Session 3a: Post Class tests

1. In intrinsic valuation, you try to assess the value of an asset by incorporating the expected cash flows, the growth in those cash flows and the risk into those cash flows into value. Which of the following approaches are consistent with intrinsic valuation?
    a. Applying a PE ratio to a company, by looking at PE ratios of comparable firms
    b. Estimating how much you would get today, if you sell off the firm's assets in a liquidation
    c. Estimate expected cash flows on the asset, and discount back at the riskfree rate
    d. Estimate expected cash flows on the asset, and discount back at a risk-adjusted rate
    e. Make conservative estimates of cash flows and discount back at the risk-adjusted discount rate
2. Warren Buffett has sometimes claimed that he does not risk adjust cash flows, and that he uses a risk free rate as a discount rate. He can justify doing so, because
    a. His success in the past implies that he is never wrong on his expected cash flows
    b. His holdings are so vast that he faces no risk
    c. When valuing companies, he focused only on the earnings and cash flows that are highly predictable.
    d. The risk and return models in finance (CAPM, betas) are wrong and adjusting for risk is therefore flawed
    e. None of the above
3. The consistency rule in discounted cash flow valuation requires you to match up whether your cash flows are to just equity investors or to both equity investors and lenders with your discount rates (cost of equity or cost of capital). Which of the following mismatches is going to yield a (mistaken) value that is too low (relative to true value)?
    a. Discounting cash flows to equity at the cost of equity
    b. Discounting cash flows to the firm at the cost of capital
    c. Discounting cash flows to equity at the cost of capital, and not netting out debt
    d. Discounting cash flows to the firm at the cost of equity, and not netting out debt
    e. Discounting cash flows to the firm at the cost of equity, and netting out debt

    Why?

4. The dividend discount model is a special cash of equity valuation, where you estimate dividends and discount them at the cost of equity. It is simple to use

but it does create a skew to value? Which of the following should concern you the most in using this model? (More than one answer is possible0

a. That there are high growth companies that pay little or no dividends
b. That there are mature companies that pay very high dividends
c. That there are companies that pay out roughly what they can afford to in dividends
d. That there are companies that pay out less than they can afford to in dividends
e. That there are companies that pay out less than they can afford to in dividends

5. When valuing a business, you discount cash flows to the firm at the cost of capital. Which of the following is intuitively the best explanation for what you are doing?
    a. You are discounting cash flows that equity investors make at a rate that reflects what it costs you to raise money from both equity and debt.
    b. You are discounting cash flows that equity and debt investors collectively make at a rate that reflects what it costs you to raise money from both equity and debt.
    c. You are discounting cash flows that equity investors make at a rate that reflects what it costs you to raise money from equity investors.
    d. You are discounting cash flows that equity and debt investors collectively make at a rate that reflects what it costs you to raise money from equity investors.