Index

A

Accelerated depreciation, 405
Accounting:
  changes and irregularities in, 218–219
  financial institutions (see Banks)
  goodwill amortization, 621
  mergers and acquisitions (M&A), 621–623
  statements (see Financial statements)
Analysts, sell-side, 689
Analyzing performance. See Historical performance analysis
Anders, William A., 564
Arbitrage pricing model, 296–297
Asset-based valuations, 266–267
Asset health metrics, 585
Assets, traded vs. untraded, 804–805
AT&T, 631

B

Balanced scorecard, 583
Balance sheet, 169, 170–171, 175, 243–248. See also Income statements
Banks, 757–783
  economics of banking, 758–760
  fee- and commission-trading activities, 782
  income sources for, 759–760
  interest-generating activities, 781
  trading activities, 781–782
  valuation complications, 775–782
  convergence of forward interest rates, 775–776
  loan loss provisions, 776–777
  multibusiness banks, 780–782
  risk-weighted assets and equity
  risk capital, 777–780
INDEX

Banks (Continued)
valuation principles, 760–774
analyzing and forecasting equity cash flows, 764–766
discounting equity cash flows, 766–767
economic spread analysis, 770–774
equity DCF method, 760–770
value driver trees, 765, 773
Basel III guidelines, 777
Below-investment-grade debt, 306–307
Best Buy, 6
Best ownership, 562–563
Beta, 720–722
in cross-border valuation, 502–504
in emerging markets, 720–723
equity beta, 301
estimating, 297–299, 387–388
industry beta, 300–301
levered, 838–839
market portfolio, 293–297
smoothing, 299
unlevered, 301–303
Black, Fischer, 165
Black-Scholes value, 330
Bolt-on acquisitions, 123
Bond ratings, 304–306
Bonds, government, 304–307
Bottom-up forecasting, 235–236
Bubbles, 68–69. See also Financial crises

C

Cadbury, 640
Capital asset pricing model (CAPM), 44, 284
applying in practice, 297–303
beta, 297–301
emerging markets, 719–720
for foreign currencies, 495–504
global, 495–497, 501–504
international, 497–498
local, 498–502
market risk premium, 292–294
risk-free rate, 293–294
Capital cash flow (CCF) model, 160–161
Capital intensity, 736–739
Capitalized expenses, 456–464
adjusting invested capital for, 458–459
adjusting NOPLAT for, 458, 459–460
free cash flow (FCF) and, 459–460
research and development (R&D), 458–459
ROIC and, 462–464
Capitalized research and development, 201
Capital productivity, 584
Capital structure, 221–225, 649–679
case example, 673–678
cash flow projections, 673–674
choices between debt and equity, 650–652
complex, 312–313
credit ratings and, 657–661
coverage and size, 658–661
credit spreads, 661
debt/equity tradeoffs, 653–657
effective setting of, 657–661
estimating cost of equity, 545–546
estimating current, 308–312
financial engineering, 669–673
derivative instruments, 670
hybrid financing, 672–673
off-balance-sheet financing, 670–672
four-stage approach to developing, 650–652, 673–678
leverage, 653–657
leverage, coverage, and solvency, 847–849
market-based rating approach, 846–847
payout and financing decisions, 661–669
debt financing, 669
equity financing, 668–669
shareholder payouts, 663–668
pecking-order theory, 843–846
valuation metrics, 250
Capital turnover, and inflation, 479
Carve-outs, 641, 644–645
INDEX 857

Cash distribution, 90–91
Cash flow:
- availability to investors, 105, 197–198
- in emerging markets, 707–711
- foreign, forecasting, 489–494
- relationship to ROIC and growth, 19–22
Cash flow return on investment (CFROI), 449–450, 452–456
- equaling IRR, 452–453
- vs. ROIC, 453–456
Cash flow risk, 44–47
Cash flow statement. See Financial statements
Cash-flow-to-equity (CFE) valuation model. See Equity cash flow (valuation model)
Closet indexers, 687, 688–689
Coca-Cola, 694
Colgate-Palmolive, 23
Commercial health metrics, 584
Commercial real estate crisis (1990s), 11
Commodity price risk, 46
Comparables. See Multiples
Compass, 215–216
Competitive advantage, 98–104
- brand, 100
- cost and capital efficiency advantages, 102–104
- customer lock-in, 101
- economies of scale, 103–104
- innovative business methods, 102–103
- innovative products, 99–100
- persistence of, 105
- price premium advantages, 97–102
- quality, 100
- rational price discipline, 101–102
- scalable product or process, 104
- unique resources, 103
Competitive advantage period, 268–269
Conglomerate discount, 83–84
Conscious Capitalism (Mackey), 7
Consensus EPS forecasts, 697–700
Conservation of value principle, 35–47
- and acquisitions, 39–41
- and executive stock options, 36–37
- financial engineering, 41–42
- foundations of, 37–38
- managerial implications, 38
- and share repurchases, 38–39
ConsuCo, 706–707, 708, 709–711, 716–718, 720–728
Contingent liabilities, 329
Contingent NPV, 797–800
Contingent valuation. See Decision tree analysis (DTA);
- Real-option valuation (ROV)
Continuing value (CV) estimation, 259–279
- advanced formulas for, 277–278
- asset-based valuations, 276–277
- discounted cash flow approaches, 273–277
- aggressive growth formula, 275
- convergence formula, 273–274
- key value driver formula, 260–263
- recommended formula, 260–263
- economic profit valuation formula, 264–267
- Heineken (case study), 547–549
- key value driver formula, 147–148
- misunderstandings about, 265–271
- effect of forecast length on value, 265–268
- length of competitive advantage period, 268–269
- timeframe for, 269–271
- multiples (comparables), 276
- pitfalls in, 271–273
- naive base-year extrapolation, 271–272
- naive overconservatism, 272
- purposeful overconservatism, 272–273
Convergence formula, 273–274
Conversion value, 330
Convertible bonds/preferred stock, 329–332
Corporate growth. See Growth;
- Revenue growth
Corporate portfolio strategy, 557–574
acquisitions and divestitures, 564–565, 574
best-owner lifecycle, 562–563
constructing a portfolio of businesses, 569–573
diversification, 566–569, 574
dynamic portfolio management, 563–566
ownership and value creation, 558–562
Cost and capital efficiency advantages, 102–104
Costco, 23
Cost of capital, 42–43, 283–313. See also Weighted average cost of capital (WACC)
 beta, 287–301
capital structure, 308–313
in emerging markets, 718–725
estimating cost of debt, 304–308
 below-investment-grade debt, 306–307
 bond ratings and yield to maturity, 304–306
interest tax shield, 307–308
estimating cost of equity, 286–303
adjusting for industry/company risk, 292–303
arbitrage pricing theory, 296–297
capital asset pricing model (CAPM), 293–294, 297–304
Fama-French three-factor model, 294–296
market implied cost of equity, 290–292
market return, 286–292
estimating in foreign currency, 490–502
in multiple business units, 387–389
for operating leases, 435–436
target weights, 308–312
Cost of debt, estimating, 304–305, 546
Cost of equity: capital asset pricing model (CAPM), 297–303
estimating, 286–303, 545–546
(see also Cost of capital, estimating cost of equity)
alternatives to capital asset pricing model (CAPM), 294–297
beta and, 297–303 (see also Beta)
leverage and, 768–769
levered/unlevered, 157–159, 833–836
Cost of goods sold (COGS), 237–238
Costs, fixed vs. variable, 252
Cost structure health metrics, 582–583
Coughlin, Chris, 631
Country risk premium, 712, 713–716, 724–725, 726–728
Coverage, 847–849
Covidien, 632
Credit health, 221–225
Credit ratios, and inflation, 480
Credit risk, 779
Credit spreads, 661
Cross-border valuation, 489–510. See also Currency, foreign
currency translation, 507–509
estimating beta, 502–504
estimating cost of capital, 494–504
forecasting cash flows, 489–494
foreign currency risk, 504–507
Cross-listed shares, 86–88
Currency:
effects on revenue growth, 195, 216
foreign (see also Cross-border valuation)
forecasting cash flows, 490–494
forward rate vs. spot rate, 490–494
incorporating currency risk in valuation, 504–507
translation approaches, 507–509
risk, 46–47
Customer lock-in, 101
Cyclical companies, 747–754
forecasting for, 748–752
management implications, 753–754
share price behavior, 747–751
earnings forecasts, 748–749
market and DCF valuations, 747–749
valuation approach, 751–753

D

Data, in forecasting, 230–231
Debt:
  below-investment-grade, 306–307
  changes in, 197
  convertible, 669, 672
  debt-to-value ratio, 311–312
  defined, 182
  enterprise DCF model, 150
  estimating cost of, 304–308
  repayment, 672
  valuing, 309–310, 325–327
Debt equivalents, 171, 182–183, 195, 325–329
Debt financing, 669
Decision tree analysis (DTA), 786–787, 798–805, 811–814
Deferred gains, 202–203
Deferred taxes, 184–186, 247–248
Depreciation:
  accelerated, 405
  in forecasting, 239–241
Derivative instruments, 670
Diageo, 558
Direct equity approach. See Equity cash flow (valuation model)
Disclosure. See Transparency
Discounted cash flow (DCF), 31–33, 507–509
  alternatives to, 164–166
  in banking, 760–761
cyclical companies, 747–749
drivers of cash flow and value, 18–20
with extreme inflation, 480–486
scenario DCF approach, 711–716
valuation models
  adjusted present value (APV), 137–138, 155–160
capital cash flow (CCF), 138
decision tree analysis (DTA), 786–787, 798–805, 811–814
economic profit, 137–138, 152–155
enterprise DCF, 137–152 (see also
    Enterprise discounted cash flow)
equity cash flow, 161–163
real option valuation (ROV), 787
real-option valuation (ROV), 796–798
scenario approach, 345–348, 785–786
scenario DCF approach, 729–730
single-path DCF, 785
stochastic simulation DCF, 786
Discount rate, 42–43. See also Cost of capital
Disentanglement costs, 638
Diversification:
  and conglomerate discounts, 83–84
  effect on cost of capital, 43–44
  in portfolio of businesses, 566–569
Diversitures, 629–646
  assessing potential value from, 636–640
  barriers to, 639
  conflict of interest and, 642
  in corporate portfolio strategy, 564–565
  costs associated with, 637–640
  deciding on, 636–640
  earnings dilution from, 635
  executive resistance to, 634–636
  exit prices, 640
  legal/regulatory issues, 639–640
  pricing/asset liquidity, 640
  research into, 631–632
  transaction structure choice, 640–645
carve-outs, 641, 644–645
IPOs, 641, 642
private vs. public transactions, 641–642
spin-offs, 641, 642–643
tracking stock, 641, 645
value created vs. value forgone, 637
value creation from, 631–640
Dividends, 197, 649, 664, 668
Dot-com bubble, 10–11, 72–73, 297–298, 302
Dupont, 442–446

E

Earnings per share (EPS), 74–83
  consensus earnings estimates, 80–82
  and different accounting standards, 78
  earnings management, 78–83
  earnings volatility, 79–80
  effect of share repurchases on, 38–39
  from employee stock options, 77–78
  guidance, 82–83
  and investor communications, 694–697
  from mergers and acquisitions, 75–76
  and mergers and acquisitions (M&A), 621–623
  overfocus on growth of, 18
  short-term focus, 12
  from write-downs, 76
East-Asian debt crisis, 11
eBay, 95–96, 126

EBIT (earnings before interest and taxes), 187

EBITA (earnings before interest, taxes, and amortization), 186–188, 221–223, 416, 476–477

EBITDA (earnings before interest, taxes, depreciation, and amortization), 187, 223–225

EBITDAR (earnings before interest, taxes, depreciation, amortization, and rental expense), 221–223. See also Multiples

Economic profit, 28–29
  as alternative to ROIC, 465–470
  for continuing value (CV) estimation, 264–265
  discounted free cash flow equivalence, 821–823
  valuation models based on, 137–138, 152–155

Economic spread analysis, 770–774

Economies of scale, 103–104, 610–611

Efficient market theory, 37–38

Emerging markets, 705–728
  calculating and interpreting results, 725–728
  ConsuCo, 706–707, 708, 709–711, 716–718, 720–728
  cost of equity
    beta, 720–722
    market risk premium, 722
    risk-free rate, 720
  estimating cost of capital, 718–725
    after-tax cost of debt, 723
    cost of equity, 719–723
    country risk premium, 724–725
    weighted average cost of capital (WACC), 724
  exchange rate movements, 707–709
  forecasting cash flows, 707–711
  historical analysis, 706–707
  incorporating risk in valuation, 711–718
  country risk premium, 712, 713–716
  scenario DCF approach, 711–716

Employee stakeholders, 7

Employee stock options, 77–78, 150, 332–334

Employment growth, correlation with TRS, 8–9

Energy companies, 7

Enterprise discounted cash flow, 137–152, 827–830
  four steps of, 140
  nonequity claims, identifying/valuing, 140, 150–151
  nonoperating assets, identifying/valuing, also ch. 14, 140, 149
  operations valuation, 140
  valuing equity, 140, 151–152
  valuing operations, 142–149
INDEX 861

Enterprise value:
- converting to value per share, 317–335
- in multiples, 356–360, 367–368
- relationship to equity value, 138–139

Equity:
- defined, 183–184
- valuing (DCF model), 151–152

Equity beta, 301

Equity cash flow (valuation model), 161–163, 760–770

Equity equivalents, 171, 184–186

Equity financing, 668–669

Equity risk capital, 769–770, 777–780

Equity value:
- contingent liabilities, 329
- convertibles, 329–332
- debt, 325–327
- employee stock options, 332–334
- noncontrolling interests, 334
- operating leases, 327
- postretirement liabilities, 328
- provisions, 328–329
- relationship to enterprise value, 138–139
- securitized receivables, 327–328

Event trees, 806–807

Excess capacity, reducing, 608–609

Excess cash, 180–181, 319–320

Executive stock options, 36–37

Exercise value approach, 333

Expectations:
- decomposing TRS, 54–61
- treadmill analogy, 49–54, 62–63
- understanding, 61–62

Expected rate of return on new invested capital. See RONIC

Expensed investments, capitalizing, 456–464. See also Capitalized expenses

Extraordinary dividends, 668

F

Fama-French three-factor model, 294–296

Fayard, Gary, 694

Fee and commission income, 759–760

Finance subsidiaries, 322–323

Financial Accounting Standards Board (FASB) accounting rules, 36–38

Financial crises, 10–11. See also Financial crisis of 2007–2009
dot-com bubble, 10–11, 72–73, 297–298, 302

East-Asian debt crisis, 11


Financial engineering, 41–42, 669–673
derivative instruments, 670
hybrid financing, 672–673
off-balance-sheet financing, 670–672

Financial institutions. See Banks

Financial projections, and inflation, 480–486

Financial statements. See also Balance sheet; Income statements
in forecasting, 229–230
Heineken (case study), 516–528
historical income statement, 186
in multiple business units, 380–387
reconciliation to net income, 192
reorganizing, 142–143, 169–203
calculating NOPLAT, 186–192
capitalized research and development, 201
case study (UPS/FedEx), 174–197
cash flow available to investors, 194–195
computing total funds invested, 180–182
defered gains, 202–203
free cash flow, 194–196
invested capital, 170–171, 172, 174–180
key concepts, 169–174
nonoperating charges and restructuring reserves, 201–202
operating leases, 105, 198–199
Financial statements (Continued)
pensions and postretirement benefits, 199–201
reconciliation to net income, 194
Flexibility, 785–788
managing, 793–794
recognizing, 791–793
structuring, 794
vs. uncertainty, 785–786
valuation, four-step process, 805–811
valuation examples, 806–818
valuation methods, 795–805
compared, 786–787, 799–805
decision tree analysis (DTA), 786–787, 798–805, 811–814
real-option valuation (ROV), 787, 796–798, 799–805, 806–811, 814–818
risk-neutral valuation, 797–798
value and, 788–793
Forecasting, 229–254
components of a good model, 230–232
consensus EPS forecasts, 697–700
in continuing value (CV) estimation, 265–268
costs, fixed vs. variable and, 252
cyclical companies, 748–752
forecast ratios, 231, 237
inflation and, 252–254
length/deal determination, 229–230
mechanics of, 232–251
step 1 (prepare/analyze historical financials), 233–235
step 2 (revenue forecasting), 235–237
step 3 (income statement forecasting), 237–243
step 4 (invested capital and nonoperating assets forecast), 243–248
step 5 (investor funds forecasting), 248–250
step 6 (ROIC and FCF calculating), 251
midterm, 542
nonfinancial operating drivers, 251–252
short-term, 534–538
stock vs. flow approach, 243–244
Foreign currency. See Currency, foreign
Frameworks. See Valuation frameworks
Free cash flow (FCF), 192–196, 525–528. See also Cash flow
defined, 30, 170
discounted economic profit equivalence, 821–823
effects of inflation on, 476–478
in forecasting, 232, 251, 541
key concepts, 172–174
projecting, 145–146
valuing at unlevered cost of equity, 157–159
and weighted average cost of capital, 148–149, 821–825
Freeman, R. Edward, 7
Fundamental investors, 66–68

G
Gartner Group, 691
General Dynamics, 566
Generally Accepted Accounting Principles (GAAP), 78, 507–509
General Mills, 18, 558
Goodwill amortization, 571
Gross, Bill, 65
Gross cash flow, 194
Growth. See also Market value, and ROIC/growth; Revenue growth
across industries, 130
balancing with ROIC, 22–23
components of, 118
decay analysis, 132
defined, 30
empirical analysis of, 127–133
Heineken (case study), 529–531
interaction between ROIC and,
17–23, 26–28
portfolio treadmill, 127
real revenue growth vs. GDP,
128–129
relationship to ROIC and cash flow,
19–22
sustaining, 124–127, 130–133
trends, 128–129
types of, 25–26
value creation and, 120–124
variation in, 125
Growth companies. See High-growth companies
Growth strategies, 25–26
Hedging, 46–47
Heineken (case study), 513–553
calculating and interpreting results,
549–553
aggressive-acquisition scenario,
552
business-as-usual scenario,
549–551
DCF valuation, 549
economic profit valuation, 550
operating-improvement scenario,
551–552
value of equity, 549
company background, 509–510
currency risk and, 46–47
estimating continuing value,
547–549
estimating cost of capital, 542–547
capital structure, 545–546
cost of debt, 546
financial statement reorganizing,
514–528
balance sheets, 517, 522–525
calculating NOPLAT, 516–522
free cash flow (FCF) statement,
525–528
income statements, 516–522
invested capital, 527
forecasting performance, 533–542
balance sheet forecast
assumptions, 537
creating scenarios, 533–534
economic profit, 542
free cash flow, 541
income statement forecast
assumptions, 535
invested capital, 540
midterm, 542, 543, 545
NOPLAT and shareholder’s equity, 539
short-term, 534–538
historical performance analysis,
528–533
growth and ROIC analysis,
529–531
stock market comparisons,
531–533
High-growth companies, 731–744
uncertainty of, 743–744
valuation process, 732–743
estimating operating margin,
capital intensity, and ROIC,
738–741
scenario development, 741–742
scenario weighting, 742–743
sizing market, 732–738
starting from future viewpoint,
732–741
working backward to current performance, 741
Yelp, 733–740
Historical analysis, in forecasting, 231
Historical market risk premium,
286–290, 292
Historical performance analysis,
207–225
credit health and capital structure,
221–225
DCF-based models, 143–145
guidelines, 224–225
Heineken (case study), 528–533
revenue growth, 215–220
ROIC, 207–215
Home Depot/Lowes, 61–62, 219–220
Hotel partnerships, 41
Hybrid financing, 672–673
Hybrid securities, 183, 318, 329–335

I
Income statements, 169, 186, 235–243, 516–522. See also Financial statements
Income taxes. See Taxes
Index membership, 85–86
Inflation, 473–486
  distortion of financial indicators, 479–480
  effect of passing on to customers, 475–479
  extreme, historical analysis of, 479–480
  and financial projections, 479–486 in forecasting, 232–234
  and lower value creation, 473–479
Informed investors, 66–68
Initial public offerings (IPOs), 639, 640
Interest expense/income, 241–242
Interest expenses, 197
Interest tax shield (ITS), 307–308
Internal rate of return (IRR), 450–453
International Financial Reporting Standards (IFRS), 507–509
Internet bubble, 10–11, 72–73, 297–298, 302
Intrinsic investors, 685–686, 687–693
Intrinsic value, 682–684
Invested capital, 172
  case illustration (UPS/FedEx), 174–180
  defined, 29, 170
  forecasting, 540
  goodwill and acquired intangibles, 179–180
  investments in, 193–195
  key concepts, 170–171
  in multiple business units, 387
  multiples of, 369
  operating working capital, 176–178
  other assets and liabilities, 178–179
  production equipment and facilities, 178
Investment-grade debt, 325–326
Investment rate (IR), 30
Investments, option to defer, 789–790, 792
Investor communications, 681–701
  and consensus earnings forecasts, 697–700
  earnings guidance, 694–697
  and intrinsic investors, 687–693
  intrinsic value vs. market value, 682–684
  listening to investors, 693
  objectives of, 682
  targeting by segment, 687–689
  transparency, 689–690, 692–693
  understanding investor base, 682, 684–689
Investor funds, forecasting, 248–250
Investors:
  classification of, 684–689
  closet indexers, 687, 688–689
  intrinsic, 685–686, 687–693
  opinions of, 693
  segmentation of, 684–687
  traders, 686–687

J
Japanese financial crisis, 11
Johnson & Johnson, 40
Joint ventures, 641

K
Kaplan, Robert, 583
Key value driver formula, 260–263

L
Leases. See Operating leases
Leverage, 223, 653–657, 847–849
  and beta, 838–839
  capital structure and credit ratings, 654–662
  and cost of equity, 768–769
  and the price-to-earnings multiple, 841–842
Line item analysis, 212, 237
Long-Term Capital Management, 11
Lowe’s, 691
Lucent, 631

M

Mackey, John, 7
Managing for Stakeholders (Freeman), 7
Market access, accelerating, 609
Market bubbles, 68–69
Market implied cost of equity, 290–292
Market return, estimating, 286–292
Market risk, 779
Market share performance, defined, 118
Market value, 330
Mathematical formulas in value creation, 29–33
Mechanical investors, 687
Mergers and acquisitions (M&A), 599–626
  best-acquirer characteristics, 623–626
  priority themes, 623–624
  reputation management, 624–625
  strategic vision, 625
  buying cheap, 613–614
  consolidation, 608–609, 612
defined, 118
earnings from, 75–76
effects on revenue growth, 217–219
empirical research on success of, 602–607
estimation of operating improvements, 614–618
cost and capital savings, 614–617
implementation issues, 618
revenue improvements, 617–618
payment method (cash/stock), 617–620
performance improvement reassessment, 625–626
roll-up strategies, 611–612
transformational mergers, 612–613
value creation and, 600–602
value creation strategies for, 607–614
value creation vs. accounting focus, 621–623
Merton, Robert, 165
Miller, Merton, 37, 156
Modigliani, Franko, 37, 156
Molson Coors, 699
Multibusiness companies. See Valuation by parts
Multiple expansion, 40–41
Multiples, 351–371
  adjusting for nonoperating items, 363–365
  alternative multiples, 367–371
  as alternative to discounted cash flow, 165
  best practices for, 352–353
  comparables analysis, 351–352
  in continuing value (CV) estimation, 276
  EBITA vs. EBITDA, 360–361
  EBITA vs. NOPLAT, 361–363
  in emerging markets, 726–728
  enterprise value to EBIT, 358–360
  enterprise value to EBITA (or NOPLAT), 356–358
  enterprise value to revenues, 367–368
  forward-looking, 354–356
  of invested capital, 369
  of operating metrics, 369–371
  peer group selection, 365–367
  PEG ratios, 368–369
  price to earnings, 357–358
  sum-of-parts valuation, 353–354

N

Net capital expenditures, 193–195
Net income, reconciliation to, 192
Net interest income, 759, 773–774
Net investment, defined, 30
Net operating profit less adjusted taxes. See NOPLAT
Net present value (NPV), 788–793.
  See also Contingent NPV
Neutrogena, 40
Noise investors, 66–68
Nonconsolidated subsidiaries, 320–322
Noncontrolling interests, 150–151, 183, 334–335. See also Nonconsolidated subsidiaries
Nonequity claims, 136, 150–151, 317–318
Nonfinancial operating drivers, 251–252
Nonoperating assets, 180–182, 319–325 discontinued operations, 323
excess cash and marketable securities, 319–320
excess pension assets, 324–325
excess real estate, 323–324
finance subsidiaries, 322–323
forecasting, 247–248
identifying/valuing, 140, 155
loans to other companies, 323
nonconsolidated subsidiaries, 320–322
tax loss carryforwards, 324
Nonoperating charges, 201–202
Nonoperating expenses, 414–422
amortization of acquired intangibles, 418–420
asset write-offs, 420–421
defined, 317, 414
gains/losses on sale of assets, 422
intangibles, 418–420
litigation charges, 422
one-time vs. ongoing, 416–417
persistence of special items, 417–422
reorganizing income statement, 424
restructuring charges, 421–422
separating from operating expenses, 414, 415–416
special items, 417–418
Nonoperating income, 244–245
NOPLAT (net operating profit less adjusted taxes), 177–178
calculating, 186–192, 516–522
continuing value and, 260–263, 273–274
declared, 29, 170, 171
key concepts, 171–172
in multiple business units, 384
for operating leases, 434
Norton, David, 583
Novo Nordisk, 6
Off-balance-sheet debt, 318
Off-balance-sheet financing, 670–672
One-time expenses, 416–417
OpenTable, 738–740
Operating analysis, 212–215
Operating cash flows, projecting/testing, 651
Operating-cost productivity, 583–584
Operating expenses:
forecasting, 238–239
separating from nonoperating expenses, 414, 415–416
Operating leases, 198–199, 327, 431–439
adjusting for, 432–437
capitalized, 195
enterprise DCF model, 150
enterprise valuation with, 436–437
as form of debt, 439
proposed accounting changes for, 439
valuing, 438
Operating margins:
in high-growth companies, 738–741
and inflation, 480
Operating metrics, multiples of, 369–371
Operating taxes:
accrual-based, 398–404
converting to operating cash taxes, 404–407
deferred, 404–410
on reorganized balance sheet, 407–409
valuing, 409–410
determining, 398–404
comprehensive approach, 401–402
erroneous alternatives for, 404
INDEX 867

public statements, 399–402
simple approach, 402–403
estimating, 188–189
forecasting, 242
Operating working capital, 176–178, 194, 245–246
Operational risk, 779
Operations valuation, 142–149
Options, real, 165–166
Organizational health, 585
Overconservatism, 272–273

P
Payout ratio, 223–224
Pecking-order theory, 845–846
Peer groups, 366–367
PEG ratios, 368–369
Pensions and postretirement benefits, 182, 199–201, 324–325, 328
analyzing and valuing, 440–446
expected return and earnings, 446
manipulation, 446
forecasting, 247–248
unfunded, 441–446
Percentage of property, plant, and equipment (PP&E), 239
Performance analysis. See Historical performance analysis
Performance management, 577–597
consequences, appropriate, 596–597
metrics, 581–592
identifying value drivers, 581–585
understanding value drivers, 585–586
value driver trees, 586–589
organizational support, 592–597
performance reviews, 595–596
target-setting, 595
transparency, 594–595
perspective levels, 578–581
target-setting, 589–592
Perpetuities, 821–823
Pfizer, 40
Pillsbury, 558
Portfolio management, 563–566
Portfolio momentum, 118
Portfolio treadmill, 127
Preferred equity/stock, 150
Price-to-earnings ratio (P/E), leverage and, 841–844
Principles of Corporate Finance (Brealey, Myers, and Allen), 37
Privately held subsidiaries, 321–322
Property, plant, and equipment (PP&E), 246
Provisions, 422–429
defined, 422
income-smoothing, 328, 428
long-term operating, 328, 425–426
nonoperating, 328
ongoing operating, 328, 424–425
restructuring provisions, 427–428
taxes and, 429
Publicly traded subsidiaries, 318–321

R
R&D. See Research and development
Rackspace Hosting, 78
Rational price discipline, 101–102
Real options, 165–166, 751
Real-option valuation (ROV), 787, 796–798
REITS (real estate investment trusts), 41
Replicating portfolios, 167–168, 796–797
Reputation management, 624–625
Rerating, 40–41
Research and development (R&D), 5, 201, 458–462
Reserves. See Provisions
Restructuring reserves, 201–202
Retirement liabilities, unfunded, 150, 441–446
Return on invested capital (ROIC), 14, 71–72, 95–115, 268–269
alternative measures of, 449–470
capitalizing expensed investments, 456–464
cash flow return on investment (CFROI), 452–456
economic profit, 465–470
INDEX

Return on invested capital (ROIC) (Continued)
analyzing goodwill and acquired intangibles, 209–210
UPS/FedEx, 208
balancing with growth, 22–23
competitive advantage and, 98–104
cost and capital efficiency advantages, 102–104
decay analysis, 112–114
decomposing, 210–215
defined, 30, 170
differences across industries, 108–111
drivers of, 96–98
effect of acquisitions on, 114–115
effect on value creation, 17–23
empirical analysis, 106–115
equaling IRR, 450–452
focus on high- vs. low-ROIC companies, 26–27
in forecasting, 232, 255
Heineken (case study), 529–531
in high-growth companies, 736–739
historic trends, 107–108
intangible resources, 456–464
interaction between growth and, 17–23, 26–28
interpreting, 462–464
and length of product life cycle, 105
line item analysis, 210
managerial implications, 24–28
operating analysis, 210–215
for operating leases, 434–435
persistence by industries, 111–112
production outsourcing and, 466–468
and product renewal potential, 105–106
projecting, 145–146
relationship to growth and cash flow, 19–22
stability of, 111–114
sustainability of, 104–106
Return on new invested capital (RONIC), 262–263, 268–269
Revenue forecasting, 235–237
Revenue growth, 117–133. See also Growth
analyzing, 215–220
accounting changes and irregularities, 218–219
currency effects, 216
mergers and acquisitions (M&A), 217–218
from attracting new customers, 122
and balance with ROIC, 117
decay analysis, 132
decomposing, 219–220
drivers of, 118–120
empirical analysis, 127–133
historical trends, 128–129
from increasing market share, 122
from new product development, 120–121
from persuading existing customers to buy more product, 121
projecting, 145–146
rates across industries, 130
sustaining, 124–127, 130–133
through acquisitions, 122
through incremental innovation, 122
through product pricing and promotion, 122
transition probability, 132–133
and value creation, 120–124
value of major types of, 121
variation in, by industry, 119
variation in, over product life cycle, 125
volatile, by industry, 131
Risk:
cash flow risk, 44–47
diversifiable vs. nondiversifiable, 800–804
exposure level, 44–47
hedging, 46–47
price of, 42–44
Risk-free rate, 289–290, 720
Risk-neutral valuation, 797–798
Risk-weighted assets (RWA), 777–778
Rockwell Automation, 23
INDEX 869

ROIC. See Return on invested capital (ROIC)
Roll-up strategies, 611–612
RONIC (return on new invested capital), 262–263, 268–269
Russian government default crisis, 11

S
Sale-leaseback transactions, 41–42
Sales productivity, 583
Savings and loan crisis, 11
Scalability of products/processes, 104
Scenario analysis, 339, 344–348
Scenario DCF approach, 711–716, 729–730, 785–786
Scenario development, 743–744
Scenarios, creating, 533–534
Scenario weighting, 742–743
Schiller, Robert, 65
Scholes, Myron, 165
Securitized receivables, 327–328, 440
Sell-side analysts, 689
Sensitivity analysis, 339, 342–344
Shareholder capitalism, 6–10
Shareholder payouts, 663–668
Shareholder returns. See Total returns to shareholders (TRS)
The Shareholder Value Myth (Stout), 7
Share repurchases, 38–39, 197, 649, 664–668
Short-termism, 11–14
Siemens, 629, 640
Simplified intermediate forecast, 230
Single-path DCF, 785
Social responsibility, 6, 9–10
Sodexo, 215–216
Solvency, 847–849
Spin-offs, 641, 642–643
Split-offs, 643
Stakeholder interests, 6–10
Stochastic simulation DCF, 786
Stock market:
bubbles, 68–69 (see also Financial crises)
cross-listings, 86–88
diversification, 83–84
earnings (see Earnings per share (EPS))
fundamentals of, 66–74
growth vs. value stocks, 68
index membership impact on company, 85–86
informed investors vs. noise investors, 66–68
market mechanics, 85
relationship of company size to value, 84–85
stock splits, 88–90
total returns to shareholders (see Total returns to shareholders (TRS))
understanding expectations, 61–62
Stock splits, 88–90
Stout, Lynn, 7
Stranded costs, 638–639
Strategic vision, 625
Subsidiaries, 150–151, 181–182

T
Taiwan Semiconductor, 24
Target-setting, 589–592, 651–652
Target weights, 308–312
Taxes, 397–410
delayed, 184–186, 404–410
forecasting, 242–243
operating, 398–407 (see also Operating taxes)
provisions and, 429
Tax loss carryforwards, 182, 324
Tax-loss carryforwards, 405
Tax on a maturity mismatch (TMM), 771
Tax penalty on equity, 769–770
Tax shields, valuing, 159–160
Technology bubble, 10–11, 72–73, 297–298, 302
Top-down forecasting, 235–237
Total debt, 244
Total funds invested, computing, 180–182
Total returns to shareholders (TRS), 5, 69–70
correlation with employment growth, 8–9
decomposing, 54–61
diversification and, 567–568
enhanced approach to analyzing, 58–59
impact of debt financing on, 59
key drivers of, 57
managerial implications, 62–63
as measure of management performance, 49–50
and spin-offs, 643
traditional approach to analyzing, 54–57
traditional vs. enhanced decomposition, 58
Tracking stock, 641, 645
TradeCo, 465–467
Traders, 686–687
Trade sales, 641
Transformational mergers, 612–613
Transparency, 594–595, 689–690, 692–693
Triangulation, 736–738
TRS. See Total returns to shareholders
Tyco, 630, 631

U

Uncertainty. See Flexibility
United Parcel Service (UPS), 140–141
Unlevered cost of equity, 157–159
UPS/FedEx:
coverage ratios, 222
ROIC, 208

V

Valuation by parts, 375–392
corporate overhead costs, 381
cost of capital, 387–389
enterprise to equity value buildup, 379
estimating invested capital, 387
estimating NOPLAT, 386
financial subsidiaries, 385
individual unit financial statements, 380–387
intercompany receivables and payables, 384–385
intercompany sales and profits, 383–384
intercompany transactions, 381–383
mechanics of, 376–380
multiples of peers valuation, 389–392
public information, 386
ROIC breakdown, 380
valuation summary, 377
Valuation frameworks, 137–166
chart of, 138
DCF alternatives, 164–166
DCF-based approaches
adjusted present value (APV), 137–138, 155–160
capital cash flow, 160–161
economic profit, 137–138, 152–155
enterprise discounted cash flow, 137–152 (see also Enterprise discounted cash flow)
equity cash flow, 161–163
Valuation fundamentals, 17–33
Valuation metrics, 224–225, 250
Valuation results, analyzing, 339–348
art of valuation, 348
consistency check, 340–341
model validation, 339–342
plausibility check, 341–342
scenario analysis, 344–348
sensitivity analysis, 342–344
Valuation summary, in forecasting, 232
Value, defined, 4
Value conservation principle. See Conservation of value principle
Value creation:
from acquisitions (see Mergers and acquisitions (M&A))
for current and future shareholders, 4–6
importance, vs. value distribution, 90–91
math of, 29–33
and revenue growth, 120–124
risk and, 42–47
stakeholder vs. shareholder focus, 6–9
Value distribution, 90–91
Value drivers, 582–585
flexibility, 791–793
long-term strategic, 585
medium-term, 584–586, 590
short-term, 583–584
Value driver trees, 582, 586–589, 590, 765
Value per share, calculating, 317, 335

W

WACC. See Weighted average cost of capital (WACC)

Walgreens, 18
Wal-Mart, 126
Webvan, 95–96
Weighted average cost of capital (WACC):
components of, 283
defined, 30
discounting free cash flow at, 148–149
in emerging markets, 724
estimating, 284–286
in forecasting, 231, 250
Whole Foods, 690
Write-downs, 76

Y

Yelp, 733–740