Session 01

Why Value, Value?

Programme : Postgraduate Diploma in Business, Finance & Strategy (PGDBFS 2017)
Course : Corporate Valuation (PGDBFS 203)

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Lecture Outline

- What is Value and Why value, value
- Consequences of Forgetting to Value, VALUE
- Benefits of Focusing on Long Term Value
- Challenges of Focusing on Long Term Value
- Growth and ROIC: Drivers of Value
- Relationship of Growth, ROIC, and Cash Flow
- Foundations of the Value Conservation Principle
- Risk and Value Creation

"Price is what you pay. Value is what you get"

Warren Buffett

Reference : Valuation : Measuring and Managing the Value of Companies, Tim Koller, Marc Goedhart and David Wessels : 05th Edition, Chapter 1 and 2

Business Value

- Companies create value by investing capital from investors to generate future cashflows at rates of return exceeding the cost of capital – *Core Value (a combination of growth and ROIC)*

- Value is created for shareholders when companies generate higher cashflows, not by rearranging investors claims on those cashflows – *Conservation of Value*

Business Value

- Companies performance in the stock market is driven by changes in the stock markets expectations, not just the company's actual performance – *Expectations Treadmill*

- Value of a business depends on who is managing it and what strategy they pursue – *Best Owner*

Consequences of Forgetting to Value VALUE

- Market Bubbles
- Financial Crisis
- Excess Leverage
- Equity Market

Benefits of Focusing on Long Term Value

- Objective function of the corporation is to maximize shareholder value

- An often-expressed concern is that companies that emphasize creating value for shareholders have a short time horizon that is overly focused on accounting earnings rather than revenue growth and return on invested capital

- Value-creating companies also create more jobs

Challenges of Focusing on Long Term Value

- Focusing on return on invested capital and revenue growth over the long term is a tough job for executives
- Companies that fail to create value over the long term do less well in the stock market
- The pressure to show strong short-term results often mounts when businesses start to mature and see their growth begin to moderate
- Sorting out the trade-offs between short-term earnings and long-term value creation is part of a manager's job
- Applying the principles of value creation sometimes means going against the crowd

Challenges of Focusing on Long Term Value

- **A divorce, of ownership and control**

Modern corporation has a very diffuse and fragmented set of shareholders and control often lies in the hands of directors

- **Principal–Agent problem**

The separation of ownership and control raises worries that the management team may pursue objectives attractive to them, but which are not necessarily beneficial to the shareholders

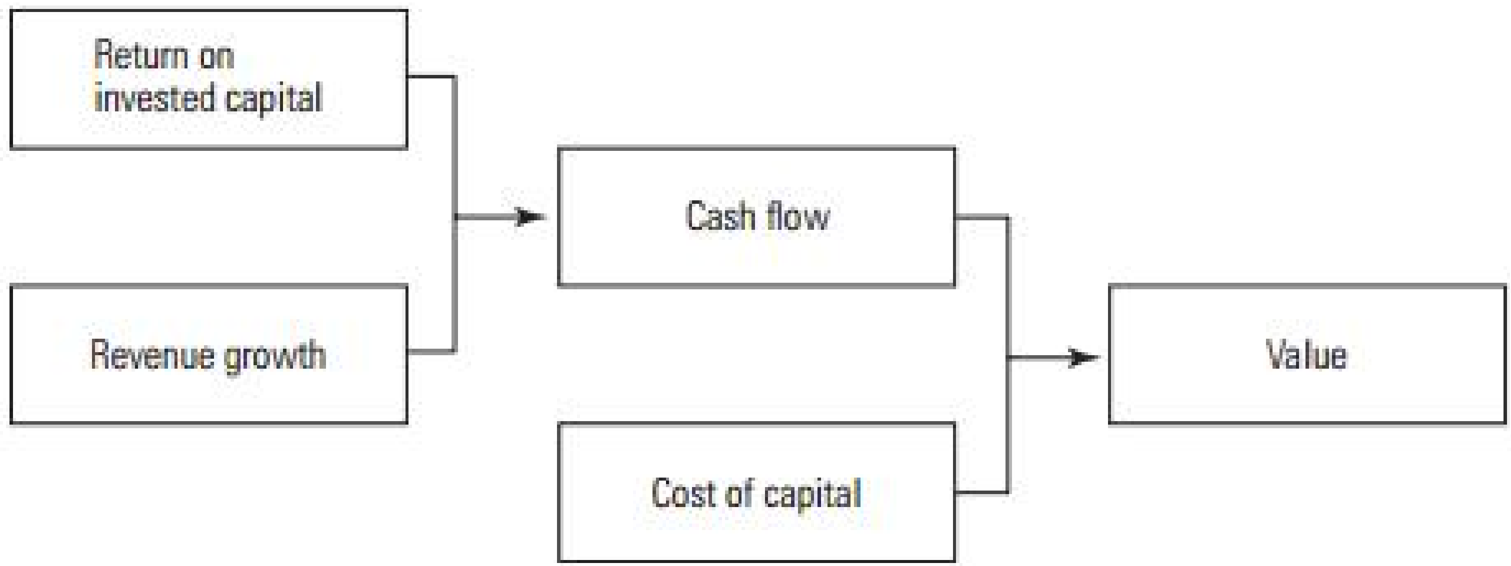
- **Agency Costs**

  - Monitor managers' behavior
  - Create incentive schemes and controls for managers to encourage the pursuit of shareholders' wealth maximisation

- **Corporate governance**

The system by which companies are managed and controlled

Growth and ROIC: Drivers of Value



- Earnings don't tell the whole story of value creation (Example 01)

Relationship of Growth, ROIC, and Cash Flow

- A company's cash flow was $100 last year and will be $150 next year
- The $50 increase in cash flow could come from many sources, including revenue growth, a reduction in capital spending, or a reduction in marketing expenditures
- Company was generating revenue growth of 7 percent per year and would earn a return on invested capital of 15 percent

$ million

	Value Inc.					Volume Inc.				
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue	1,000	1,050	1,102	1,158	1,216	1,000	1,050	1,102	1,158	1,216
Earnings	100	105	110	116	122	100	105	110	116	122
Investment	(25)	(26)	(28)	(29)	(31)	(50)	(53)	(55)	(58)	(61)
Cash flow	75	79	82	87	91	50	52	55	58	61

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Foundations of the Value Conservation Principle

- Share repurchases
- Acquisitions
- Financial engineering

The use of financial instruments or structures, other than straight debt and equity, to manage a company's capital structure and risk profile

Risk and Value Creation

- Price of risk
- Deciding how much cash flow risk to take on
- What risks to hedge


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