
Equity Management Strategy

Return

- The returns on the investment can be broken in to two parts.
 - 1. Dividend yield-The reward investor gets by owning this asset over the holding period
 - 2. Capital gain-The gain investor makes upon selling the asset after the holding period.
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PRESENT VALUE OF THE RETURN

The return occurs at the end of the period. If it is to be expressed at the beginning of the holding period, it has to be given in terms of the present value .

$$P_0 = \frac{D_1}{1+r} + \frac{P_1}{1+r}$$

P_0 = Present Selling price

P_1 = Selling Price at the end of one year period

D_1 = The dividend received during the one year holding period

r = Investor's required rate of return

Problem

- An investor holds shares of T.V.S. Suzuki from 13.01.2009 to 23.01.2010. The beginning and end period prices are Rs.335 and Rs.421 . The dividend paid is 3.50 . The investor can find out whether the price he has to offer is suitable to his required rate of return .
 - Now, if the investor wants to get 20 per cent return by holding T.V.S. Suzuki stock for a year , then find out whether the purchase price is high or low and what the investor should do?
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The investor can also find out the anticipated selling price for the stock with his expected rate of return from holding the stock . His expected return is 20 per cent .

$$P_0 = \frac{D_1}{1+r} + \frac{P_1}{1+r}$$

$$\text{Rs.335} = \frac{3.5}{1+.2} + \frac{P_1}{1+.2}$$

$$\text{Rs.335} = 2.92 + \frac{P_1}{1.20}$$

$$335 - 2.92 = \frac{P_1}{1.2}$$

$$332.08 \times 1.2 = P_1$$

$$P_1 = 398.5$$

CONSTANT GROWTH MODEL

- In this model, the basic assumption is that dividends will grow at the same rate (g) into an indefinite future .
- When the period approaches infinity the equation takes the form

$$P_0 = \frac{D_1}{r - g}$$

P_0 = Present Value of the stock

r = Required rate of return

g = The growth rate

D_1 = The next year dividend

Example

The company ABC's next year dividend per share is expected to be Rs.3.50. The dividend in subsequent years is expected to grow at a rate of 10 per cent per year . If the required rate of return is 15 percent per year, what should be its price ? The prevailing market price is Rs.75 .

VALUATION THROUGH P/E RATIO

- Price-earnings ratios are used to estimate the value of the stocks by the investors rather than adopting the discounting models .
 - Every financial magazine and the newspaper at regular interval publish price earnings per share .
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- P/E ratio=Market price per share/ Earning per share
 - If in a company EPS is rs 6 and price is rs 50 then
 - P/E ratio = $50/6=8.33$
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Comparison of the estimated P/E ratio with the actual P/E ratio

- If current P/E ratio $>$ Estimated P/E ratio ,the stock is over priced .It is better to sell the share before the fall in price.
 - If current P/E ratio $<$ Estimated P/E ratio ,the stock is under priced .It is better to buy the share with the expectation of rise in price.
 - If current P/E ratio $=$ Estimated P/E ratio ,the stock is correctly priced . No significant changes in prices are likely to occur.
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WHITBECK KISOR MODEL

The P/E ratio can be related to concerned variables by using multiple regression technique .

Whitbeck Kisor has developed the following model

P/E = f {growth rate of earnings g, dividend payment rate D/E ,risk in the growth rate (standard deviation)}

They took 135 stocks and estimated the relationship between P/E and the above mentioned variables . The results are given below .

$$P/E = 8.2 + 1.5g + 0.067 D/E - 2.0 \text{ s.d}$$

This equation indicates the impact of all the three variables on the P/E ratio and consistent with the model

$$P/E = \frac{D/E}{r - g}$$

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- All the three variables in the multiple regression are associated with the above mentioned equation . The coefficients of the equation indicate the weights of the variables on the P/E ratio . The signs show the direction of impact of the particular variable on the P/E ratio . One per cent increase in the standard deviation of growth rate would cause 2.0 unit decrease in the P/E ratio.



Further, the equation indicates that 1 per cent increase in earnings' growth would cause 1.5 unit increase in the P/E ratio .One percent increase in dividend payout ratio would result in 1.5 unit increase in the P/E ratio .

Thus , the equation indicates higher growth, higher dividends and lower risk would lead to high P/E ratio and vice versa . With the help of the Whitbeck Kisor model, the analyst can calculate the theoretical value of the P/E ratio and compare it with actual value .

The model is sample sensitive . The co-efficient of the particular period and sample may not give correct estimation of P/E for another period .

Example :

Company 'A', s stock growth rate is 15 per cent, its dividends pay out ratio is 40 per cent and its standard deviation in the growth rate is 5 per cent .The estimated value of the P/E ratio is 22.5 per cent . The price of the share is rs 100.On the basis of Whitbeck Kisor's model, what is your advice ?
