Financial Management

MS109

UNIT 6 VALUATION OF SECURITIES

MBA Second Semester

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- Valuation is the process that links risk and return to determine the worth of an asset. It can be applied to expected benefits from real/physical as well as financial to determine their worth at a given point of time.

Bond

- Bonds are an important source of funds for the companies, government, municipality, public sector organizations who raise funds to finance variety of projects and activities. The position of a bond holder is totally different with that of an equity-holder. Whereas the former is creditor or we can say the partial lender to company the latter is the ultimate owner of the company.

Bond Terminology

- **Coupon** The periodic interest payment made by the issuer.
- **Coupon rate** The interest rate used to calculate the coupon amount the bond will pay.
- **Face (par) value** The amount printed on the certificate. The face value represents the principal in the loan agreement, which is the amount the issuer pays at maturity of the bond.
- **Maturity date** The date the loan contract ends. At this time, the issuer pays the face value to the investor who owns the bond.

- **Current Yield** is a Bond Yield that is determined by dividing the fixed coupon amount (that is paid as a percentage on the face or original value of the specific bond) by the current price value of the particular bond

- **In other words, Current Bond Yield = Coupon amount / current market price of a bond.**

Yield to Maturity (YTM)

- **Yield to Maturity** is the most popular measure of yield in the Debt Markets. YTM refers to the percentage rate of return paid on a bond, note or other fixed income security if the investor buys and holds the security till its maturity date.

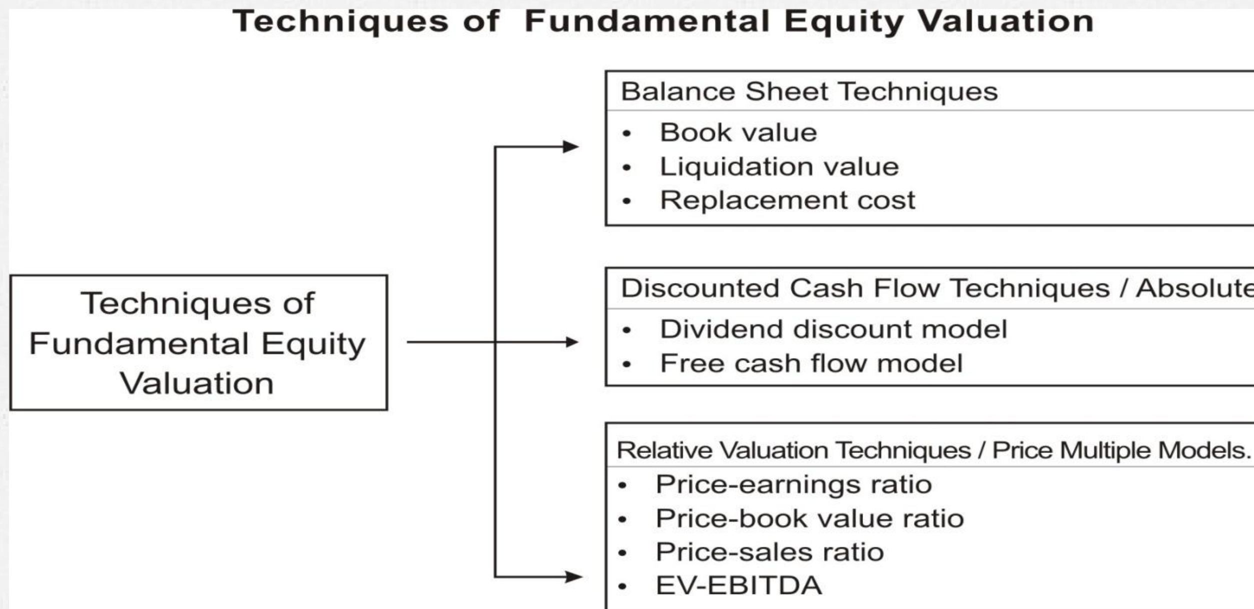
Pricing of Bonds

- Pricing a bond involves finding the present value of the cash flows from the bond throughout its life.

Types of Risk in Bonds Investment

- ***Real Interest Rate Risk***
- ***Default Risk***
- ***Call Risk***
- ***Liquidity Risk***

Techniques of Equity Valuation



Book Value

- Book value is nothing but Net worth (Equity share capital plus reserve and surplus) of a company divided by total no. of outstanding equity shares. Thus this form of valuation is based on the books of a business, where owners' equity, is determined by a simple equation of total assets minus total liabilities and this is used to set a price.

Liquidation Value

This approach is similar to the book valuation method, except that the liquidation value of assets are used instead of the book value of the assets. Using this approach, the liabilities of the business are deducted from the liquidation value of the assets to determine the liquidation value of the business.

Discounted cash flow/Absolute Techniques

The value of an asset is the present value of the expected future cash flows from that asset, discounted at a rate appropriate to the level of risk of the cash flows. Just like that, to determine the value of an equity, one needs to know the future cash flow to equity.

Relative Valuation Techniques

In relative valuation, we value an asset based upon how similar assets are priced. A prospective house buyer decides how much to pay for a house by looking at the prices paid for similar houses in the neighbourhood. Thus these techniques determine the share prices based upon shares of the similar companies in the same industry

Economic Value Added – EVA

- A measure of a company's financial performance based on the residual wealth calculated by deducting cost of capital from its operating profit (adjusted for taxes on a cash basis). (Also referred as "economic profit".)
- The formula for calculating EVA is as follows:
- = Net Operating Profit After Taxes (NOPAT) - (Capital * Cost of Capital)

Market Value Added - MVA

- A calculation that shows the difference between the market value of a company and the capital contributed by investors (both bondholders and shareholders). In other words, it is the sum of all capital claims held against the company plus the market value of debt and equity.

Thank You !

References:

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