**EFFECTIVE FINANCIAL MANAGEMENT**

**Learning Outcome 4: ACTIVITY 3**

**The market value of equity**

The market value of a share is determined by supply and demand – the willingness of participants in a market to buy and sell shares. In theory, the value of a share should be equal to the sum of the expected future price of the share and present value (PV) of the expected dividends from that share.

Suppose an investor plans to hold a share of Tavares plc for a year. The expected cash flows include the next period's dividend (D1) and the expected market price of the share at the end of the year ($P\_{1}$). If the required rate of return is r, the current market price of this share ($P\_{O}$) is:

$P\_{O}$ = $ \frac{D\_{1}}{(1+r)}+\frac{P\_{1}}{(1+r)}$

From equation (1), the current market price of a share ($P\_{O}$) is the present value (PV) of the expected future cash flows. By the same analogy, $P\_{1}$ should be the PV of the dividend at the end of period 2 (*D2*) and the market price of the share at the end of period 2 ($P\_{2}$). This could be written as:

$$P\_{1}=\frac{D\_{2}}{(1+r)}+\frac{P\_{2}}{(1+r)} $$

By combining equations (1) and (2), we get:

$P\_{0}$ *=* $ \frac{D\_{1}}{(1+r)}+\frac{D\_{2}}{\left(1+r\right)^{2} }+\frac{P\_{2}}{\left(1+r\right)^{2} }$

#### Individually, and then in pairs

1. True or false?
	1. All stocks in an equivalent risk class are priced to offer the same expected rate of return.
	2. The value of a share equals the present value of future dividends per share.
2. Company X is expected to pay an end-of-year dividend of $5 a share. After the dividend, its stock is expected to sell at $110. If the market capitalisation rate is 8%, what is the current stock price?
3. True or false?
	1. The value of a share equals the discounted stream of future earnings per share.
	2. The value of a share equals the present value of earnings per share, assuming that the business does not grow, plus the net present value of future growth opportunities.