



2026 Level 2 - Equity Valuation

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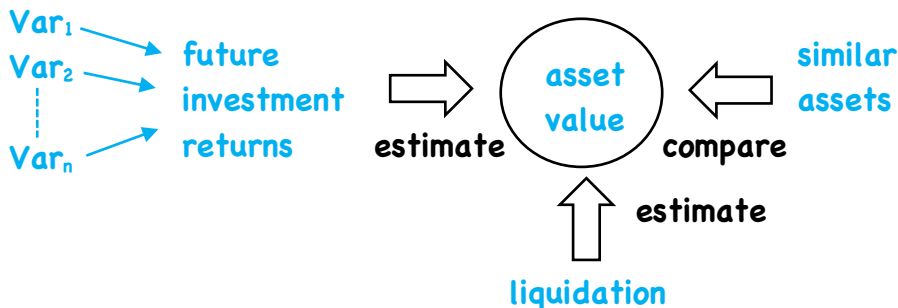
Equity Valuation: Applications and Processes

- a. define valuation and intrinsic value and explain sources of perceived mispricing
- b. explain the going concern assumption and contrast a going concern value to a liquidation value
- c. describe definitions of value and justify which definition of value is most relevant to public company valuation
- d. describe applications of equity valuation
- e. describe questions that should be addressed in conducting an industry and competitive analysis
- f. contrast absolute and relative valuation models and describe examples of each type of model
- g. describe sum-of-the-parts valuation and conglomerate discounts
- h. explain broad criteria for choosing an appropriate approach for valuing a given company

Valuation & Intrinsic Value

- The goal of valuation is to identify mispriced securities/assets

Page 1
LOS a
- define
- explain



⇒ **Price vs. Value** ⇒ **Intrinsic Value (unobservable)**
 { market price (observable) }
 - value of an asset given a hypothetically complete understanding of the asset's investment characteristics

- undertaking valuation efforts assumes

① mispricing exists ($P \neq V$)

- at odds with market efficiency

⇒ **Grossman-Stiglitz paradox** - if markets were informationally efficient, no rational person would incur costs of valuation

- how would prices reflect value?

Thus/ - investors will not rationally incur the costs of analysis unless expectations of reward to effort exists (**abnormal return, excess risk-adjusted return**)

(α)

Page 2
LOS a
- define
- explain

- undertaking valuation efforts assumes

② P&V will converge

$$V_e - P = (V - P) + (V_e - V)$$

estimated value market price true mispricing (α) error
 • forecast • model

V- intrinsic value (unobservable)
 ⇒ key element
 • differ from consensus
 • correct

Page 3

LOS a

- define
- explain

- ⇒ convergence should be expected within some Investment Horizon
 - requires a catalyst ⇒ what will cause convergence (i.e. next 2-3 earnings reports)

Going Concern/ Liquidation

⇒ going concern value

- a company will continue business activities
 - some assets only have value if the 'going-concern' assumption is valid

⇒ liquidation value → immediate

vs

→ orderly liquidation value

companies in financial distress

- Focus of valuation readings → intrinsic value estimated under a going concern assumption

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LOS b

- explain
- contrast

Value

- Intrinsic Value

- typically, the relevant concept of value for valuing public equities

- Fair market value

- value at which an asset/liability would change hands between a willing buyer/seller when they are not under any compulsion to buy/sell

- both are informed to all material aspects

- Investment value

- an asset may be worth more to a particular buyer (e.g. synergies)

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LOS c

- describe
- justify

Applications

- **Selecting stocks** ⇒ I.V. vs. MV.
(over, under, fairly)
 - **Inferring (extracting) market expectations**
 - assume Price reflects consensus expectations of investors about future performance
 - reasonable?
- $$\text{Price} = \underbrace{\text{Var}_1 + \text{Var}_2 + \text{Var}_3}_{\text{known}} + X - \text{solve for fundamental variable } X$$
- **evaluating corporate events**
 - M&A, divestiture, spin-off

Page 6
LOS d
- describe

- **rendering fairness options**
 - parties to a merger may be required to get 3rd party opinion on the fairness of the terms
- **evaluating business strategies & business models**
- **communication with analysts/shareholders**
- **appraise private businesses**
 - transactional (sale)
 - taxation (estate)
 - IPO
- **evaluating/setting share-based compensation**

Page 7
LOS d
- describe

Industry/Competitive Analysis

- ⇒ **Valuation Process**
- understanding the business
 - forecasting company performance
 - selecting the appropriate valuation model
 - converting forecasts to a valuation
 - applying the valuation conclusions

Page 8
LOS e
- describe

Understanding the business/

- industry/competitive analysis
- identify the economic drivers of a business
- threats/opportunities

Understanding the business/

A/ industry attractiveness in terms of prospects
for sustained profitability

- ⇒ Porter's 5-forces model
- intra-industry rivalry
 - threat of new entrants
 - buyer power
 - supplier power
 - availability of substitutes

B/ company's relative competitive position within
the industry & its competitive strategy

- level of and trend in market share

Page 9

LOS e

- describe

Understanding the business/

B/ company's relative competitive position within
the industry & its competitive strategy

- business model
 - how it turns its
strategy into revenues

- cost leadership
- differentiation
- focus-niche

C/ how well has the company executed on its
strategy and what are its prospects for future execution



Financial
reports
+
qualitative factors

Page 10

LOS e

- describe

Absolute vs. Relative

Page 11
LOS f
- contrast
- describe

- selecting the appropriate valuation model/
A/ Absolute valuation models
 - specifies an asset's intrinsic value
 (present value, discounted cash flow)

Cash flows {

- shareholder level ⇒ Dividends
- company level ⇒ FCF, Residual Income

(CFO-Capex-ΔWC) } economic profit

$$\sum_{i=1}^{\infty} \frac{CF_i}{(1+r)^i}$$

↗ type
 ↘ forecasts
 ↓
 often subjective

Page 12
LOS f
- contrast
- describe

- selecting the appropriate valuation model/
A/ Absolute valuation models
asset-based valuations → MV of assets/resources it controls
(REIT)

B/ Relative valuation models (method of comparables)
 - estimate of value relative to another
 - law of one price: similar assets should
 sell for similar prices
 - price multiples or enterprise multiples
 (derives relative over/under valuation)

Sum-of-the-Parts

a.k.a. break-up or private market value

- the estimated value of the company by the sum of the estimated values of the various businesses considered as independent going concerns
 - corp. with segments indifferent industries that have different valuation characteristics
 - few synergies between segments (although not zero)
 - useful for valuing spin-offs (+ pure-play premium)
- requires a detailed breakdown of each segments contribution to earnings & cash flow

Page 13
LOS g
- describe

Conglomerate Discount

⇒ market typically applies a discount to the stock of a company operating in multiple, unrelated businesses

- Explanations/
- inefficiency in capital allocation
 - capital allocation across segments may not maximize shareholder value
 - path to conglomerate status
 - poorly performing companies tend to expand by diversifying the earnings base (acquisitions in unrelated businesses)
 - does not exist
 - measurement error

Page 14
LOS g
- describe

Valuation Approach

<p>→ broad criteria/</p> <p>business understanding →</p> <ul style="list-style-type: none">• consistent with the characteristics of the company being valued• appropriate given the availability and quality of data• consistent with the purpose of valuation, including the analyst's perspective <p>→ use of multiple models/valuation approaches</p> <p>→ Converting forecasts to a valuation/</p> <ul style="list-style-type: none">• sensitivity analysis - how changes in an input affect the outcome	<p>Page 15 LOS h - explain</p>
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<p>→ Converting forecasts to a valuation/</p> <ul style="list-style-type: none">• situational adjustments<ul style="list-style-type: none">- incorporate valuation impact of specific issues <ol style="list-style-type: none">1) control premium2) lack of marketability discount3) illiquidity discount	<p>Page 16 LOS h - explain</p>
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Discounted Dividend Valuation

- a. compare dividends, free cash flow, and residual income as inputs to discounted cash flow models and identify investment situations for which each measure is suitable
- b. calculate and interpret the value of a common stock using the dividend discount model (DDM) for single and multiple holding periods
- c. calculate the value of a common stock using the Gordon growth model and explain the model's underlying assumptions
- d. calculate the value of non-callable fixed-rate perpetual preferred stock
- e. calculate and interpret the implied growth rate of dividends using the Gordon growth model and current stock price
- f. calculate and interpret the present value of growth opportunities (PVGO) and the component of the leading price-to-earnings ratio (P/E) related to PVGO
- g. calculate and interpret the justified leading and trailing P/Es using the Gordon growth model
- h. describe strengths and limitations of the Gordon growth model and justify its selection to value a company's common shares
- i. explain the growth phase, transition phase, and maturity phase of a business
- j. explain the assumptions and justify the selection of the two-stage DDM, the H-model, the three-stage DDM, or spreadsheet modeling to value a company's common shares
- k. describe terminal value and explain alternative approaches to determining the terminal value in a DDM
- l. calculate and interpret the value of common shares using the two-stage DDM, the H-model, and three-stage DDM
- m. explain the use of spreadsheet modeling to forecast dividends and to value common shares
- n. estimate a required return based on any DDM, including the Gordon growth model and the H-model
- o. calculate and interpret the sustainable growth rate of a company and demonstrate the use of DuPont analysis to estimate a company's sustainable growth rate
- p. evaluate whether a stock is overvalued, fairly valued, or undervalued by the market based on a DDM estimate of value

LOSs will match between the video and the PDFs, but may be in a different order than the CFAI readings