

Notes on the individual assignment

MBAC 813 - 2019

Marks for the assignment allocated more or less according to the following:

NB marks were allocated in line with the indicated values below however based on judgement slight deviations were allowed for.

Introduction and general comments on risk and the affecting variables: 5 marks

The section **Business risk in relation to Share price risk** / Question 1:: 40 marks

Calculations 25 marks discussion 15 marks

Stand-alone business risk (SD and specifically CV of some EBIT related variable) to Stand-alone risk share price return (SD and specifically CV of some share price return variable ROE not the correct approach)

The final comparison related to the risk relationship between Business risk and Rate of return for the share to should have been based on the Coefficients of Variation of the two mentioned variables

The section **Share Price equilibrium** / Question 2: 40 marks

Calculations 25 marks discussion 15 marks

Calculate some form of expected return or use some form of realized return (assignment say at year end date it makes it justifiable to use realized return) need to motivate why a specific return is used and compare it to the Required return as determined by CAPM model.

The final comparison related to equilibrium of the share price should have been based on the relationship of the required rate of return as calculated using CAPM and an expected rate of return variable.

Then make adjustment for the share price Expected return (realized return) / Required return X Current share price

The section **Strategic ratios** / Question 3: 10 marks

Calculations 5 marks discussion 5 marks

General comments was considered whether discussed as a “unit”/in a section or whether addressed at several places in the text.

The section **Business risk in relation to Share price risk** was considered specifically on discussion, relevance and correctness of arguments.

Business risk as indicated is normally created by the factors that influence the operating effectivity of an entity. Business risk in the context of the Statement of Comprehensive Income is a result of the operating activities that influence and is numerically reflected in the section from Sales to EBIT.

Share price risk is related to either changes in share price or changes in rates of return of share price. Return will mostly be considered to be capital gains only or capital gains plus dividend yield

Question 1 of the assignment

Compare Business risk to Share price risk on standalone basis:

- 1) Calculate Standard Deviation (SD) and specifically Coefficient of Variation (CV) for an operating profit/EBIT related variable. One that could work well is Operating profit margin ($\text{EBIT} / \text{Sales}$) ROIC ($\text{EBIT} / \text{Total Operating Capital}$) can also work and there are other approaches as well.
- 2) Do the same as in 1 above for either change in Share price or change in share Rate of return or any variable related to share price rate of return.
- 3) Then compare values determined in 1 and 2 specifically look at CV because it is a “standardize” measure of volatility/risk
- 4) Offer your arguments to rectify the situation in case of differences or what to do to sustain situation if no differences
- 5) Management factors to consider for Business risk – the most relevant variables (80:20 principle) from sales to EBIT that directly or indirectly influence EBIT or variability of EBIT
- 6) For Share price risk follow the same recipe as in 5 above.

Question 2 of the assignment

Determine Share Price equilibrium

- 1) Determine the required return using the CAPM equation

$$\text{Required return} = r_f + \beta(r_m - r_f)$$

To be able to solve the equation one needs 1) beta use either the graph or the calculation approach to determine 2) one needs a market rate of return (r_m) use either the average or the last year market return 3) for r_f use long bond rate.

- 2) Expected rate of rate of return ($E(R)$)

Determine expected rate of rate of return ($E(R)$) possible approaches 1) the assignment says equilibrium based on historic data therefor possible to use either average realized return for a period or return for a past period 2) calculate an expected return using the probability of return approach 3) use the dividend yield approach where $E(R) = D_0 (1+g) / P_0 + g$ at the time of the assignment submission this approach has not been discussed. But if followed it is fine. There may be other approaches.

Compare expected return to required return and conclude according to rule whether over- or undervalued. Can also and should preferably use SML graph to illustrate.

Using the FCF approach to determine price equilibrium can only be use conditionally 1) one needs required return to be determined correctly (CAPM) approach 2) forecasting future cash flows should be spot on. It is better to use the FCF approach in terms of calculating intrinsic value 3) for purposes of the assignment we have at the time not done FCF 4) the assignment scope was given as for chapters 1 to 6.

If the CF approached was used it was not penalized however, it negatively influenced the marks that could have been allocated however, marks were still allocated depending on correctness of approach.

Question 3 Ratios

One mark was allocated for the calculated value for the Class Case Company and a second mark for interpretation and management assessment of the situation.

The emphasis here should have been on a discussion of the compounded values and the relationship between the values of critical variables for example a comparison between asset and sales growth over time many times give valuable management information. Comparison based on the so called CAGR approach.

Please talk to me if uncertain. NB go through the comments in your assignment obviously I could not correct everything for everyone but address for each assignment the major issues. Finally, one could only comment on issues that were discussed in the document if it was not in the document one could not comment.