percent. Using a linear interpolation in this range, we find that \( r \) is equal to:

\[ 12\% + \frac{(13\% - 12\%) \times (1,050.0 - 1,035.4)}{1,071.7 - 1,050.0} = 12.60 \text{ percent} \]

(b) The approximate YTM works out to:

\[ \text{YTM} = \frac{140 + (1,000 - 1,050)/5}{0.40 \times 1000 + 0.6 \times 1050} = 12.62 \text{ percent} \]

7.3 A ₹ 100 par value bond bears a coupon rate of 14 percent and matures after 5 years. Interest is payable semi-annually. Compute the value of the bond if the required rate of return is 16 percent.

Solution

In this case the number of half-yearly periods is 10, the half-yearly interest payment is ₹ 7, and the discount rate applicable to a half-yearly period is 8 percent. Hence, the value of the bond is:

\[ V = \sum_{t=1}^{10} \frac{7}{(1.08)^t} + \frac{100}{(1.08)^{10}} \]

\[ = 7 \times (PVIFA_{8\%, \ 10 \ yrs}) + 100 \times (PVIF_{8\%, \ 10 \ yrs}) \]

\[ = 7 \times (6.710) + 100 \times (0.463) \]

\[ = 46.97 + 46.30 \]

\[ = ₹ 93.27 \]
7.4 The equity stock of Rax Limited is currently selling for ₹ 30 per share. The dividend expected next year is ₹ 2.00. The investors’ required rate of return on this stock is 15 percent. If the constant growth model applies to Rax Limited, what is the expected growth rate?

Solution

According to the constant growth model

\[ P_0 = \frac{D_1}{r - g} \]

This means

\[ g = \frac{r - D_1}{P_0} \]

Hence, the expected growth rate \( g \) for Rax Limited is:

\[ g = 0.15 - \frac{2.00}{30.00} = 0.083 \] or 8.3 percent

7.5 Vardhman Limited’s earnings and dividends have been growing at a rate of 18 percent per annum. This growth rate is expected to continue for 4 years. After that the growth rate will fall to 12 percent for the next 4 years. Thereafter, the growth rate is expected to be 6 percent forever. If the last dividend per share was ₹ 2.00 and the investors’ required rate of return on Vardhman’s equity is 15 percent, what is the intrinsic value per share?

Solution The intrinsic value per share of Vardhman may be computed using a 3-step procedure.

Step 1: The dividend stream during the first eight years when Vardhman would enjoy a relatively high rate of growth will be:

\[ D_1 = 2.00 \times (1.18) = 2.36 \]
\[ D_2 = 2.00 \times (1.18)^2 = 2.78 \]
\[ D_3 = 2.00 \times (1.18)^3 = 3.29 \]
\[ D_4 = 2.00 \times (1.18)^4 = 3.88 \]
\[ D_5 = 2.00 \times (1.18)^4 \times (1.12) = 4.34 \]
\[ D_6 = 2.00 \times (1.18)^4 \times (1.12)^2 = 4.86 \]
\[ D_7 = 2.00 \times (1.18)^4 \times (1.12)^3 = 5.45 \]
\[ D_8 = 2.00 \times (1.18)^4 \times (1.12)^4 = 6.10 \]

The present value of this dividend stream is:

\[ 2.36 \times (0.870) + 2.78 \times (0.756) + 3.29 \times (0.658) + 3.88 \times (0.572) \]
\[ + 4.34 \times (0.497) + 5.45 \times (0.432) + 6.10 \times (0.376) = ₹ 16.83 \]

Step 2: The price of the share at the end of 8 years, applying the constant growth model at that point of time, will be:

\[ P_8 = \frac{D_9}{r - g_n} = \frac{D_8 \times (1 + g_n)}{r - g_n} \]
\[ = \frac{2.00 \times (1.18)^4 \times (1.12)^4 \times (1.06)}{0.15 - 0.06} = ₹ 71.84 \]

The present value of this price is:

\[ \frac{71.84}{(1.15)^8} = 23.49 \]
Step 3: The sum of the above components is:

\[ P_0 = \text{₹} 16.83 + \text{₹} 23.49 = \text{₹} 40.32 \]

7.6 The current dividend on an equity share of Pioneer Technology is ₹ 3.00. Pioneer is expected to enjoy an above-normal growth rate of 40 percent for 5 years. Thereafter, the growth rate will fall and stabilise at 12 percent. Equity investors require a return of 15 percent from Pioneer’s stock. What is the intrinsic value of the equity share of Pioneer?

Solution The inputs required for applying the two-stage growth model are:

- \( g_1 = 40\% \)
- \( g_2 = 12\% \)
- \( n = 5 \) years
- \( r = 15\% \)
- \( D_1 = D_0(1 + g_1) = \text{₹} 3(1.40) = \text{₹} 4.20 \)

Plugging these inputs in the two-stage growth model, we get the intrinsic value estimate as follows:

\[
P_0 = \frac{4.20}{0.15 - 0.40} \left[ \frac{1}{1.15^5} \right] + \frac{4.20(1.40)^4(1.12)}{0.15 - 0.12} \left[ \frac{1}{(1.15)^5} \right]
\]

\[ = 28.12 + 299.48 = \text{₹} 327.60 \]

7.7 The current dividend on an equity share of National Computers Limited is ₹ 5.00. The present growth rate is 50 percent. However, this will decline linearly over a period of 8 years and then stabilise at 10 percent. What is the intrinsic value per share of National Computers, if investors require a return of 18 percent from its stock?

Solution The inputs required for applying the \( H \)-model are:

- \( D_0 = \text{₹} 5.00 \)
- \( g_a = 50\% \)
- \( H = 4 \) years
- \( g_n = 10 \) years
- \( r = 18\% \)

Plugging these inputs in the \( H \)-model we get the intrinsic value estimate as follows:

\[
P_0 = \frac{5.00[(1.10) + 4(0.50 - 0.10)]}{0.18 - 0.10} = \text{₹} 168.75
\]

### PROBLEMS

7.1 A ₹ 100 par value bond, bearing a coupon rate of 11 percent will mature after 5 years. What is the value of the bond, if the discount rate is 15 percent?

7.2 A ₹ 100 par value bond, bearing a coupon rate of 12 percent, will mature after 7 years. What is the value of the bond if the discount rate is 14 percent? 12 percent?

7.3 The market value of a ₹ 1,000 par value bond, carrying a coupon rate of 12 percent and maturing after 7 years, is ₹ 750. What is the yield to maturity on this bond?

7.4 The market value of a ₹ 100 par value bond, carrying a coupon rate of 14 percent and maturing after 10 years, is ₹ 80. What is the yield to maturity on this bond?

7.5 A ₹ 100 par value bond bears a coupon rate of 12 percent and matures after 6 years. Interest is payable semi-annually. Compute the value of the bond if the required rate of return is 16 percent, compounded semi-annually.

7.6 You are considering investing in one of the following bonds:

<table>
<thead>
<tr>
<th>Coupon rate</th>
<th>Maturity</th>
<th>Price/₹ 100 par value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bond A</td>
<td>12%</td>
<td>10yrs</td>
</tr>
<tr>
<td>Bond B</td>
<td>10%</td>
<td>6yrs</td>
</tr>
</tbody>
</table>
Your income tax rate is 30 percent and your capital gains tax is effectively 10 percent. Capital gains taxes are paid at the time of maturity on the difference between the purchase price and par value. What is your post-tax yield to maturity from these bonds?

7.7 A company’s bonds have a par value of ₹ 100, mature in 7 years, and carry a coupon rate of 12 percent payable semi-annually. If the appropriate discount rate is 16 percent, what price should the bond command in the market place?

7.8 The share of a certain stock paid a dividend of ₹ 2.00 last year ($D_0 = ₹ 2.00$). The dividend is expected to grow at a constant rate of 6 percent in the future. The required rate of return on this stock is considered to be 12 percent. How much should this stock sell for now? Assuming that the expected growth rate and required rate of return remain the same, at what price should the stock sell 2 years hence?

7.9 Sherief Corporation’s previous dividend was ₹ 12.00. Earnings and dividends are expected to grow at a rate of 10 percent. The required rate of return on Sherief’s stock is 15 percent. What should be the market price of Sherief’s stock now?

7.10 The equity stock of Max Limited is currently selling for ₹ 32 per share. The dividend expected next is ₹ 2.00. The investors’ required rate of return on this stock is 12 percent. Assume that the constant growth model applies to Max Limited. What is the expected growth rate of Max Limited?

7.11 Fizzle Limited is facing gloomy prospects. The earnings and dividends are expected to decline at the rate of 4 percent. The previous dividend was ₹ 1.50. If the current market price is ₹ 8.00, what rate of return do investors expect from the stock of Fizzle Limited?

7.12 The Commonwealth Corporation’s earnings and dividends have been growing at the rate of 12 percent per annum. This growth rate is expected to continue for 4 years. After that the growth rate would fall to 8 percent for the next four years. Beyond that the growth rate is expected to be 5 percent forever. If the last dividend was ₹ 1.50 and the investors’ required rate of return on the stock of Commonwealth is 14 percent, how much should be the market value per share of Commonwealth Corporation’s equity stock?

7.13 Determine the intrinsic value of an equity share, given the following data:
   - Last dividend ($D_0$) : ₹ 2.00
   - Growth rate for the next five years : 15 percent
   - Growth rate beyond 5 years : 10 percent
   - Assume a required rate of return.

7.14 You can buy a ₹ 1000 par value bond carrying an interest rate of 14 percent (payable annually) and maturing after 4 years for ₹ 900. If the re-investment rate applicable to the interest receipts from this bond is 16 percent, what will be your yield to maturity?

7.15 The current dividend on an equity share of Dizzy Limited is ₹ 2.00. Dizzy is expected to enjoy an above-normal growth rate of 18 percent for 6 years. Thereafter the growth rate will fall and stabilise at 12 percent. Equity investors require a return of 16 percent from Dizzy’s stock. What is the intrinsic value of the equity share of Dizzy?

7.16 The current dividend on an equity share of International Chemicals Limited is ₹ 4.00. The present growth rate is 20 percent. However, this will decline linearly over a period of 8 years and stabilise at 10 percent. What is the intrinsic value per share of International Chemicals Limited if investors require a return of 18 percent?

7.17 Mahaveer Electronics is expected to give a dividend of ₹ 8 next year and the same would grow by 12 percent per year forever. Mahaveer pays out 40 percent of its earnings. The required rate of return on Mahaveer’s stock is 15 percent. What is the PVGO?
MINICASE - I

You have recently graduated from a business school and joined SMART INVEST as a financial analyst. Your job is to help clients in choosing a portfolio of bonds and stocks. Dinshaw Mistry, a prospective client, seeks your help in understanding how bonds and stocks are valued and what rates of return they offer. In particular, you have to answer the following questions.

a. How is the value of a bond calculated?

b. What is the value of a 5-year, ₹ 1,000 par value bond with a 10 percent annual coupon, if the required rate of return is 8 percent?

c. What is the approximate yield to maturity of an 8-year, ₹ 1,000 par value bond with a 10 percent annual coupon, if it sells for ₹ 1,060.

d. What is the yield to call of the bond described in part (c), if the bond can be called after 2-years at a premium of ₹ 1,050.

e. What is the general formula for valuing any stock, irrespective of its dividend pattern?

f. How is a constant growth stock valued?

g. Magnum chemicals is a constant growth company which paid a dividend of ₹ 6.00 per share yesterday \( (D_0 = ₹ 6.00) \) and the dividend is expected to grow at a rate of 12 percent per year forever. If investors require a rate of return of 15 percent (i) what is the expected value of the stock a year from now? (ii) what is the expected dividend yield and capital gains yield in the first year?

h. Zenith Electronics paid a dividend of ₹ 10.00 per share yesterday \( (D_0 = ₹ 10.00) \). Zenith Electronics is expected to grow at a supernormal growth rate of 25 percent for the next 4 years, before returning to a constant growth rate of 10 percent thereafter. What will be the present value of the stock, if investors require a return of 16 percent?

i. The earnings and dividends of Ravi Pharma are expected to grow at a rate of 20 percent for the next 3 years. Thereafter, the growth rate is expected to decline linearly for the following 5 years before settling down at 10 percent per year forever. Ravi Pharma paid a dividend of ₹ 8.00 per share yesterday \( (D_0 = ₹ 8.00) \). If investors require a return of 14 percent from the equity of Ravi Pharma, what is the intrinsic value per share?

MINICASE - II

Jagan Reddy, the MD of Reddy Lifestyle was much dejected when his bankers simply refused any additional funding for his company. Somehow they didn’t seem to share his enthusiasm over the company’s prospects. Coming out of the bank, he called his CFO and close confidante Ram Rao. After showering a couple of choice adjectives on the bank manager he sobered down: ‘What is the point in blaming the bank? Anyone can see that our stock is one of the worst performers in the market. Any idea why it is jinxed? Frankly, I have had enough of this useless furniture business. It can take us only thus far. Now, here is a secret- just keep it strictly to yourself: I think the time has come to unlock value in our old land investments. We can easily diversify into realty business by the end of this year. We will then raise the needed funds by placing equity privately at a good premium. We can flaunt a growth rate as high as forty percent for the first four years and a fair twelve percent thereafter. All that is needed is a bit of guts! I will give you a whole six months’ time to work on those hardnosed directors to make them see the writing on the wall, so that when I eventually come up with the real estate idea, they would jump for it. Enough for the day. Tomorrow we will discuss these in detail. Specifically I want you to come up with some answers, even if approximate for the following:

1. For our immediate need of ₹ 10 crores, I think the only way left is to go for a new series of unsecured debentures. Could you figure out the coupon rate we will have to offer for a five year issue now at par?
2. What should be our P/E ratio if we go for the new debenture issue? Also, based on our current earnings prospects, come up with some convincing calculations to show why our stock would continue to be a laggard in the market if we just stick to the present furniture business.

3. At what possible price would we be able to place the shares privately after a year, assuming that the board approves the diversification? Also let me know what would be the present value of growth opportunities then?

If you were the CFO, how would you have worked out the solutions for the above queries with the following data?

Currently the company’s 8 percent coupon debentures of face value of ₹ 100, with a remaining maturity of five years are trading at ₹ 90 per debenture. The current market price per equity share of face value ₹ 10 of the company is ₹ 24.70 and the average P/E multiple for the industry is 14. For simplicity you assume that the profitability, payout and turnover ratios remain unchanged. You decide to use a discount rate of 15 percent for the diversified company. The summarised financial statements of the company for the year ended just now are as under:

<table>
<thead>
<tr>
<th>₹ in millions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net sales</strong>  625</td>
</tr>
<tr>
<td><strong>Reserve &amp; surplus</strong> 80</td>
</tr>
<tr>
<td><strong>Cost of goods</strong> 495</td>
</tr>
<tr>
<td><strong>Gross profit</strong> 130</td>
</tr>
<tr>
<td><strong>PBIT</strong> 92</td>
</tr>
<tr>
<td><strong>Interest</strong> 20</td>
</tr>
<tr>
<td><strong>PBT</strong> 72</td>
</tr>
<tr>
<td><strong>Tax</strong> 22</td>
</tr>
<tr>
<td><strong>PAT</strong> 50</td>
</tr>
<tr>
<td><strong>Dividend</strong> 30</td>
</tr>
</tbody>
</table>

**PRACTICAL ASSIGNMENT**

Value the equity share of the company that you have chosen, using the two-stage growth model. Based on your understanding of the company and its financials, make suitable assumptions, along with justification, with respect to the following:

1. $g_1$, the extraordinary growth rate;
2. $n$ the period for which the extraordinary growth rate is applicable;
3. $g_2$, the stable growth rate applicable after $n$ years; and
4. $r$, the discount rate.

Compare the value figure that you have arrived at with the prevailing market price of the share and explain the discrepancy, if any.