



Course information 2011–12

AC3143 Valuation and securities analysis

This course provides insights and understanding of security analysis and valuation from both theoretical and empirical perspectives. It is aimed at students who are interested in equity research, corporate finance and fund management.

Prerequisite

If taken as part of a BSc degree, courses which must be passed before this course may be attempted:

FN1024 Principles of banking and finance
and
AC1025 Principles of accounting.

Aims and objectives

This course is aimed at students interested in equity research, corporate finance, and fund management. It is designed to provide the tools, drawn from accounting, finance, economics, and strategy, required to:

- analyse the performance of securities
 - value securities
 - assess returns on active investment strategies.
- Furthermore, it provides empirical evidence on returns to fundamental and technical analysis.

Essential reading

For full details please refer to the reading list

Palepu, K., V. Bernard and P. Healy. *Business Analysis & Valuation*. (South-Western College Publishing)

Penman, S. *Financial Statement Analysis & Security Valuation*. (McGraw-Hill,)

Assessment

This course is assessed by a three hour unseen written examination.

Learning outcomes

At the end of this course and having completed the essential reading and activities students should be able to:

- ✓ carefully analyse the financial performance of given securities and critically review equity research published by financial analysts
- ✓ competently apply valuation technologies required in corporate finance with minimum guidance
- ✓ critically assess third-party valuation reports
- ✓ recall main insights and key facts of the fund management industry
- ✓ clearly recognize the difficulties associated with measuring abnormal returns in fundamental and technical analysis.

Students should consult the *Programme Regulations for degrees and diplomas in Economics, Management, Finance and the Social Sciences* that are reviewed annually. The Prerequisites, Exclusions, and Syllabus are subject to confirmation in the *Regulations*. Notice is also given in the *Regulations* of any courses which are being phased out and students are advised to check course availability.

Syllabus

This is a description of the material to be examined, as published in the *Regulations*. On registration, students will receive a detailed subject guide which provides a framework for covering the topics in the syllabus and directions to the essential reading.

This course covers three broad topics: financial analysis, securities valuation, and returns to fundamental and technical analysis.

Introduction

Introduction to the analysis framework using financial statements: The setting: investors, firms, securities, and financial markets. The framework for analysis. Business strategy analysis. Accounting analysis. Financial analysis. Prospective analysis.

Introduction to stylised financial statements: Stylised profit and loss, balance sheet, and cash flow statements. Accounting relations governing the stylised financial statements.

The Framework for Analysis: Industry analysis. Competitive strategy analysis. Sources of competitive advantage. Achieving and sustaining competitive advantage.

Financial analysis: performance evaluation: Concept of comprehensive earnings. Earnings and stock returns. Bottom line profitability. Cost of equity capital. Concept of residual earnings. Business profitability. Economic value added. Link between business and bottom line profitability. Accounting rates of return and stock rates of return. Determinants of business profitability. Business profitability and free cash flows.

Accounting analysis: Overview of the institutional framework governing financial reporting. Factors influencing accounting quality. Assessing the quality of accounting.

Prospective performance evaluation and valuation: Forecasting: simple forecasting and full information forecasting. Empirical evidence on the behaviour of accounting rates of return, residual earnings, economic value added, financial leverage, and determinants of business profitability. Present value of expected residual earnings.

Securities valuation

Securities valuation: Introduction to valuation methods based on dividends, free cash flows, residual earnings, and economic value added. Inferences on valuation accuracy. Comparison of valuation methods: empirical evidence.

Implications for price-to-earnings and price-to-book ratios: Determinants of price-to-book ratios. Residual earnings growth. Determinants of price-to-earnings ratios. Empirical evidence. Strategic taxonomy. Implications of strategic taxonomy for price-to-book and price-to-earnings ratios. Empirical evidence on the joint distribution of price-to-book and price-to-earnings ratios.

Financial Information and Stock Prices: Usefulness of earnings to investors: the empirical evidence from capital markets research. Earnings response coefficients. The Lev critique. Competing hypotheses to explain the earnings response conundrum. Relevance of financial versus non-financial information. Application to internet stocks.

Applications

Mergers and acquisitions: Motivation for mergers and acquisitions. Strategic and financial analysis of mergers and acquisitions. Acquisition pricing. Accounting issues. Acquisition financing. Acquisition outcome.

Credit analysis and distress predictions: The market for credit. The credit analysis process. Financial analysis for credit evaluation. Prospective analysis for credit analysis. Financial analysis and public debt. Predictions of financial distress and turnaround.

Empirical evidence on returns to fundamental and technical analysis

Measuring returns to active investment strategies: Introduction to common performance measures. Concepts of abnormal return. Measures of market timing ability

Returns to fundamental analysis: Contrarian strategies. Implications of current earnings for future earnings. Do stock prices fully reflect information in accruals and cash flows about future earnings? Earnings management and the long run performance of IPOs.

Returns to technical analysis: Contrarian strategies. Momentum strategies. Reconciliation of empirical evidence.