Q&A with Tim Koller and Marc Goedhart on the new edition of "Valuation" for McKinsey.com

The fourth edition of Valuation: Measuring and Managing the Value of Companies comes out in May. So far, the first three editions have sold a total of more than 400,000 copies. Investment banks, private equity firms, management consultancies, and more than 200 universities around the world all use the book, and Harvard, Wharton, University of Chicago, MIT, Northwestern, Yale and INSEAD all teach courses from it.

Authors Tim Koller and Marc Goedhart answer questions on what makes Valuation the "must-read" in corporate finance.

What is "Valuation" about?

Essentially, it's about how to create shareholder value, which is what makes companies thrive. It shows executives and corporate finance practitioners how to value companies using the discounted cash flow (DCF) approach and applying that information to make wiser business and investment decisions , such as those involving corporate portfolio strategy, acquisitions, or performance management.

Executives must not only have a theoretical understanding of value creation, but must be able to create tangible links between their strategies and value creation. This means, for example, focusing less on recent financial performance and more on what they are doing to nurture a "healthy" company that can create value over the longer term.

Aren't CEOs more worried about next quarter's results than the long term?

Some are, but they shouldn't be. In spite of popular belief, the stock market is not overly concerned with the next quarter's earnings. Research shows that earnings surprises explain less than 2 percent of share price changes around announcements. We have found that when share prices react negatively to earnings announcements, this is driven by changes in long-term – not just short-term – earnings expectations.

Expectations of future performance are the main driver of stock prices. In almost all industry sectors, up to 80 percent of the stock market value is attributable to expectations about cash flows beyond the next 3 years. These longer-term expectations are driven by investor judgements of company growth plans and their long-term profitability.

What should CEOs worry about instead?

Of course, some analysts and investors will always clamor for short-term performance from companies. But the techniques described in the book help managers to look after their companies' overall health, by which we mean their capacity to sustain strong performance, quarter after quarter, over the long term. Sometimes, managers have to make trade-offs between short-term earnings and long-term value creation. Investments they make today may come at the expense of next year's earnings, but also may be crucial to producing earnings in later quarters. DCF approaches help provide the right answer when making such trade-offs.

In addition, performance in the short-term is a legitimate predictor of long-term performance. Getting the balance right is the key to maximizing value creation.

How can companies explain that kind of trade-off to investors and analysts?

In this edition of Valuation, we present some ways to measure corporate performance and assess long-term health, and to test the robustness of particular strategies. Companies can use these to communicate to markets the wisdom of their choices. As we said, investors do take a long-term perspective. But sometimes, the only thing that they can base their perspectives on are short-term earnings, because companies do not provide any information on the underlying fundamentals.

Yet investors want to know what drives the earnings results. These drivers will vary from company to company, and from industry to industry. But at the very least, investors want to understand the drivers of revenues, costs, and capital. For revenues, they want to know how big the market is, what new products are in the pipeline, how well the company develops new products, and what market share the company has achieved. For costs, investors want to know how well the company is driving down costs compared with competitors. Similarly, they want to know how much capital will be required to achieve future revenue growth. For example, retailers provide some of these answers when they disclose the number of stores they have and/or same-store sales growth. {I'm not sure if this is right yet} When they also report sales per square foot, investors can monitor the impact of changes in store size and configuration. Mobile telephone companies typically disclose information about their customer base, such as number of subscribers and average revenue per subscriber. In the pharmaceutical industry, many players detail their results by therapeutic area (e.g., cardiac drugs versus gastrointestinal drugs), describe drugs in the pipeline, and project market share and revenues for each major product.

Does long-term health mean long term growth?

When most managers think about long-term performance, they think about growth. But a healthy company isn't necessarily one with high-growth plans. Indeed, many companies have destroyed value through their growth ambitions, particularly when they resorted to overpaying for acquisitions; after all, over half of all mergers fail to

create value for the buyer. Growth may well be part of sustaining performance, but the other key component is a decent return on capital invested. In fact, because many mature industries face low or declining growth, managing health may be more about sustaining returns on capital for most companies.

Aren't companies focused on satisfying their shareholders the most likely to forego investment for the future?

That's a concern we often hear, but we've found it to be a fallacy. For example, when we examined the relationship between shareholder returns and investments in R&D, we found a strong positive correlation: companies that earned the highest shareholder returns also invested the most in R&D, securing their future returns. This pattern was quite consistent in the U.S. and Europe and in all industry sectors.

Do investors value companies correctly?

Yes, by and large market valuations and the "intrinsic" value of companies do coincide, although recently some economists have argued that they don't. We find that significant deviations are typically isolated and short-lived incidents, applying to some companies, some of the time only.

For this edition of the book, we looked at the fit between the price-earnings ratios of the stock market as a whole in the U.S. and the U.K., and the fundamental price-earnings ratio, based on long-term profitability and growth. Over the last 40 years, there has been a remarkably close fit between the two. There were some deviations but none of them lasted for more than a couple of years, and most only for a couple of months.

What about the Internet bubble?

The Internet bubble was the longest deviation – it shows what happens when managers, investors, and bankers ignore the fundamental principles of economics and the underlying history of value creation. It was also a classic example of herding behavior, as investors, managers, and commentators followed the crowd rather than relying on their own independent analysis. For example, many equity analysts could not justify the values of companies based on fundamentals, so they resorted to commenting only on relative values – in other words, how one company was valued relative to another, rather than in absolute terms. But after the bubble burst in 2001, the market values of most companies in the U.S. had returned to their fundamental values by 2002. Ultimately, fundamentals prevail over emotions: therefore managers and investors should follow the fundamentals rather than the crowd. To us, following the fundamentals means driving performance and health.

If companies focus on creating value for shareholders, won't they neglect their social responsibilities?

No. Companies that focus on shareholder value are usually healthier companies, and healthy companies that sustain strong performance are the ones that create the biggest benefits for society at large, like stronger economies, higher living standards, and more jobs.

Looking after their health means they look after their employees. We found that U.S. and European companies that created the most shareholder value in the last 15 years have also shown healthier employment growth.

Companies are under pressure to strengthen their governance. What can the discounted cash flow approaches in "Valuation" do to help?

Among other things, good corporate governance implies that boards focus more on long-term health of the company – just as boards were intended to do in the first place. By definition, discounted cash flow approaches adopt such a long-term perspective. A deeper understanding of what drives value creation in the long-term helps boards in constructively challenging management on key decisions and in focusing on what matters in investor communication.

Are discounted cash flow approaches relevant in companies operating outside developed economies?

Yes, they're universal. They apply equally as well to mature manufacturing companies as to high-growth technology companies, and as well to U.S. companies as to European and Asian companies. In fact, differences between valuation levels in these markets are largely explained by differences in fundamentals such as growth and return on capital. For example, Asian companies, on average, have significantly lower price-earnings ratios than their U.S. counterparts, in spite of their great growth prospects. The reason is that returns on capital for Asian companies are far lower than for U.S. companies.

Are there any new valuation techniques in this edition?

The most relevant insights for financial managers and practitioners come from valuation approaches that have not changed that much over the last decades. The reason is that these approaches are grounded in fundamental economic principles that are universally true. Companies create value when they invest at returns higher than the cost of capital and by growing if they achieve these returns. DCF approaches are based on these principles and if applied intelligently, and in combination with scenarios and decision-tree analyses, they can be used for the valuation of any real-life investment. Of course, we also discuss more recent valuation approaches, including real option models, showing how these bring additional insights mostly in very specific circumstances.