

Valuation and Rates of Return

- LO 10-1 The valuation of a financial asset is based on the present value of future cash flows.
- LO 10-2 The required rate of return in valuing an asset is based on the risk involved.
- LO 10-3 Bond valuation is based on the process of determining the present value of interest payments plus the present value of the principal payment at maturity.
- LO 10-4 Preferred stock valuation is based on the dividend paid and the market required return.
- LO 10-5 Stock valuation is based on determining the present value of the future benefits of equity ownership.

Valuation appears to be a fickle process to stockholders of some corporations. For example, if you held The Coca-Cola Company common stock in February 2015, you would be pleased to see that stockholders were valuing your stock at 26 times earnings. Certainly there was some justification for such a high valuation. Coca-Cola is sold in more than 200 countries, and it is the best-known brand in the world.

But keep in mind that the company's earnings were only 5 percent higher in 2014 than they had been in 2009, although dividends were up 50 percent from \$0.88 to \$1.32 per share.

If stockholders of Coca-Cola were happy with the firm's strong P/E (price-earnings ratio) valuation in February 2015, those who invested in ExxonMobil were not. The corporate giant was trading at a P/E ratio of 11 even though both its earnings and dividends had grown more rapidly than Coke's (69 percent and 64 percent, respectively). Keep in mind ExxonMobil is one of the largest companies in the world in terms of revenue (almost \$400 billion per year). It is a dominant player among integrated oil companies (those that not only discover oil but also sell it at the retail level). Furthermore, the stock has outperformed the popular market averages over the last 10-, 20-, and 30-year time periods. Thus ExxonMobil stockholders probably were not pleased with a low P/E ratio of 11.

The question then becomes, why are P/E ratios so different and why do they change so much? Informed investors care about their money and vote with their dollars. The factors that influence valuation are many and varied, and you will be exposed to many of them in this chapter.

In Chapter 9, we considered the basic principles of the time value of money. In this chapter, we will use many of those concepts to determine how financial assets (bonds, preferred stock, and common stock) are valued and how investors establish the rates of return they demand. In the next chapter, we will use material from this chapter to determine the overall cost of financing to the firm. We merely turn the coin over. Once we know how much bondholders and stockholders demand in rates of return, we will observe what the corporation is required to pay them to attract their funds.