COLLEGE OF ACCOUNTING

FINANCIAL MANAGEMENT | BASIC

Video Transcription: Valuations – Understanding the Market and Market Value

UCT College of Accounting

During your financial management course, you are required to do valuations of different financial instruments. These financial instruments are shares of companies, debentures, preference shares and bonds.

The aim of doing the valuation is to determine at what price you are willing to purchase those financial instruments. The valuation is done using Time Value of Money principles. Once the value of the financial instrument has been determined, we will compare to the market price of the same financial instrument or a financial instrument that falls within the same risk class. If the value you calculated is higher than the current market price that means the investment is a good investment and you should buy it. If, however, the value you calculated is less than the current market price, then it is a bad investment and you should not buy it. So what does this market value represent, and where is it set? This video aims to answer these questions.

You should actually be very familiar with the concept of market values. If you buy any product in the shops, the value at which you buy that product is some kind of market value. That product has to be bought somewhere and at a certain price. Now purchasing financial instruments is very similar to that. You have to buy it somewhere, the market, and at a certain price, the current market value.

A market is a place where buyers and sellers meet. In order for there to be a market price, there has to be a market. You would have learnt about these concepts during microeconomics. Microeconomics demonstrates that the market price is determined by the "demand of" and "supply for" the specific item in question. Here, we have the demand and the supply curves. We can see that demand quantity increases as the price of a product decreases and supply quantity increases as the price of the product increases. The market price is where the demand and supply is equal.

Consider the following scenario: you wish to buy a phone and there are ten vendors, all selling the particular phone you want. You are willing to spend R7 000. The first vendor is willing to sell the phone at R7 500; the second vendor is only willing to sell the phone at R7 200. Finally, the third vendor is willing to sell the phone at R7 000. The next buyer wants the best price and therefore goes to the same vendor where you purchase your phone. All the other vendors will now have to sell their phones at R7 000 in order to make sales. We can see that the market operates through the interaction between supply from the sellers and demand from the buyer.

Purchasing a financial instrument is no different to purchasing that phone, and the way that prices set is very similar. In the case of a financial instrument, the market consists of buyers and sellers of those financial instruments. In South Africa, the Johannesburg Stock Exchange, also known as the JSE, is the only place where financial instruments can be publicly traded. The JSE offers primary and secondary financial markets across a diverse range of financial instruments and it also offers post-trade services and regulatory services. The financial instruments that are traded on the JSE are shares of listed companies, debentures, preference shares and bonds. Now, let us look at one financial instrument in particular, a share of a publicly-listed company. The JSE is a place where buyers and sellers of those shares meet together to trade.

In the past, shares used to be traded through buyers and sellers physically meeting in a room, these days everything takes place electronically. The number of buyers determines the demand for the shares and the sellers determine the supply of the shares. If the demand for a certain share is greater than the supply of that share, then the price will increase. If the supply of that share is greater than the demand of that share, the price will decrease. Let us have a look at what a trading platform looks like and we are going to specifically look at the shares of MTN, a large telecommunications company.

Here we have the general trading information of MTN for a specific day. The ruling price is the current market price of the share. We can also see some other information – the share price has decreased by 72 cents today from the previous day's closing price. The high represents the highest price of the day and the low the lowest price. The volume shows us the number of shares that traded on that day. If we look at the last trade, we can see that the trade was done at this ruling price. It is the price where a willing seller and a willing buyer could be found.

Now, let us look at the current demand and supply of MTN shares. Here, we can see some of the orders that have been placed in the market. The bid price shows what a person, who is looking at buying MTN shares, is willing to pay, and the bid volume is the amount of shares they want to buy at the bid price. Consequently, it determines the demand for the MTN shares. The offer price is what someone is willing to sell their shares at and the offer volume is the amount of shares they are willing to sell at that price. Consequently, it determines the supply of MTN shares. If we look at the total bid volume and the offer volume from these orders, we see that the offer volume is higher than the bid volume. Therefore the supply is larger than demand, which explains why the share price is decreasing. Now, let's see if there is currently a trade that will take place. Based on this information, there is now a matching bid and offer price and therefore no trade will take place.

If I were to place an order for a MTN share, I would fill in the following form. We can see we need to put in the share code, the price at which we want to buy the share as well as the quantity of shares that we want to buy. If I put in a price that is too low, my price will not be met by a bid and I will most likely not get the shares. If I put in a price that is much higher than the current market price, I will quickly find someone who is willing to sell the shares at the price, but the market will bid the price down again as there are no other buyers willing to pay the same amount. This is where we will need the information of our own valuation of MTN shares. Let's say that we valued MTN shares at R240 per share. We can see that the current market price is lower and therefore we are willing to buy the shares. We make the following order: we put in our price of R238 and remember we have to put it in as cents so its 23 800 cents. We put in a quantity of 1 000 and we select to "buy". The price is attractive and we find the orders go through, we now own 1 000 MTN shares at R238.

Now, let's say that we have owned our MTN shares for a couple of months. We want to find out what the current market price is, so that we can report our shares at fair value in our financial statements. To find this out, we once again go back to the market.

We can see that the current ruling price at the close of the day on the reporting date was R240.41 cents. If we look at the last trades of the day, we can see that the last trades happened just after 5pm and it was at 24 041 cents. We will use this price to report the value of your shares. We now own 1 000 MTN shares at R240 and 41 cents. This means the value of our shares have increased by R2 and 41 cents per share.

So in this video, I showed you what the market value of a share is and how it is obtained. It is important to notice that in order for anything to have a market value, there has to be a market. The same principles, we have discussed here, apply to any of the financial instruments that we learn about in financial management. Whether it be bonds or debentures or preference shares, it will be the same.